Financial Intermediation: A Review

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Abstract - According to classic models, intermediary theories are based on transaction costs and asymmetric knowledge. Financial institutions, insurance companies, and the monies they provide to businesses are all part of the scope of this system. However, significant adjustments have been made during the last few decades. Despite decreased transaction costs and less asymmetric knowledge, intermediation has expanded. New financial futures and options markets are mostly for intermediaries, not individuals or businesses. The changes we've seen thus far cannot be explained by conventional wisdom. We analyze the role of intermediation in this new risk trading and participation cost context.

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INTRODUCTION

Economically developed countries, or those that are moving toward economic growth and development, rely heavily on the financial system and its funding methods. Finances play a crucial role in facilitating investment in funds by facilitating the transfer of savings. Additionally, the financial system should enable the transfer of cash from savings to people who seek to invest in capital goods, as well as organizations or individuals who wish to finance investment projects. To have a well-functioning financial system (bank-based or market-based), there must be some economic difficulty that hinders the growth and development of the country. The focus of this research will be on the theory of financial intermediation (from institutional and functional perspectives), why financial intermediaries are important, why financial intermediaries should be regulated, the function of financial intermediaries and their various forms, as well as other related theories that aid in the proper execution of the intermediation process. [1]

Economic and non-economic elements play a significant role in the process of development, and the rate at which capital is amassed and how it is put to use are two of the most important determinants of growth. As indicated by Patrick, this evolution can either be a supply-leading or demand-following movement (1966). When an economy's growth is sparked by the link between the Financial System and the actual sector of the economy, it is known as supply-leading development.

All of these elements are necessary for the movement of money and other forms of financial services throughout a nation's economy.

Additionally, it encompasses the setting in which institutions interact with one another and with other entities, as well as the rules that govern such interactions. The Okigbo (1981). The financial sector or system is made up of regulated and controlled financial interconnections between financial intermediaries and the market. It's not just financial institutions and market that make up a financial system, as Revell (1973) explains. "The primary element of any financial system is a number of financial inter-relationships between the people and bodies that make up an economy," he adds. "And the basic structure of a financial system includes three aspects." [2]

- The extent of these inter-relationships
- The forms of financial claims in which the inter relationship are expressed; and
- The pattern of relationship between persons and bodies of different kinds, between independent economic units.

It is a superstructure built atop the wealth of an economic system. According to Goldsmith (1969), this is referred to as a link between super structure and the financial infrastructure (real wealth or national income). Financial inter-ratio relation's is the name given to this ratio. In other words, it measures how well financial intermediaries and institutions are performing in comparison to one another.

FINANCIAL STRUCTURE AND ECONOMY

Economists in both the finance and development sectors agree on the need of a well-structured financial system. Schumpeter's distinctive contribution to economic growth and development was the establishment of a domestic financial

structure and behavioral patterns essential to create and deploy limited capital funds (1934). In order to create the kinds of assets that both the banking and non-banking public desire to own, and the kinds of financial responsibilities that debtors are ready to accept, a financial framework is necessary. A well-managed and adaptable country's financial system may have a significant impact on the economy. [3]

Different nations, on the other hand, have a variety of structural models tailored to their particular economic circumstances. In any country, financial intermediaries and markets play an important role as a means of bridging the financial gap while also driving economic growth. For the most part, this is due to the fact that they have the potential to help build the economy. Financial intermediation affects economic growth through influencing the saving rate, investment share of savings, or societal marginal productivity from investments. This is how financial intermediation works. Economic growth will benefit from financial development in the long run. Though advances in risk-sharing and household credit markets may reduce the saving rate and, hence, the growth rate;

There are different views on how the financial structure affects economicgrowth exactly.

- Banking systems, especially those in their early phases of development, are seen to promote economic growth more than market-based systems.
- In the standpoint of the market, markets provide important financial services that drive innovation and long-term growth.
- The financial services approach emphasizes the role of banks and markets in investigating companies, imposing corporate control, constructing risk management devices and mobilizing society's savings for the most productive pursuits simultaneously. •. The quality of financial services provided by the whole financial system is the primary concern of this approach, which views banks and markets as complementary rather than competing entities.
- Financial structural debates are rejected by the legal-based position. It claims that the legal system has a significant impact on the quality of financial services. As a result of this legal-based perspective, the long-term growth of the economy is strongly influenced by the legal system. In order to illustrate the link between financial and economic progress, political issues have also been included.

FINANCIAL INTERMEDIARIES

In the event that lenders or investors are unable to deal directly with borrowers in the financial markets, an unique financial company known as a financial intermediary serves the task of efficient allocation of money. Depository institutions, insurance firms, regulated investmentcompanies, investment banks, and pension funds are examples of financial intermediaries. Financiers that specialize in buying and selling assets and financial transactions are known as "dealers." Financial intermediaries act as go-betweens, bridging the gap between those who have financial resources to lend and those who need it. Financial intermediation refers to the transfer of cash from a surplus spending unit to a deficit spending unit via financial intermediaries. The following are the various financial intermediaries, divided into two groups. [4]

- Banking Financial institutions (bank-based system).
- Non – Bank Financial institutions (market based system).

