

Study on the function of financial intermediaries finance essay



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Financial institution consists of two parts. They are financial structure and financial market. Financial intermediaries are banking or non-banking which transfers funds from economic agent with surplus fund to economic agent (shortage fund). Economic agents stand from household, firm and government. Bank financial intermediaries are central banks and commercial banks. Non-bank financial intermediaries are insurance companies, mutual trust fund and investment companies. Financial market allows people to buy and sell stock, bonds and commodities at reasonable prices. Any financial transaction can help business grow and investor make money is called financial market. Financial market allocates available savings to productive use in macroeconomics. A good function of allocation will increase economic growth rapidly. The types of financial market are money-foreign exchange market, capital market, derivatives market and money market.

The function of financial intermediaries is to convert short term liabilities to long term asset. This function is called maturity transformation. Financial intermediary accepts deposits of short term and place those funds with debtor in long term. Most borrowers like to match their maturity of their liabilities to maturity of their assets as *ceteris paribus*. Financial intermediaries gain profit by engaging in maturity transformation. Besides, it also converts risky investment into relatively risk-free one by lending to multiple borrowers to spread the risk. In the risk transformation, financial intermediaries offer low-risk securities to investor to attract funds and the funds will be used to purchase high-risk securities. The last function of financial intermediaries is matching small loans with large deposits and large loans with small deposits. The three functions performed by intermediaries

are benefit society. Cost is reduced through developing of expertise and taking advantage of economic of scale. When the economic is in risk aversion situation, intermediaries help to spread out the news. This may help lenders and borrowers reduce their risk. Financial intermediaries try to enhance the products and services which are on the demands of the borrowers and lenders. The most important of financial intermediaries' role in society is protecting market failure. It reconciles the conflict needs between lenders and borrowers to ensure market operates smoothly.

In the financial market, capital markets provide financing through issuance bonds and stocks. Trading of commodities will be facilitates in commodity markets. Money markets provide short term debt financing and investment. The third market, derivative markets is providing instruments for the management of financial risk. Money-foreign exchange market facilitates trading of foreign exchange or currency. Returning of mortgage securitizations bring benefit to economy.

Financial intermediaries affect economic growth by acting on the saving rate, on the social marginal productivity of investment or on the fraction of saving channeled to investment. The improvement in risk-sharing and in the credit market for the household may decrease the saving rate. There are four views how financial intermediaries affect economic: bank-based view, market-based view, finances service view and legal-based view. Relationship between economic and financial development appears in determining of growth and design of financial institutions and markets. Efficient of financial intermediaries will bring two important benefits. It will increases the level of investments and savings. It also increases the efficiency in the allocation of <https://assignbuster.com/study-on-the-function-of-financial-intermediaries-finance-essay/>

financial funds in the economic system. Financial intermediaries are direct finance. There are some effects of financial development in the long term growth. It allows an increasing part of saving to be used in the investment financing. The productivity of capital in allocating savings will be increase toward the most profitable project. Financial system which included financial intermediaries and financial market play an important role in the economic. They facilitate trade of goods and services. By this way, they reduce the information and help the payments. Some agents are devoted to screen the projects and obtain reliable information. An efficient financial system is help to reduce liquidity risk. Risk adverse people are allowed to invest in riskier project with higher return. There are some relationship between financial intermediaries and financial markets. Banks are supposed to be more efficient in solving information asymmetries. Information asymmetries cause by adverse selection problem and moral hazard. Banks can keep the benefice of their work because they produce private information. In financial market price include and then spread all new information. Thus, there will be overload of different information. Therefore, a long term relationship allows them to co-operate in controlling price and information. Banks have more comparative advantage compare to capital market. This is because the information extraction is harder than for a big corporate. Financial markets can finance bigger project. The evaluation of a project is made from a larger group of person and the risk is disseminated. Besides, financial markets able to allocate funds quickly because they show higher reactivity to the news.

Asset-backed security is financial security backed by a loan, lease or receivables against asset other than mortgage-backed securities. Asset-

backed security is the alternative that uses to invest in corporate debt. Securitization is the process of pooling the assets into financial instruments and allows them to be sold to investor. Funding costs and asset-liability mismatch will be reduced through securitization. Securitization allow bank to create a self-funded asset book. It also increases the efficiency of financial intermediaries by lowering capital requirement to issuer. By securitizing the assets, the firms able to decrease the equity while maintaining ' earning power' of the assets. In addition, securitization process able to transfer risk such as credit, prepayment, liquidity and asset concentration. Secondary market is a market where investor can buy a security directly from another investor in lieu of the issuer. Secondary market is more liquid compare to primary market. The activities in secondary market will increase the efficiency of financial intermediaries' process. Secondary markets are New York Stock Exchange, Nasdaq and American Stock Exchange. They play an important role behind the development of financial institutions. Secondary market links the investors' liquidity with the capital users of using their capital. For example, in the partnership, a partner only can access his or her self investment and cannot access other partners' investment. He or she may break the ownership of equity into parts and sell to another investor. This case can happened in the secondary market. Private secondary market is only allows trading of unregistered private companies and institutionals.