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THE ROLE OF FINANCIAL INTERMEDIARIES IN ECONOMIC DEVELOPMENT

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ABSTRACT

In a financial system, financial intermediaries alongside financial instruments and financial markets have a main role to play. The financial intermediaries has improved drastically, which implies the development and growth of financial systems, which in turn leads to economic development. They mobilize savings, directs savings to investments and improve the allocation of capital, as suggested by Pagano. Moreover, credit screening, delegated monitoring with optimal debt contracts with bankruptcy costs, help in reducing informational asymmetries problems. Policy implications suggest that financial liberalization helps in removing restrictions and financial repression on financial intermediaries and stimulate economic development.

In capitalist economies, savings/investment process is organized around financial intermediation, making them a central institution of economic growth. Financial intermediaries are firms that borrow from consumer/savers and lend to companies that need resources for investment. The major questions answered in this paper are:

Why do financial intermediaries exist?

What are the types of financial intermediaries?

What are their roles?

What are their functions?

And so on.

KEYWORDS: Credit, Financial Intermediaries, Financial System, Screening, Monitoring, Economic Development

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1. INTRODUCTION

Financial intermediation is a pervasive feature of all of the world's economies. However, as Franklin Allen (2001) observed in his AFA Presidential Address, there is a common belief that financial intermediaries have no real impact and but they can be ignored. They are a veil. Asset prices or the allocation of resources are not affected by them. For example, Allen pointed out that the Journal of Finance's millennium issue contained surveys of asset pricing, regular finance, and corporate finance but did not survey financial intermediation. Here we take the view that one should apprehend about financial intermediaries to have a clear view of savings to the investment process, the workings of capital markets, corporate finance decisions, and consumer portfolio choices.

Why are financial intermediaries important? One reason is that, as per national flow-of-funds data, banks contribute a larger proportion of every dollar financed externally. Bank loans are a major source of external funding. In no other country, capital markets have a substantial role in financing. Equity markets are unrelated. In other words, if staffing in the finance department shows how companies fund themselves, approximately 25 % of the faculty will be researchers in financial intermediation, and the rest would study internal capital markets.

During periods of institutional distress and bankruptcy, banks play a major role in corporate governance by acting as a core source of external funding. The idea that banks "monitor" firms are one of the major roles of bank loans in corporate finance. Bank loan contracts can act as tripwires indicating to the bank that it can and should interfere with the firm's activities. Unlike bonds, bank loans tend not to be distributed across many investors. This enables interference and renegotiation of capital structures. Bankers are often on company boards of directors. Banks are also crucial in producing liquidity by, for example, backing commercial paper with loan commitments or standby letters of credit.

Schumpeter (1912) debates by pointing out that "financial intermediary help redefining capital allocation to support technological innovation by identifying and assisting those entrepreneurs with profitable projects, thus influencing economic development." "Financial repression restricts the role of financial intermediaries and financial liberalization intensifies the impact of financial intermediaries on economic development" (Goldsmith, 1969; Gurley and Shaw 1955, 1973; and McKinnon, 1973). Stiglitz and Weiss (1981) explain the part played by financial intermediaries in taking credit screening to develop the credit allocation to low-risk investment projects. Diamond (1984, 1996) and Williamson (1986a, 1986b, 1987) endorses the theory of financial intermediation, "expanding the allocation of credit monitoring to financial intermediaries would lessen the cost of monitoring information and resolve incentive problems

between borrowers and lenders. Credit screening and monitoring by financial intermediaries develop capital allocation to improve the effective use of capital".

Endogenous growth models established by Greenwood and Jovanovic (1990), King and Levine (1993), Levine (1997), Levine (1998) explains the relationship between the role of financial intermediaries and economic development.

Pagano (1993) brings an endogenous growth model, explicating financial intermediaries in economic development through controlling transaction costs, increasing productivity, saving rates, and investment rates. Cost related to credit screening is reduced by diversification within an intermediary (Stiglitz and Weiss, 1981) and substituted monitoring (Diamond, 1984, 1996; and Williamson, 1986a, 1986b, 1987) offers incentives for a financial intermediary to handle the problem of asymmetric information.