THEORY OF FINANCIAL INTERMEDIATION

Financial intermediation is a hypothesis that began in the 1960s, with Gurley and Shaw's work as the beginning point (1960). The information asymmetry and agency theories constitute the foundations of the financial intermediation theory. Attributable to the following factors: high transaction costs, lack of timely information, and regulation mechanism; financial intermediaries' presence is explained in theory.

Financial intermediation studies are unusual in that they focus on the issue of information asymmetry. Adverse selection can be caused by this asymmetry, as well as moral hazard (principal-agent relationship) and costly verification and auditing processes or even the forced execution of a debtor due to this imbalance. Errors in the idea of perfect markets are caused by informational asymmetry, according to the Arrow-Debreu model. There is no way that financial intermediaries could be useful in the economy as a whole if we were in heaven, but since we are still on Earth, it is certain that there will be imperfections and incomplete information that have a benefit-cost effect for both intermediaries and markets, according to the Arrow-Debreu perfect markets synopsis. [5]

According to the model of perfect financial markets in the neo -classical theory, they fulfill the following conditions:

- No one participant can influence the prices;
- Then placement/borrowing conditions are identical for all participants;
- There are no discriminatory fees;
- The lack of competitive advantages at the level of participants;
- All financial securities are homogeneous, dividable and transactional;
- There are no transaction costs for obtaining information or of insolvency;
- Participants have access to all the relevant information on the variables and aspects

that might affect the present or future value of financial instruments.

Many of these defects are caused by knowledge asymmetry, which results in the establishment of certain transaction costs. It is precisely because of these expenses that financial intermediaries have sprung up, at least in part. For example, Diamond and Dybvig (1983) believe that banks are a group of depositors who work together to protect the interests of individuals who save. A coalition of financial intermediaries is defined by Leland and Pyle (1977) as one that deals with the dissemination of information. Financial intermediaries, according to Diamond (1984), can benefit from scale economies since they function as authorized representatives of savers. To put it another way, folks who have money saved up may trust these intermediaries to invest it in whatever projects they see fit. Depositors have the option to retrieve their monies at any moment under the pre-established terms. [6]

Informational asymmetry research focuses on the thorny issue of the bank's symbiotic connection with its borrowers and creditors. The major focus of this study is on the role of the selection bank and the tracking of the loans issued, as well as the issues of adverse selection and moral hazard in the interaction between the bank and the borrower. With regard to the bank-depositor relationship, it's important to focus on what motivates customers to take their money out early.

INSTITUTIONAL PERSPERCTIVE OF FINANCIAL INTERMEDIAITION.

Financial intermediaries are for-profit corporations, and as such, their primary goal is to maximize shareholder value. Opportunities for surplus units to deposit cash and then distribute them to deficit units at a price levied through financial engineering should be provided.

However, financial intermediaries' primary end products are the loans they provide to customers, and their primary variable inputs are the deposits that they solicit from potential customers. Financial intermediaries may also be seen as businesses that benefit from the discrepancy between the interest rates perceived on loans given and the interest rates reduced on deposits received. Marginal income equals marginal costs, and profit maximizing occurs when this ratio is at its highest value. The financial intermediary must raise the interest paid to depositors in order to attract additional resources (deposits) essential for an increase in the volume of loans given (surplus spending unit). There is no perfect competition among intermediaries in the viewpoint, but rather an imperfect competition. While profit maximization is a common goal for financial intermediaries, they often give it up in favor of increasing market share. [7]

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FUNCTIONAL PERSPECTIVES OF FINANCIAL INTERMEDIATION

In order to establish a financial system from the ground up, the core subject of effective resource allocation must be at the forefront. Financial intermediaries must generate assets and liabilities for creditors and debtors that are considerably more appealing to each of them than if monies were transferred directly between the two parties via their creativity and financial engineering potential. Six fundamental functions of financial intermediaries to promote economic development and growth have been outlined by Merton (1995) in addition to the basic function of resources allocation:

- A payment system for the exchange of goods and services is provided by a financial intermediary.
- Large-scale, indivisible projects can be funded by the pooling of money provided by financial intermediaries.
- Using a financial intermediary, you may move money over long distances and between different sectors and locations.
- For both the investor and the financial intermediary, uncertainty and risk may be managed through the use of a financial intermediary.
- Price information provided by a financial intermediary aids in the coordination of decentralized decision-making across diverse economic sectors.
- The asymmetric-information and incentive difficulties that arise when one party to a financial transaction possesses knowledge

that the other party does not can be addressed by a financial intermediary.

