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Financial Intermediaries: Its different role

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Abstract

The paper does a descriptive and explorative study to understand the importance of financial intermediaries (FI) role in the context of a monetary policy perspective, a financial inclusion perspective, and a fiscal policy perspective. In the process, the paper looks at the rights of FIs in lending money, taking deposits (only for banks), and other operations that include risk control and financial stability. The study finds that the monetary policy in procyclical leverage affects the FIs balance sheet, affecting the household balance sheet. It expands when the asset's price booms and vice versa. It also develops the capital market. The study also finds that the FIs (banks) are well organized to give financial literacy training as they interface between speculative money-related considerations of insufficiency and opportunity cost with a reasonable "cash in-the-pocket" associations. This can set the poor to an abundance accumulation of financial savings in a rational way. The study also looks at the frauds in the FIs and finds that internal and external factors are equally responsible for such scams.

Keywords: Financial Intermediary, Monetary policy, Fiscal policy, Financial Inclusion, Stability, Frauds

Introduction

Financial Intermediation act as a backbone to the country's economy. It acts as a mediator between the providers of liquidity and takers of the liquidity at the primary level. It also plays a crucial role in the country's financial stability as well. Yet when we look at this phenomenon from a credit market perspective, we find the financial intermediators (FI) at the center of disruption with their lending capacities. It actually became a significant roadblock for the development of the economy, especially during the years 2006-08 in the US. After that, there had been some changes in the regulators and the financial intermediaries' regulations. Today, we can say that a country's central bank will use the financial intermediaries as a passive player to implement its policies. In this way, they (FI) also play a significant role in the economic fluctuations the country will face. The FIs are nothing but Banks and NBFCs majorly.

The functions of these banks and NBFCs are enormous in the financial and economic development of the country, and hence, require proper management. This paper makes a descriptive approach to explore and understand its importance in terms of a monetary policy perspective, a financial inclusion perspective, and a fiscal policy perspective. In the process, this paper looks at the rights that these FIs have, such as lending money, taking deposits (only for banks), and other operations, including acting as a cushion and helping in controlling the risks, bringing financial stability to the economy. The paper also looks at the different scams and frauds in the FIs in the last two decades because of various lacunae in policies.

FIs mainly the banks help the government implement their policies, majorly the fiscal policy and the RBI in India, by implementing the monetary policy. They also help the poor in their upliftment by providing them with different schemes and policies. These include providing them with various subsidies through their different financial policies; providing them with financial literacy through educational programs. These also include access to loans to develop business and to save through deposits. At the same time, we also find that the NBFCs help the poor provide risky short-term loans with high costs without or with collateral through different schemes. Overall, these FI play a significant role in the development of the society and economy as a whole.

Financial Intermediaries: Functional Perspectives

We first start with the functions of the FIs. We understand that the primary function of a country's financial systems is to perform the role of transferring the resources of economic units with surplus funds (savers) to units with funding needs (borrowers). We try to explore the “how and why” this role varies across time and countries. We start with the importance of FIs. Schmidt et al. (1999), in a study in Europe, find that in Germany and UK, compared to France, the banks are more important, but intermediation chains have lengthened in all three countries. The NBFCs have also increased their presence. In the context of India, the literature suggests that there is an increase in the importance and the chains of FIs (banks) in the recent past. It is majorly because of the implementation of government policies through FIs (banks), highlighting its importance. The banks also work as a cushion in implementing the monetary policy and help implement the fiscal policy that is the money supply into the market and control the liquidy via the FIs. The FIs (banks) also help in the financial inclusion of the poor. They help in reducing the risk and bring financial stability to the economy.

The central role of FIs is that they help in facilitating the risk by transferring and dealing with the financial instruments and markets maze. And, they also reduce the participation cost by using the markets most efficiently. The existence of FIs mainly lies in the imperfections of the markets. As soon as the market starts functioning efficiently, then the FIs are useless. Once the market becomes transparent and efficient, the FIs will become extinct. Another critical role of FIs is the reduction of participation costs. With the mutual funds coming into the picture to help individuals invest, we can say that the FI's job has been evenly distributed. They also help in the income distribution, resulting in the increased value of the time and the top-notch distribution. The risk management aspect of the FIs can be divided into four types. These are: first, the management's self-interest; second is the issue with taxes; third is the financial distress cost; and, fourth is the issue with the capital markets and their imperfections.