Financial intermediary influences economic development in various channels. Empirical investigations explain the role of financial intermediaries on economic development with some policy implications.

2. THE EXISTENCE OF FINANCIAL INTERMEDIARIES

The fundamental question to be asked related to the firm's theory, why do financial intermediaries exist? This is because they are themselves firms! When firms dominate trade in a market, the organization of economic activity within a firm occurs. The case in households with enough resources to invest could go to capital markets and buy securities issued directly by firms. In such cases, there is no scope for intermediation. A different point to discuss is that non-financial firms can consider investors who directly invest in capital markets. Though, as stated in the introduction, most of the external fund to companies does not occur this way. Instead, it happens through bank-like intermediation, in which households buy securities dispensed by mediators who, in turn, invest the money by lending it to borrowers. Again, firms' responsibilities and the rights of the investors are not the same securities; intermediaries change claims. The presence of such mediators indicates direct contact in capital markets between households and firms is dominant. "Why is this?" is the central question for the theory of intermediation.

"Bank-like mediators are persistent, but this may not require much clarification. On the liability side, demand deposits seem to be a special kind of security, but originally this may have been due to regulation. Today, money market mutual funds may be good substitutes for demand deposits. On the asset side, intermediaries may simply be passive portfolio managers, i.e., there may be nothing special about bank loans relative to corporate bonds," as stated by Fama (1980). Similarly, Black (1975) sees nothing unusual about bank loans. Therefore, we begin with an impression of the empirical evidence, which recommends that there is indeed a need for explanation.

3. TYPES OF FINANCIAL INTERMEDIARIES

There is a long list of firms that come under the list of financial intermediaries. Many times, people may not even comprehend that they are dealing with an agent who is just overseeing the transaction in question. Nevertheless, without these entities, the investment markets would be crippled.

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Major financial intermediaries operating in an economy are as follows:

Banks:

Unquestionably, banks are the most prevalent financial intermediaries in the world. They come in multiple forms: saving, investing, lending, and many other sub-categories to fit precise criteria. The most ancient way in which these institutes act as brokers is by linking lenders and borrowers. For example, when somebody raises a bank loan, they will be given the money that another person deposited into that bank for saving. Likewise, large companies also use banks to help find investors. Not to mention their role as the bodies that people use to receive paychecks via direct deposits.

Credit Unions:

Like mentioned before, credit unions also attract people who need the money and those who have it. For example, they provide credit terms to people by using the deposits collected from other customers. When somebody needs credit from a credit union, they will obtain it because there are funds at the credit union's disposal, which is contributed by depositors. The main difference between these entities and typical banks, though, is their role with consumer credit. Further lending, they also oversee many credit-related inquiries.

Pension Funds:

It is another financial intermediary that full-time employees often meet. This is used by millions of workers to save for their retirement. The way it works is based on a risk factor, matching contribution, and long-term investing. For illustration, when someone signs up for a pension fund, they choose how much of their salary will be kept aside. Often, their employer matches that contribution to a certain extent. A major portion of that money is used to purchase assets that will grow and have a good yield. Once the employee retires, they get all the aids alongside any interest and realized gains.

Insurance Companies:

Though there are numerous different types of insurance organizations, most of them operate in the same way. First, they find a large number of customers who need to obtain coverage. Whether it is a car, home, or health policy does not matter. Once those customers purchase their insurance coverage, all of the funds are pooled together. Later on, whenever someone needs to claim and use the insurance company to request a payout, the insurance provider will access that pool of money. This means that there is no net inflow of cash to the market.

Stock Exchanges:

Buying corporate stocks can be a long and tedious process. In order to simplify this, the stock exchanges were invented. They act as large platforms where people can make stock orders. After paying for them, the stock exchange is used to buy the actual stocks from corporations. Then, the customer gets their desired assets while the corporations get funding. In the meantime, the stock exchanges facilitate the entire process and every transaction. Hence they are considered as the financial intermediary. As with most other similar institutions, these exchanges earn revenues by adding transaction fees and interest rates.

Finally, because of the absence of them, the whole investment and financial sector would suffer. People find it difficult to make daily transactions, and large companies would find it hard to get funding. That is why it is necessary to understand the significance of the role of financial intermediaries.

