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An analysis of the role of financial intermediaries in the economy

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In this project, you would analyze the role of financial intermediaries in the economy. Assess different types of financial intermediaries and their roles in the economy. Examine their impact on the markets, such as stock markets, bond markets, and currency markets. You should also examine the impact of their activities on economic growth.

Further evaluate by looking at the role of financial intermediaries in the banking system and how they help support the flow of capital and credit in the economy. Finally, assess the potential benefits and risks associated with the activities of financial intermediaries.

INTRODUCTION:

A financial intermediary refers to an institution that acts as a middleman between two parties in order to facilitate a financial transaction. The institutions that are commonly referred to as financial intermediaries include commercial banks, investment banks, mutual funds, and pension funds.

A financial intermediary refers to an institution that acts as a middleman between two parties in order to facilitate a financial transaction. The institutions that are commonly referred to as financial intermediaries include commercial banks, investment banks, mutual funds, and pension funds. They reallocate uninvested capital to productive sectors of the economy through debts and equity.In simple terms, financial intermediaries channel funds from individuals or corporations with surplus capital to other individuals or corporations that require cash to carry out certain economic activities.

Functions of Financial Intermediaries

A financial intermediary performs the following functions:

Asset storage

Commercial banks provide safe storage for both cash (notes and coins), as well as precious metals such as gold and silver. Depositors are issued deposit cards, deposit slips, checks, and credit cards that they can use to access their funds. The bank also provides depositors with records of withdrawals, deposits, and direct payments they have authorized. To ensure the depositors' funds are safe, the Federal Deposit Insurance Corporation (FDIC) requires deposit-taking financial intermediaries to insure the funds deposited with them.

Providing loans

Advancing short-term and long-term loans is the core business of financial intermediaries. They channel funds from depositors with surplus cash to individuals who are looking to borrow money. Borrowers typically take out loans to purchase capital-intensive assets such as business premises, automobiles, and factory equipment.

Intermediaries advance the loans at interest, some of which they pay the depositors whose funds have been used. The remaining amount of interest is retained as profits. Borrowers undergo screening to determine their creditworthiness and their ability to repay the loan.

Investments

Some financial intermediaries, such as mutual funds and investment banks, employ in-house investment specialists who help clients grow their investments. The firms leverage their industry experience and dozens of investment portfolios to find the right investments that maximize returns and reduce risk.

The types of investments range from stocks to real estate, Treasury bills, and financial derivatives. Sometimes, intermediaries invest their clients' funds and pay

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them an annual interest for a pre-agreed period of time. Apart from managing client funds, they also provide investment and financial advice to help them choose ideal investments.

Benefits of Financial Intermediaries

Financial intermediaries offer the following advantages:

Spreading risk

Financial intermediaries provide a platform where individuals with surplus cash can spread their risk by lending to several people rather than to only one individual. Lending to just one person comes with a higher level of risk. Depositing surplus funds with a financial intermediary allows institutions to lend to various screened borrowers. This reduces the risk of loss through default. The same risk reduction model applies to insurance companies. They collect premiums from clients and provide policy benefits if clients are affected by unforeseeable events like accidents, death, and disease.

Economies of scale

Financial intermediaries enjoy economies of scale since they can take deposits from a large number of customers and lend money to multiple borrowers. The practice helps to reduce the overall operating costs that they incur in their normal business routines. Unlike borrowing from individuals with inadequate funds to loan the requested amount, financial institutions can often access large amounts of liquid cash that they can loan to individuals with a strong credit rating.

Economies of scope

Intermediaries often offer a range of specialized services to clients. This enables them to enhance their products to cater to the requirements of different types of clients. For example, when commercial banks are lending out money, they can customize the loan packages to suit small and large borrowers. Small and medium enterprises often make up the bulk of borrowers. Preparing packages that suit their needs can help banks grow their customer base.

Similarly, insurance companies enjoy economies of scope in offering insurance packages. It allows them to enhance their products and services to satisfy the needs of a specific category of customers such as people suffering from chronic illnesses or senior citizens.

Examples of Financial Intermediaries

Bank

A bank is a financial intermediary that is licensed to accept deposits from the public and create credit products for borrowers. Banks are highly regulated by governments, due to the role they play in economic stability. They are also subject to minimum capital requirements based on a set of international standards known as the Basel Accords.

Credit union

A credit union is a type of bank that is member-owned. It operates on the principle of helping members access credit at competitive rates. Unlike banks, credit unions are established to serve their members and not necessarily for profit purposes. Credit unions claim to provide a wide variety of loan and saving products at a relatively lower price than other financial institutions offer. They are governed by a board of directors, who are elected by the members.