The FIs help individuals in accessing the capital markets. They do it in different ways. One way is that they provide advisory to needy people. The majority of such people who need advisory are usually financially literate and know the financial markets well enough to work self-reliantly but need the advisory to choose the best products amongst the good ones. The FIs also have financial products for the people who are not financially literate. These are products like mutual funds or sip's (systematic investment plans), which can be directly invested, and the FIs handle the risk and other aspects. Hence, it can also be looked upon as one of the critical roles of the FIs. On the other hand, the FIs (NBFC) government regulations are more strict and are more closely monitored by the RBI. The NBFCs mostly have their branches extended to the rural regions. They also help the people establish a business by giving small loans at higher interest rates as their loans are relatively very risky in nature.

Financial Intermediaries: Fiscal policy Perspectives

Next, we take a look at the role of FIs concerning fiscal policy. We try to understand how the FIs help brings financial stability by controlling inflation and other macroeconomic attributes. The FIs do this in different ways. The FIs control the money supply into the market. They also bring stability by buying government bonds and other financial products from the governments. They also provide stability by having insurance for the deposits. They even maintain foreign currencies so that it helps them in their day-to-day transactions by bringing stability by holding foreign reserves. And, by keeping these forex reserves, the FIs also reduce the risk for the country as a whole. Hence we can again say that the FI's play a crucial role in maintaining financial stability. In the earlier section, we mentioned the management of risks by the FIs and its four types. Let us take a look at these four types.

Management's self-interest: In an FIs, we understand that the role of it is to lend money and accept deposits. Now, when they are lending money, they analyze the risk aspect and usually lend it to the person or entity that is less risky. They would charge more interest rates if it were riskier. Now comes the management's self-interest into the picture. If they lend to higher risky clients, it will directly affect the FIs balance sheets.

The issues with Taxes: In this scenario, in India, the taxes are not linear. The taxes depend on the debt the entity holds at a certain point in time, and this plays a significant role from the companies point of view to borrow a certain amount of loan or vice versa. Hence, taxes will indirectly affect the FI's balance sheets, which is again a key factor.

The Financial distress cost: In this context, the FIs will usually absorb or reduce different costs in a particular scenario for any given entity. For the FIs, the distress cost is again a considerable burden directly linked to the riskiness of the entity. The risker is the entity, the higher the financial distress cost for the FIs to bear.

The Issue with the Capital Markets and their Imperfections: If the capital markets exist perfectly, then the Financial intermediaries wouldn't be there. Capital markets are not so easy to access for an ordinary person, due to which the FIs came into the picture. They act as a mediator between the common person and the Capital markets. When individuals try to invest in the capital markets, they will approach the FIs, which will look into the capital markets and help the individuals access the markets. If the capital markets are efficient enough, they would be accessed by the individuals directly, and hence, there won't be any need for the FIs in the first place.

Financial Intermediaries: Monetary Policy perspectives

Traditionally the central bank of the country mainly controls the FIs. In India, it is the Reserve Bank of India (RBI) that controls the FIs. In terms of monetary perspective, the FIs help the central bank push monetary policies into the country's citizens by being a passive player. At the same time, these passive player's roles must be independent in nature. In reality, these FIs, when they implement the monetary policy, also absorb some residuals into their balance sheets. For example, when we inspect a suitable balance sheet of a FI. We find these are reflected in hidden subsidizing conditions in capital market transactions. We can catch these transmissions in the instrument through the credit supply all the more completely.

When there is a supply of credit, there is friction among the FIs that originated with the agency relationship between the organizations of the market and the FIs. It is noticed through the balance sheets of the FIs. But, with the increase in the private entities in the FIs, this friction has decreased significantly. These frictions are reflected in the balance sheet of the FIs. Similarly, besides lending, there is also an impact of risks on the balance sheet of FIs. There are positive effects; if the interest rates were reduced, i.e., with the low yield on safe assets, the FI's incentivizes the risky assets, then low-interest rates can lead people for long-term investments like pension funds, etc.

In procyclical leverage (Andiran et al., 2008a), when the assets boom's price, they will reduce the risk-weighted assets, which affects the leverage ratios in the bank's balance sheets. Hence this affects the bank's balance sheets. It expands. By the same logic, now, when the monetary policy has such effects on the aggregate demand, the household's balance sheets and spending patterns also expand.