4. IMPORTANCE OF FINANCIAL INTERMEDIARIES

They act as middlemen between two parties and manage the financial transaction. Commercial banks, investment banks, stock exchanges, and insurance companies' are the financial intermediaries that play a significant role in the economy.

With the help of financial intermediaries, individuals get fixed income at a low cost. When an individual uses financial intermediaries' service, he need not spend time and money to find good borrowers.

He need not bear the risk of loss because the financial intermediaries bear the risk. For example, banks gain funds from depositors and lend them to borrowers. Banks uphold information and policy statements about their clients, and they diversify the investments accordingly.

Financial intermediaries observe the borrower activity, and if borrowers have any chance to invest in a risky project, they suggest solutions.

They have a vital role in the saving-investment process. A vital role of financial intermediaries is that they satisfy the portfolio inclination of both depositors and borrowers at the same time.

The pooled funds are invested by issuing securities like bonds, mortgages, bills, amongst others. Instead of directly purchasing stocks, investors deposit funds with financial intermediaries, and they lend those funds to ultimate borrowers.

Non-bank financial intermediaries supply debt instruments to the borrowers independent of the asset type and offer financial assets to the lenders independent of the type of the debt instrument.

Besides bringing depositors and borrowers together, financial intermediaries transform primary securities into secondary securities for ultimate lenders' portfolios.

Financial intermediaries allocate primary securities from ultimate borrowers to ultimate lenders. The efficiency of resource allocation is improved by investing in various projects and thus improving the efficiency of distributive techniques of intermediation.

Their role in the saving-investment process is such influential that they inspire investors to spend more efficiently.

In under-developed countries, the capital market is unorganized, and financial intermediaries play a unique role in those countries. The majority of the people are poor in those countries, and those who save invest their savings in real estate, jewelry, foreign exchange, amongst others.

They inspire the circulation of personal savings from unproductive to productive uses. When the economy of a country develops, the non-financial sector gradually transformed into the financial sector.

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Then the banking practices of the common man also increased. It is difficult for commercial banks alone to organize savings and use them for productive purposes. Here the financial intermediaries have an essential role in organizing and investing these savings for economic development.

In under-developed nations, financial intermediaries identify investment opportunities by helping small and new enterprises. They help control inflation in under-developed countries by economizing the use of currency, which pedals the money supply and the demand for goods and services.

The need for two different parties - lenders and borrowers - is the main reason for intermediaries' existence. They make diversified investments and save both time and costs, and thus help in lowering their risks. They provide a large number of services so they can customize services for their clients. They reduce the risk of asymmetric information.

Thus, financial intermediaries are significant for a country's economic development. Finance provides the funds for starting self-employment programs, entrepreneurial development programs, housing finance, a certain percentage of their lending to priority sectors, and loans to industries that started in a backward area. Financial comes with risks such as the risk of default, liquidity, credit, amongst others. The most recent financial crisis is an example of the possibility of the collapse of the world's most prominent financial institutions.

All parties related to the system should bear the risk of being able to continue. Reassigning all the risks is not the solution, which means one party will not have anything, and the other party will have everything if an economic crisis occurs.

If the crumpling party is the bank, the crisis will spread to the whole economy. Nevertheless, given the financial system's complications, by helping the government eliminate poverty and implement different social programs, they play a vivid role in the economic development of a country.

5. CHARACTERISTICS OF FINANCIAL INTERMEDIARIES

The characteristics of financial intermediaries are as below:

Risk Reduction:

Compared to others, financial intermediaries have more excellent resources at their disposal and diversify the risk between various individuals. Since they have know-how in handling the spread portfolios and use other financial experts' expertise. As they control large sizes of the portfolio, they can reduce risk through diversification. They prudently select and scrutinize the borrowers and handle the risk of default. They deliver safety in accessing money and spread the risk by lending to several people.

For example, insurance firms collect premiums from customers and deliver the policy's benefits if unpredictable accidents influence any customer.

Scale Economies:

Commercial banks, mutual funds, credit unions, stock exchanges, insurance companies, etc. are the financial intermediaries that support the economy's growth process. They take deposits

from a wide range of clients and lend money to multiple borrowers, thus maintaining the economies of scale.