Mutual funds

Mutual funds pool savings from individual investors. They are managed by fund managers who identify investments with the potential of earning a high rate of return and who allocate the shareholders' funds to the various investments. This enables individual investors to benefit from returns that they would not have earned had they invested independently.

Financial advisors

A financial advisor is an intermediary who provides financial services to clients. In most countries, financial advisors must undergo special training and obtain licenses before they can offer consultancy services. In the U.S., the Financial Industry Regulatory Authority provides the series 65 or 66 licenses for investment professionals, including financial advisors.

intermediaries of financial services with the aim of making financial transactions safer and easier to access for clients. Here we show you which financial intermediaries there are, how they work, and what advantages and disadvantages they have.

Financial intermediaries: Meaning

Financial intermediaries act as an intermediary between two parties when it comes to the settlement of financial transactions or financial business in general. They offer their clients several advantages, such as security, access to and management of assets, and liquidity.

Financial intermediaries: Examples

There are numerous companies or institutions that act as financial intermediaries. These include, for example:

- Banks: lending and borrowing money is simplified
- Stock exchanges: Trading in shares and other stock exchange products will be centralised and thus more easily accessible for buyers and sellers
- Pension funds: Future pensioners pay the pensions of current pensioners
- Factoring provider: Factoring clients receive money from the factoring provider for their outstanding receivables and thus liquidity
- Insurance: For money, insurance companies protect their customers against certain risks

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Role of financial intermediaries

Financial intermediaries bring two parties together through their activities: usually buyers and sellers. They create a central intermediary platform that enables both parties to conduct their financial transactions there quickly and easily. This creates efficiency and saves costs on both sides.

Depending on the industry in which financial intermediaries operate, they offer different services to their clients. While a commercial bank manages its clients' money and offers all services around financing and payment services, a private credit company only offers lending but does not manage accounts or cash.

A company that offers pension funds receives money from contributing customers, some of which is invested and used to cover costs, and some of which is paid out to current pensioners.

How do financial intermediaries finance themselves?

Like any other business, financial intermediaries need a functioning business model with which they can make profits and grow.

Banks as financial intermediaries

Banks earn money, for example, by offering their services in exchange for fees, receiving interest payments from loans, or getting a commission for selling a financial product.

A commercial bank mainly generates profit by granting loans and the associated interest payments on the part of the borrowers.

Investment banks, on the other hand, have a stronger focus on the investment business, where profit maximisation is paramount. This is achieved by investing in stock market products, real estate, commodities and other assets.

Financial intermediaries in capital market

Financial intermediaries active in the capital market are, for example, brokers. They provide investors with suitable stock market products, e.g. shares of a certain company. A fee is due for this brokerage, which the investor has to pay.

In the meantime, however, there are also brokers who rely exclusively on direct trading on electronic exchanges. These brokers are in many cases fintech companies that want to offer their customers low-cost access to stock exchange products. They finance themselves through commissions they receive from the electronic exchanges for brokering securities.

Advantages of financial intermediaries

The biggest advantage of financial intermediaries is that they create a central market where financial transactions can be conducted. By scaling financial intermediaries appropriately, bureaucracy is kept to a minimum and experts take care of advising clients and processing transactions. This in turn is cost-efficient for the clients.

Another advantage is that large financial intermediaries can spread their risks very widely by investing the money or premiums paid in by their clients in a variety of financial products. This also reduces the risk for the clients.

In addition, it is easier for clients to make use of special financial services, because with the financial intermediary they have a contact person who can point out solutions.

Disadvantages of financial intermediaries

The biggest disadvantage of financial intermediaries is that they pursue their own interests. This means that they mainly recommend products that they either offer themselves or receive a commission from other providers. Clients therefore avoid a bad investment by comparing similar offers from different financial intermediaries.

Another disadvantage is that fees are charged for the services of the financial intermediary, since the latter ultimately has to cover its own costs and wants to make a profit. For this reason, some financial transactions in which buyers and sellers come into direct contact with each other are more cost-effective, e.g. direct trading on the stock exchange.

The world financial system has changed significantly in recent decades. In the US, banks and many other types of intermediaries have moved away from their traditional role of taking deposits and making loans. Although their share of intermediated funds has fallen they have not shrunk relative to GDP, and they remain an important part of the financial system. They have achieved this by moving away from simple balance sheet intermediation toward fee-producing activities.

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