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1. Introduction to Financial Institutions

Why are Financial Institutions important?

Financial Institutions are important because they serve to mitigate several issues that arise from a direct flow of funds between consumers and corporations. These problems and the way they are solved are not limited to:

A Monitoring Problems

The Problem: Lending money to a firm in exchange for financial claims causes need for supervision concerning the use of funds. Not monitoring causes problems of waste of funds, laziness, and may lead to a household wanting to withdraw their money cos they stuffed up. Otherwise referred to as the **Agency Problem**.

As such, without financial institutions:

i. There is a high cost of information collection
ii. High chance of broken contracts due to lack of monitoring

However, with financial institutions:

i. Asset transformers take the risk of agency problems and take the task of monitoring the firm
ii. Brokers collect information and provide them to investors at lower costs.

B Maturity Mismatch Problem

Investors search for liquid investments with the ability to withdrawal money whenever need. The problem is that firms search for long-term loans without risk of having to repay earlier. As such, there is a **maturity conflict of interest** because the firms and households want different thing.

However, with financial institutions:

i. Asset transformers provide short term, liquid investment opportunities to investors
ii. Asset transformers provide long-term bank loans to firms.

C Transaction Costs

The acquisition of financial assets and the selling process in the case of needed financial resources causes costs.

As such, without financial institutions:

i) Some assets are not available for individual investment due to a too large face value;
ii) Finding a trading partner is costly, causes less frequent portfolio reallocation
iii) Information is costly, leads to a lower degree of information prior to investment

However, with financial institutions:

i. Money market mutual funds help investors to overcome size constraints and reduce transaction costs (e.g. bid-ask spreads)
ii. Brokers find trading partners and provide cheaper information

D Liquidity Risk

For everyday needs households need liquid assets, which they can use whenever necessary. The direct investment in firms might be illiquid, especially without intermediation.

As such, without financial institutions:

i) There would be more buy and hold approaches as opposed to buy, and sell whenever you want.

However, with financial institutions:

i. Brokers facilitate the buying and selling of shares
ii. Asset transformers diversify withdrawal needs and offer liquid assets to investors.

E Price Risk

The value, and thus also the prices of direct investment into firms changes

As such, without financial institutions:

i) Difficulties to diversify, because direct investment in firms needs a certain size;
ii) Lower availability of risk-free assets.

However, with financial institutions:

i. Mutual funds offer diversified and managed portfolios to investors
ii. Asset transformers diversify risk inherent in corporate loans and offer safe assets to savers.

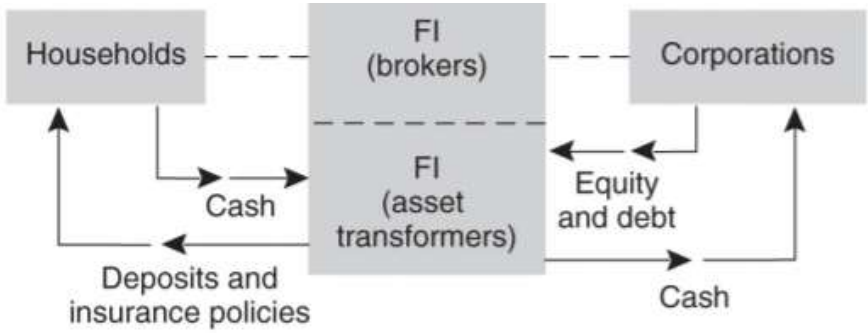
Financial institutions as Brokers and Asset Transformers

Brokers – by fulfilling a brokerage function, Financial Institutions play an extremely important role by reduce transaction and information costs or imperfections between households and corporations. Thus the FI encourages a higher rate of savings than would otherwise exist. This arises from consumers being able to benefit from **economies of scale** and the efficiency when FI performs services in the provision of assets.