They act as a bridge between ultimate lenders and borrowers and discourage stockpiles by people. Suppose they do not exist, there could be several operational costs to the investors. They help in investment and deliver investment advice to their customers, and they help in reducing their opportunity cost. They promote economic growth by encouraging savings and investments.

Regulation:

Regulation is necessary because of the complications of the financial system. Due to weak regulation, financial crises may happen and may put the economy at risk.

The monetary authorities should regulate untruthful financial intermediaries and confirm that there is adequate equilibrium in the scheme to avoid losing the economy.

Provide Loans:

They have a significant role in getting together those investors who have surplus cash desiring to lend them and those companies who wish to acquire loan facilities. They deliver liquidity to the market by providing the shares to shareholders and capital to companies.

Providing short-term and long-term loans are a primary function of financial intermediaries. They gather the deposited funds and support the entities who are looking for funds to borrow.

They award loans to borrowers at a nominal interest rate. A part of that interest is provided to the depositor whose surplus cash has been used. The remaining balance of the interest is retained as the profit of the intermediary. Before lending loans, they evaluate the debtors' capability and solvency to confirm whether the borrowers will be able to pay off the loan or not.

Asset Storage:

They deliver their customers with safe storage of both cash and precious metals such as gold and silver. Customers who make deposits obtain proof of deposit and all records of withdrawals. Depositors can use the deposit cards and checks to access their funds.

Investment Advice:

Many of them help their customers in growing the value of their investments. They support them to grow their hard-earned money through investing. Firms find it challenging to select the apt industry to make investments and maximize returns.

They invest the customer’s funds and pay them an approved rate of interest. In addition to managing customer’s funds, they also provide investment advice to their clients.

Provide Liquidity:

They bring liquidity into the system by converting assets into cash very easily. They always try their best to maintain their liquidity by providing short-term loans and finance them for longer periods and diversifying loans among different borrowers. They sustain liquidity by their diversified operation.

Bring Stability in the Capital Market:

They deal with a lot of assets and liabilities which are traded in the capital market. By following rules and regulations, financial intermediaries bring stability to the capital market helps industries through diversified financial services.

If there were no financial intermediaries, there would be unexpected changes in the demand and supply of financial assets, which will bring instability in the capital market.

In advanced nations, where there are extensive regulations under which financial intermediaries operate, there is less risk of stock scams.

6. FUNCTIONS OF FINANCIAL INTERMEDIARIES

A financial intermediary achieves the following functions:

- As said before, the principal function of these intermediaries is to transform savings into investments.
- Intermediaries like commercial banks, deliver storage facilities for cash and other liquid assets, like precious metals.
- Providing short and long term loans is a primary function of financial intermediaries. These intermediaries receive deposits from customers having surplus cash and then lend them to entities in need of funds. Intermediaries give the loan at interest, part of which is given to the depositors, while the balance is reserved as profits.
- Another key function is to support customers in increasing their money through investment. Intermediaries like mutual funds and investment banks use their expertise to offer investment products to support their consumers, maximize returns, and diminish risks.

7. ADVANTAGES OF FINANCIAL INTERMEDIARIES

- They help lower the risk of a customer with surplus cash by dispersing the risk via lending to several people. Also, they methodically screen the borrower, thus, reducing the default risk.
- They help in managing time and cost. Since they deal with a large number of clients, they relish economies of scale.
- Since they deal with many services, it helps them serve their customers by providing customized services. For example, banks can tailor loans for small and long term borrowers or their specific needs. Similarly, insurance companies modify plans for all age groups.
- They gather and process information, thus reducing the problem of asymmetric information.

Let us deliberate a simple example that will help us to gain knowledge on understanding the advantages. Supposing that you need some loan, but you do not know who has sufficient money to give you. So, you contact a middleman who has enough funds to help you in meeting your requirement.

8. POTENTIAL ISSUE WITH INTERMEDIARIES

Probably, a financial intermediary may not spread risk. They may direct the money of depositors to schemes which provide more return. Due to mismanagement, they may invest money in schemes, which may not be so attractive now. Intermediaries help us in managing such problems. Furthermore, after the 2008 crisis, the intermediaries are fronting more regulations to guarantee that they do not outwit their limits.