These FI’s also deal with the capital markets to maintain reserves and day-to-day activities. It brings in the involvement of brokers and dealers, who then show a better future movement than asset values (books). Similarly, the FIs mark out information from their balance sheets as signals will become more significant factors for contemplating the transmission system. As such, when there is slack in the FIs balance sheet, fluctuations in the credit supply will arise. Two fundamental factors control the cost of influence of such market-based FIs. These are the risk and short-term interest rates. And, in the process, the normal productivity of FIs will be proxied via conveying spreads which include the term of the spread and different credit spreads. Also, varieties in the approaching target decide the short-term interest rates, which will straightforwardly affect the benefit of FIs. In the process (Andrian et al., 2008b), when the FIs are implementing the monetary policy, at the point when the monetary policy is fixed, the slope curve becomes shallow and may invert sometimes. FIs need to decrease the supply of credit when confronted with such shallow yield bend in such scenarios. Thus, FIs monetary intermediation assumes a part in money-related strategy, which is "transmission through credit supply, and short-term interest rates matter straightforwardly for monetary policy."

This viewpoint on the significance of the short rate as a value variable is present in monetary policy reasoning. Short-term rates matter just to the degree that they decide long-term interest rates, which are viewed as being risk-altered assumptions for future short rates. Thus, the viewpoint is forward-looking when it comes to the central bank's rate projections. They define the future path of the FIs and help with the uncertainty around the direction. So, if RBI communication compresses the vulnerability from future short rates, the risk of taking the extensive assets financed by the short-time period debt is compacted. And, if the pressure expands the potential for a confusing loosening up later in the extension period of the cycle, at that point, such pressure of unpredictability may not be alluring for the adjustment of real action.

So, at the point when the financial system, in general, holds long-haul, illiquid resources financed by short-term liabilities, any strains coming about because of a sharp pullback in influence will appear someplace in the framework. Regardless of whether a few foundations can change down their monetary records deftly, there will be some who can't. And, at the point when the momentary financing flees, they will confront a liquidity emergency. It is like the emergency we found in Indian NBFCs in the new recent past. In any case, experience has shown consistently that the most potent instrument in easing total financing requirements is a lower target rate. Again, let's examine the cooperation between financial stability and monetary policy concerning the most recent many years. We find that it is essential to remember that the successful collaboration of monetary policy strategy and the FIs (bank) after all other options have run out effectively protects the economy from financial sector distress.

Now, let us interface this scenario up to the market-based financial systems (Bertero, 1994), where the expanded market-based Fis (bank) system is primarily a result of the advancement of the merchant seller area of the economy. These sellers were the market creators and guarantors, supplied credit into the market, and played an essential role in market-based financial conditions. Their growth is directly related to the development of the Fis (bank). It relies again on the procyclical nature of the system as they provide financial system liquidity to the banks. The increase in the assets' prices will strengthen the player's balance sheets and vice versa.

Financial Intermediaries: Financial Inclusion policy perspectives

FIs play a significant role in the financial inclusion of the citizens of the country. Financial inclusion's primary aim is to bring the unbanked people, including the poor people below the poverty line, into the financial system. One of the new era fintech phase three policy implications is ensuring that they can receive benefits from the government and when a new policy implementation and benefits are distributed. In the Indian context, there are regions where people don't have access to banks or bank account. Hence the FIs come into the picture.

Firstly, the FIs have an extensive network of branches that can help in financial inclusion. The FIs, which has been supporting the central bank (RBI) in its monetary policy implementations by playing a passive player role, can now play an active player role in supporting the government with its financial inclusion policy implementation. In the recent past, in the Indian context, we have seen many policies implemented for poor people and people below the poverty line. These FIs can help the government reach these policies to these unbanked regions of the country; thus, the people are supported with financial inclusion. Policies like DBT and few other policies are only possible with the help of FI's (banks only), including taking it to rural regions. The government issue guidelines to implement such policies for such rural areas of the country, and the FIs (especially banks) actively follow the guidelines and implement the policies. Thus, the poor get included in the system.

Financial inclusion is more helpful when done through the three following ways: community, financial system, and individuals. A study of the literature tells us that financial literature plays a significant role in financial development. They suggest that microfinance helps the poor in credit constraints and decreases income inequality. It also talks about the robustness of the financial growth nexus (IMF WP, 2012). It says that "financial depth does not affect growth in countries with poor institutions and an interesting finding by Rousseau and Wachtel (2002) showed that finance has no effect on growth in countries with double-digit inflation."

