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Banks and financial s have played a significant role in integrating the different economics of the world. A brief analysis of the global economic scenario can highlight the fact that the banking industry has always been that sector which has either strengthen or uplifted the economic outlook of a particular region, or has caused turmoil . Nevertheless, for a progressive and thriving economy, it is imperative for the banks to equip themselves with the awareness regarding the various risks and benefits that prevails in the market. This report elaborates on the characteristics of a financial intermediary and how the consumers derive benefits from it. In addition, the report also identifies the major components of a bank’s balance sheet and how its operations are reflected in it. The impact of inclining trend in the interest rate is also discussed in this report (a) A financial intermediary can be defined as an institution that acts as the middleman between investors and firms raising funds [1]. Several types of financial intermediaries such as Banks, Insurance companies, building societies, pension funds, credit unions etc functions in an economy. The function of a financial intermediary is of prime importance in economic growth as it brings in contact two parties i. e. one having a surplus of funds who is looking for a venture to invest in so to earn a return on the money, and the second type which is looking to borrow funds. Since in the real world, it is rare that the demand of lender and borrower reconcile and thus a financial intermediary comes into play. A financial intermediary, such as banks, acquires funds from the lenders and subsequently lends them to the borrowers according to their desire rates. In this particular exercise the financial intermediary takes into consideration various needs of the lender and borrower such as maturity (which means the duration or term for which the lender wants to lend and the borrower wants

to acquire) and rate of return/cost of debt (the lender wants to maximize the return, whereas the borrower wants to minimize the cost). The financial intermediary also aligns the information available, between lenders and borrowers, without which the parties would not be able to achieve their desired outcome. [2] Since a financial intermediary enjoys economies of scale and has greater expertise in managing the risk and rewards, it offers considerable cost savings to the lender and borrowers over direct lending and borrowing. In addition, the financial intermediary also offers risk aversion which assists the parties involved in spreading out and reducing the risk. (b) The assets side of the balance sheet of commercial banks primarily comprises of Cash and Bank balances, Loans and advances to banks and customers, financial assets and derivative financial instruments. Whereas the liability side of commercial banks presents items such as Customer deposits, subordinated loans, retirement benefit liabilities, trade portfolio liabilities and other financial liabilities. The banks usually finance its operations from the money that has been borrowed for the lenders in the form of customer’s deposits. Most commercial banks tend to invest in government securities which are readily convertible into cash at the time of need. [3] The investment portfolio of the banks, although represents a smaller portion of the bank’s assets as compared to the loans and advances exposure, is the primary source to discharge its liabilities (deposit withdrawals) and also to finance the banking operations (sanctioning of advances). In addition to maintaining a liquid investment portfolio, there are other options through which a bank can generate liquidity such as borrowing from the central bank of the country in which it operates, borrowing from other banks at the interbank borrowing rate (such as LIBOR) and raising

capital through fresh capital issue. [3] A commercial bank's capital comprises of the aggregate of issues, subscribed and paid-up capital and the retained earnings. The interbank transactions pertain to the foreign exchange transactions between various banks. In the balance sheet of a bank, these items are reflected as derivative financial instruments. These include forward foreign exchange, over the counter (OTC) options and SWAPS transactions. Money market transactions involves lending and borrowing over a short term period and involves trading of treasury bills, investment bonds and mortgages. Equity market (capital market) involves the trading of shares listed on the stock exchange. Both money market and equity market transactions are represented in the balance sheet as the trading portfolio. Bond markets involves the selling of debt securities, majorly government securities, and the transactions are usually reflected in the balance sheet under trading portfolio or are classified as available for sale assets. (c) A hike in the interest rate is likely to cause the depositor's to ask for higher return on their investments. Interest rate plays an important role in shaping the consumption patterns of the consumer. A higher interest rate would require them to forgo the current consumption and invest in the commercial banks so that they can yield good returns on their investments. On the other hand, it would increase the cost of debt for the borrowers as now they have to pay additional amount of interest to the commercial bank. The increase in the interest rate is likely to deter the companies and individuals to acquire loans and advances form the banks and thus it is likely to create a mismatch between the assets and liabilities for the commercial banks. Due to the increase in the interest rate risk, a gap is created between the interest earned and the interest expensed, thus the profitability of the

bank takes a downward plunge. Overall, the interest rate hike is likely to reduce the economic value of a commercial bank which is calculated by discounting the future cash inflows and outflows (on assets and liabilities) at the prevalent interest rate. [4] References [1] “ Financial Intermediary.” investopedia. com. Investopedia, n. d. Web. 12 May 2011. [2] Adriana Morawski, “ The Role of Financial Intermediaries and the Increased Need for Regulation of Financial Markets” Web. 12 May 2011 [3] William F Hummel, “ Bank Liquidity” wfhummel. cnchost. com. Web. 12 May 2011. [4] “ Liquidity vs. Solvency in the Financial Crisis” techdirt. com. Techdirt. n. d. Web. 12 May 2011 [5] “ Sources and effects of interest rate risks” riskinstitute. ch. International Financial Risk Institute, n. d. Web. 12 May 2011.