RELATED THEORIES TO FINANCIAL INTERMEDIATION

- **Information Asymmetry**

Bank/borrower and bank/lender relationships are the topic of "informational asymmetry" investigations. Transactional lending and lending based on relationships are the two main types of bank lending. Prior to loan origination, information that is readily available is utilized. When it comes to this class, information obtained over time from the borrower is employed. Ex ante knowledge asymmetries, the adverse selection issue, credit rationing, moral hazard, and ex post verification problems are all central to the bank/borrower relationship. Bank runs, their causes, prevention, and economic impact are all important considerations in the bank-lender relationship. Models of competition between banks for deposits in relation to their lending policies and the likelihood that they meet their obligations are another route in the bank-lender interaction.

- **Transaction Cost**

Approaching transaction expenses. This strategy, unlike the previous, does not challenge the notion of full markets. Nonconvexities in transaction technology are the basis for this. Individual lenders or borrowers form alliances with the financial intermediaries in order to take advantage of the transaction technology's economies of scale or scope. Not only do trade and monetary transaction costs fall under the umbrella of "transaction costs," but so do search and monitoring and auditing expenses. The financial intermediaries' job is to convert one sort of financial claim into another. Because of this, they provide access to liquidity and a diversified pool of investment options. For investors and savers, liquidity is critical, but diversity is becoming increasingly important in both personal and institutional finance. In asset price theory, Holmström and Tirole (2001) argue that this liquidity should play a significant role. Unique features develop from bank loans that improve efficiency between lenders and borrowers. A loan contract's structure is determined by a desire to be efficient in future talks, rather than by a thorough assessment of existing or prospective default risk. Unlike the information asymmetry explanation to the presence of financial intermediaries, transaction costs are not an exogenous reason for their existence.

- **Agency Theory**

It is imperative for intermediaries to preserve their clients' liquidity and profitability status by providing monitoring services, risk management, insurance services, producing liquidity and altering durations during the quantitative asset transformation process. Providing (hedging, capital cushioning, insuring) remedies in order to maintain client confidence in the fulfilment of their contracts is the primary economic dead-weight cost to the middleman. Banks, according to Diamond and Dybvig (1983), are an alliance of depositors that protects individuals who put money away from the dangers that may jeopardize their liquidity. Financial intermediaries, according to Leland and Pyle (1977), are a group that works with the transfer of information. They can attain scale efficiencies by acting as authorized representatives of individuals who save up, according to Diamond (1984). In this way, those who have saved money entrust it to these middlemen to be invested in whatever projects they deem viable, with the knowledge that depositors can withdraw their monies at any moment under the pre-established terms.

- **Risk Management Theory**

Grasp and interpreting the behavior of real-world financial intermediaries relies on a thorough understanding of risk management. The question of risk management is central to this behavior, we say. The financial intermediary produces economic benefit for itself and for its clients by transforming and managing risk for the final savers and lenders. Accordingly, the intermediary's contribution to society's economic well-being is based on the transformation and management of risk. A bank's profitability and the amount of capital it is obliged to retain are directly tied to how well it manages and understands the numerous risks it faces in doing business. Equity, retained profits, and subordinated debt make up the bulk of a bank's capital. Some of the most significant threats to banks are:

- **Credit risk:** The possibility of losing money if a borrower does not pay on time.
- **Liquidity risk:** An asset or security may not be exchanged swiftly enough in the market to avoid a loss (or make the required profit).
- **Market risk:** The possibility that a portfolio's value will be reduced if the market risk variables vary in value, whether as an investment portfolio or a trading portfolio.
- **Operational risk:** Risk arising from execution of a company's business functions.
- **Reputational risk:** A type of risk related to the trustworthiness of business.
- **Macroeconomic risk:** The capital requirement is a bank rule that outlines the parameters within which a bank or depository institution must manage its balance sheet in relation to the overall economy. It is possible to weight risk by standardizing asset and capital classifications.

FUNCTIONS OF FINANCIAL INTERMEDIARIES

The theory distinguishes between the following functions of financial intermediaries: [10]

- The reduction of transaction costs
- The reduction of liquidity risk
- The information provision
- The debt renegotiation.

CONCLUSION

A country's financial system should be organized like a web to facilitate communication among financial institutions, financial markets, and financial instruments. This would help the country's economy grow. It is the bloodlines of households, businesses, and even governments themselves that help fuel the money-creating and -destroying systems.

As a result, the intermediaries and the market should integrate the institutional and functional perspectives of their functions in order to maximize profitability and accelerate growth concurrently.

The CBN (Central Bank of Nigeria) should perform regular maintenance and lubrication on this vehicle (intermediaries) to ensure that it is operating in accordance with the unified purpose of the economy, which includes moral persuasion, direct deposits, and open market operations.

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