Asset Transformers – An FI issues claims that are more attractive to households than the claims directly issued by corporations. In acting as asset transformers, Financial Institutions purchase the financial claims issued by corporations – equities, bonds, and other debt claims called **primary securities** – and finance these purchases by selling financial claims to household investors and other sectors in the form of **secondary securities**.

Primary securities – securities issued by corporations and backed by the real assets of those corporations.

Secondary securities – securities issued by financial institutions and backed by primary securities.



Other Services of Financial Institutions

Financial institutions also provide a number of other functions such as:

A The Transmission of Monetary Policy

Because the liabilities of depository institutions are a significant component of the money supply that impacts the rate of inflation, they play a key role in the transmission of monetary policy from the central bank to the rest of the economy.

B Credit Allocation

Financial institutions provide credit for residential real-estate, etc..

They also provide resources for innovation and start-up and project financing.

C Time Intermediation

The ability of savers to transfer wealth across generations is also of great importance to the social well-being of a country. Because of this, life insurance and pension funds are often especially encouraged, via special taxation relief and other subsidy mechanisms to service and accommodate those needs.

D Payment Services

Two important payment services that financial institutions provide are:

i. Check clearing
ii. Wire-transfer services

E Denomination Intermediation

Both money market and debt-equity mutual funds are special because they provide services relating to denomination and intermediation.

Many assets are sold in very large denominations, such as the minimum size of a CD is $100,000. Individually, a saver may be unable to purchase such instruments and in the event they do, they may end up holding an undiversified portfolio.

However, by buying shares in a money market mutual fund with other investors, household savers overcome the constraints to buying assets imposed by large minimum denomination sizes. Such indirect access to these markets may allow small savers to generate higher returns on their portfolios as well.

Regulation of Financial Institutions

A failure of a financial institution, and the resulting breakdown of service provisions is especially costly to both the ultimate sources and users of savings. These negative effects and costs to the whole society are not taken into account by optimizing firm value by the shareholders.

As such, **regulation** is necessary. **Regulation** is the attempt to increase social welfare and reduce potential cost of system failure.

Regulation imposes private costs to the owners of financial institutions. The difference between the private cost and private benefit of regulation is called the **net regulatory burden**. The six types of regulation are:

1. Safety and Soundness regulation
2. Monetary Policy
3. Credit allocation regulation
4. Consumer protection regulation
5. Investor protection regulation
6. Entry and chartering regulation

A Safety and Soundness Regulation

These are regulations that are aimed at ensuring the 'safety and soundness' of the financial institution and maintain the credibility of the FI in the face of its borrowers and lenders. The five layers of protection are:

i. **Diversification Requirement –** requirements encouraging FIs to diversify their assets.
ii. **Minimum level of capital to risky asset ratio**
iii. **Provision of Guaranty funds** – such as the Deposit Insurance Fund. By protecting FI claim holders, when an FI fails and owners' equity or net worth is wiped out, these funds create a demand for regulation of the insured institutions to protect the funds resources.
iv. **Monitoring and Surveillance** – regulators subject all FIs to varying degrees of monitoring and surveillance

B Monetary Policy Regulation

Another motivation for the regulation concerns the special role banks play in the transmission of monetary policy from the Federal Reserve to the rest of the economy.

The central bank only controls the quantity of notes and coins in the economy – called **outside money** – whereas the bulk of the money supply consists of deposits called **inside money**.

In several countries around the world, regulators require a minimum level of cash reserves to be held against deposits

Another way in which money is controlled is capital requirements

C Credit Allocation Regulation

Credit allocation regulation supports the FI's lending to socially important sectors such as housing and farming.

These regulations may require an FI to hold a minimum amount of assets in one particular sector of the economy or to set maximum interest rates, prices, or fees to subsidize certain sectors.

D Consumer Protection Regulation

Tries to prevent discrimination on the basis of age, race, sex or income.

E Investor Protection Regulation

Laws against insider trading, lack of disclosure, outright malfeasance, and breach of fiduciary responsibilities.

F Entry Regulation

High direct entry costs

Indirect entry costs (restricting individuals who can establish FI's).