9. ROLE OF FINANCIAL INTERMEDIARIES IN ECONOMIC DEVELOPMENT

Numerous studies discuss the role played by financial intermediaries in economic development. Fry (1995) examines the effectiveness of financial intermediaries' performance judged by intermediation costs for channeling funds from the lenders to the borrowers and concludes financial intermediaries' performances in many developing countries are inefficient because of weak management, government interference, high delinquency, and default rate. Financial liberalization and financial deepening would uplift financial intermediaries' efficiency and stimulate economic development through financial intermediation.

Harris (1988) analyzed the case of Korean financial reforms in 1965, though found that an effective instrument for allocation of credits cannot be formed without financial liberalization. Cho (1988) analyzed the effectiveness of credit allocation in Korea over 1972-1984 and substantiates that the financial liberalization policy in the 1980s has significantly reduced the divergence of borrowing costs.

Using data on 80 countries over the 1960–1989 period and numerous actions of the level of financial development has been used to study intermediaries' role in an economy. King and Levine (1993) present cross-country proof that financial intermediaries can sponsor economic development. Financial intermediation growth is intensely linked with the growth of real per capita GDP, the rate of physical capital accumulation, and advances in economic efficiency.

Fry (1978) ran a regression of the gross domestic saving income ratio on the income growth, the level of real per capita income in natural logarithm, the nominal interest rate of the expected inflation rate, foreign savings relative to income, and the lagged saving ratio for a sample of seven Asian countries over the period 1962-1972. Real interest rates are identified to be positively related to domestic savings and economic growths. A World Development Report (1989) that sampled 33 developing countries over 1965-1985 found that faster economic growth was related to higher real interest rates. Using the same model specification as Fry (1978) but for a different period, Giovannini (1983) found a different conclusion for the same set of countries.

Levine (1997) offers a diagnostic framework for evaluating the quantitative significance of intermediaries and economic development. Levine (1998) explores the association between the legal system and banking development with long-run rates of per capita GDP growth, capital stock growth, and productivity growth and finds that there is a positive association between the development of financial intermediaries and per capita growth, physical capital accumulation, and productivity growth.

Ruehl (1988) specifies the case that extremely controlled the financial system, which is characterized by low-interest rates and credit rationing, which results in a "Japanese miracle"

for the two decades of high growth rates from 1953-1973. The chaos of Asian banking systems, particularly the Korean banking system's downfall, is a good lesson for the developing world. Fragile credit assessment and powerless risk management in the Korean banking system require a highly regulated financial system to stimulate and maintain the financial intermediaries' farsightedness and reliability (Ramos and Lim, 1997). Using a generalized method of moments (GMM) dynamic panel method, Petkovski and Kjosevski (2014) examines 16 transition economies from Central and South-Eastern Europe and finds the banking sector impacts economic growth, explicitly ratio of quasi money (RQM) is positively associated with economic growth.

10. CONCLUSION

Financial intermediaries play a very significant role in economic development. They play an even more prominent role in the emerging nations, including supporting the government to eradicate poverty and device other social programs.

Though, with the given complexities of the financial system and the significance of intermediaries in influencing the public's lives, they are heavily controlled. Several past financial crises, like the sub-prime crisis, have shown that loose or uneven regulations could put the economy at risk.

In conclusion, they can influence the economic development by playing a role in refining the saving-investment ratio, the social productivity of investment, and the aggregated saving rate or dealing with the asymmetric information problems of adverse selection and moral hazards. Policymakers can kindle economic development by eradicating financial restrictions and repression and promoting financial liberalization. Empirical studies offer considerable evidence that proves the positive relationship between the development of intermediaries and economic development. A negative finance economic relationship is also found in case the financial intermediaries are under the government's strict control. Financial deepening and liberalization are the keys to economic development. Developing nations should inspire the liberalization of prudent and sound financial intermediaries. Liberalization, though, should not lead to chaos or disorder. The current liberalization of financial intermediaries in developing countries should be progressed prudentially and methodically while taking into account all likely penalties to maintain macroeconomic stability and kindle economic development.

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