Many situations can arise between the growth analysis and finance. The major problem is about the identification of causality between the macroeconomic fundamentals and financial inclusion. Allen (2016) says, "greater financial inclusion is associated with lower account costs, greater proximity to FIs, stronger legal rights, and more politically stable environments." Today, we see financial markets throughout the planet have gotten progressively open to people, including the helpless who show interest in financial products from assorted FIs. In particular, the World Bank (2014) information on "admittance to fund for all" uncovers that while there is an expanded acknowledgment of availability for high freedoms to get. On the other hand, the FIs (banks) have also given refined financial products and administrations that are hard to see, particularly for poor and uneducated people.

Appropriately, financial literacy is critical to empower purchasers, especially the helpless who utilize these monetary items and administrations to settle on smart financial choices (Lusardi, 2015). Cash-related proficiency helps the purchasers by offering them the information they need to decide on sound financial decisions and secure their cash-related fates. While program plan and monetary item combination are critical parts for a beneficial financial education program, persuading development channels to appear at target people groups is likewise essential. In this manner, since FIs interface both the excess and insufficiency units, who might be financially uneducated in the financial market (Allen et al., 2016; Beck and de la Torre, 2006), advancing the financial literacy and proficiency for the deficient units will require a multi-assistant structure. This structure will work around customers, the FIs, and the public authority (RBI or the NABARD) as controllers. The Fis (banks) can give financial capability that improves financial data with improved monetary lead through "useful minutes," which can accomplish the transparency of financial devices or speedy and explicit authorization to cash-related things.

For example, Askari Bank (2018) sees that FIs (banks) orchestrated to give such financial literacy training since they interface between speculative money-related considerations of insufficiency and opportunity cost with reasonable "cash in-the-pocket" associations. In like way, interfacing financial instruction with monetary items license all people to wind up being wholly participated in the standard financial system, and setting them while on the way to abundance accumulation of financial savings. Thus, the financial proficiency programs equipped with saving cash with explicit arrangements will help the externals. These externals are the poor and the financially excluded who can have access to the standard money-related channels. And thus change into the ordinary monetary design successfully, lucidly, and with little expense.

Studies like Mejia (2018) and Joshi (2014) state that FIs (banks) through microfinance can expect a phenomenal part in advancing financial proficiency through an arranged methodology being dependent upon the hold side drives on financial consideration. They say that since banks have constantly grown new financial items and products for the various buyers, they are better positioned to target such customers with a reliable offer of suitable financial products. Much more unequivocally, the RBI's policy instruction to the banks to set up Financial Literacy Centres (FLC) to lead the education in the entirety of the spaces accomplished broadened financial-related capability. Correspondingly, Grohmann et al. (2017) uncovered that FIs invasion on a fundamental level progressed financial proficiency based on a study across 143 countries worldwide. The study found that FIs give openings that help both people and substances contribute and procure returns. Kempson et al.(2004) uncovered that while FIs benefit from apportioning excess assets from savers to borrowers, the FIs microfinance effectiveness will depend on the FI's ability to assess the benefits and costs of developing suitable financial products that meet borrower's requirements. Although the FIs in the country are given a lot of power to apply different policies of the government for the poor to lend at lower rates, they have been misused in specific scenarios, and certain frauds and scams have come out into the picture that shows us the FIs in a negative light.

Financial Intermediaries: the policy lacunae perspectives

The FIs are also continuously in the limelight for significant frauds and scams that have emerged based on policy lacunae and regulatory failures. We now look at the various scams and frauds that happened in FIs in the Indian context. The recent RBI annual report (2020) on scams and frauds says that "While there were 6,799 frauds involving Rs 71,543 crore as of March 2019, the number of frauds jumped to 8,707 involving a whopping Rs 1,85,644 crore."

