Maturity transformation

Life

Financial intermediaries accept funds of a given maturity, that is, funds which are liable for repayment to lenders at a given date or with a given degree of notice, and ‘ transform them into loans of longer maturity. The funds accepted by institutions appear as liabilities in their balance sheets while the loans into which they are transformed appear, with other items on the asset side. While the majority of assets are therefore relatively illiquid, some remaining assets are very liquid.

Financial intermediaries can draw on their deposits at the central bank without notice and can sell bills and other securities for cash quite quickly. The ability of financial institutions to engage in maturity transformation depends fundamentally on size. With large number of depositors or other types of lenders, intermediaries will have a steady inflow and outflow of funds each day. The reason that banks can hold so little cash in relation to all their other assets is that even at their maximum, net outflows on any particular day are extremely small in relation to the total stock of assets and banks know this with virtual certainty.

Large size also implies a large number of borrowers and a large quantity of funds, so there is scope for arranging it so that a small fraction of the assets is always on the point of maturity.

(b) Risk Transformation

Financial intermediation reduces risk through tow principle ways (i) Diversification and (ii) Speciality management.

(i) Diversification

Holding just one asset is more likely to produce unexpected outcomes than holding a collection or ‘ portfolio’ of assets.

The intermediary accepts a large number of small deposits, creates a large pool and then distributes the pool between a number of borrowers, who the intermediary can ensure are borrowing to fund diverse types of activity. The larger the size of the institution the larger its pool of funds.

(ii) Specialist Management

Intermediaries also offer the risk reducing benefits of specialist expertise. Recruiting and training ‘ analyst’ who specialize in assessing the risk and likely performance of particular groups of potential borrowers results in high quality information which benefits lenders.

(c) Search and Transaction Costs

At one extreme one can imagine the costs of direct lending where an individual lender has to search for, contact and arrange for an individually negotiated legally binding contract to be drawn up. High costs would also be faced by small savers trying to diversify their wealth across a range of securities. The lower costs available through an intermediary result from the ability to pool funds and to trade in large block of securities where the dealing commission is very small as a proportion of the value.

Although each transaction is in some sense unique, each can be fitted into a broad category – housing mortgage, personal loan, business overdraft etc. This means the terms on which funds are accepted and lent can be standardized. There is a set of rules for each type of deposit or other contribution and a set of rules for each type of loan. This avoids the individual negation and drawing up of contracts.

(d) Monitoring

Financial decisions between two parties are often characterized by asymmetric information.

Borrowers are likely to be much better informed about the uses to which they propose to put the funds than lenders can be. This asymmetry can often be alleviated by financial markets. Access to bond and equity markets usually require that borrowers make specified information publicly available on a regular basis and there are severe penalties for firms that fail to do so or who produce information that seeks to mislead. Given that this information is available from all borrowers to all market participants ‘ the market’ can use its experience to develop its own ‘ rating’ system and pricing the loans accordingly.

Intermediaries can also take on the monitoring task. They develop skills in discriminating between more and less risky projects and firms. They may develop long term association with successful clients so as to gain access to ‘ inside’ information or may demand information as a condition of the loan.

Types of Financial Intermediaries

1 Bank Financial Intermediaries - Retail (High Street) Banks - Investment (wholesale or merchant) Banks

2 Non-Bank Financial Intermediaries

(1) Depositors gain because the bank financial intermediaries take away the risk of default from borrowers and guarantee a virtually costless withdrawal

scheme and a stable return on deposits. Borrowers gain because the banks take away the risk of early recall of loans, guarantee the amount and term of loans and associated repayments and offer a stable interest cost. The banks gain because they make their profit from intermediation, and the difference between borrowing and lending rates.

Investment banks deals mainly with large corporation, institutional investors, governments and local authorities. A typical investment bank will perform the following functions: corporatefinance, asset management, export finance, international investment advice, agency broking and market making.

(2) The main categories of NBFI are finance houses, building societies, insurance companies (both general and life), pension funds, unit trusts and open-ended investment companies. They developed for various different and diverse historical reasons.