A small summary of some of the significant frauds are as follows:
The year 2011 - A scam of Rs. 150 crores by Executives from Bank of Maharashtra, Oriental Bank of Commerce, and IDBI created about 10,000 fictitious accounts and transferred fictitious loans to these accounts.
The year 2013 - A scam of more of Rs. 437 crores by the officials of Ahmedabad-based Electrotherm India allegedly cheated the Central Bank of India in connivance with bank employees.
The year 2014 - A Rs. 139 crores scam by Kolkata-based industrialist Bipin Vohra and others for cheating the Central Bank of India by obtaining the loan with forged documents.
The year 2015 - A fraud of Rs 212 crores by former deputy general manager of Central Bank of India and three directors of Jain Infra projects Ltd - MK Jain, Rekha Jain, and Sunil Kumar Dangi for allegedly defrauding the bank.
The year 2016 - A fraud of Rs 836 crores by Padmakar Deshpande, a Bank of Maharashtra officer from Pune, and Siddhi Vinayak Logistics Limited's director from Surat.
The year 2017 - A Rs 290 crores fraud by the promoters of Abhijeet Group - Manoj Jayaswal and Abhishek Jayaswal and TL Pai, a former DGM of Canara Bank, for allegedly defrauding Canara and Vijaya Banks
Besides, some of the other recent biggest scams are the Rs.6,000 crores money-laundering scam in Oriental Bank of Commerce.
Another one worth Rs.8,000 crores scam in Syndicate bank which included the MD, and the Ex-chairman, where nexus was found to exist among the top bank officials and different companies.
Then we have the cases of Vijaya Mallya, where the fraud value is Rs.9,000 crores and Rs.12,000 crores worth of scams by Nilesh Parekh in the year 2018. And, finally, the biggest of all we have is Nirav Modi, with fraud worth Rs.14,000 crores in the year 2018, where they are accused of defrauding Punjab National Bank.

As discussed above, the FIs play a significant role in the stability of the financial system. Frauds, scams will bring in distrust and instability. As such, Rbi also came up with its regulations to stop such instances. The RBI’s 2016 and 2017 circulars on frauds give specific guidelines. These directions are issued to provide a framework to FIs, enabling them to detect and report scams at the earliest. These include staff accountability and fraud risk management. The framework also aims to enable faster dissemination of information on frauds, related parties, safeguards, and internal checks and precautions. But it is clear from the above fraud amount, as mentioned in RBI’s annual report (2020), that these are not enough.

Further, there are scams reported in the NBFC sector as well. And, with the evolving of NBFC sector with the technological advancements, increase in size and functions, and a few NBFCs merging up with the Banks, we can say that monitoring NBFC has systemic risk and handles huge transactions, has also become an important task. Key frauds in NBFCs are related to the Hawala transactions, advancing loans without proper due diligence, Ponzi schemes, identity theft, benami accounts, and forged documents. Incorrect KYC details, missing dividend payments, and siphoning of funds by the NBFCs or brokers are few more such reasons for fraud. PWC has developed a detailed list of guidelines on this. Although the scams and frauds in NBFC's are relatively small compared to banks, the size of individual such frauds is quite comparable. Some of the RBI guidelines on NBFCs are as follows:

- There shall be a reporting system in all the NBFCs concerning record the fraud without any delay. NBFCs are required to fix the accountability of their staff in case of a delay in reporting fraud.
- The NBFC shall strictly adhere to the timeframe allotted in the master direction for reporting the fraud. If NBFC fails to report the fraud, they shall be liable for punishment as prescribed in chapter V of the Reserve Bank of India act, 1934.
- NBFC shall appoint an official of the general manager rank will have the responsibility to submit all the returns and reporting as required
- The amount of fraud shall be disclosed by the NBFCs in the balance sheet of the year.

Finally, some of the reasons for FIs frauds (Singh et al. 2016) include internal and external factors like the creditability of third parties, including the auditing firms, credit rating firms, oversight by banks, low diligence, and a lengthy fraud detection process, and incompetent staff. Some other factors include the large size of the loans, which also depend on economic booms and follow the economic cycle. The factors also include weaker enforcement laws, weak corporate governance, incentives, and short-term targets for employees. The study also finds that high sea sales by corporates, overburdened investigation agencies, long judicial process, and old/outdated technology of regulators also play a role in frauds.

Conclusion:

In this study, we explored how the FIs have different roles to play and how their presence makes a significant difference in the country's economy as a whole. They help the central bank of the country with the implementation of monetary policy. When the money is released onto the market, i.e. when there is an expansion in the monetary policy, the FIs will bring down the rates, which will help release more money into the market. In the process, the FIs will take more risky assets on their balance sheets, and the access to the capital markets will become higher. Also, when the interest rates are down, more people have access to borrow more. It keeps the money pushing into the capital markets, and the capital markets also flourish.

The FIs also helps the government of the country to implement fiscal policy. They also control the money circulation in the markets. When there is a contraction, the money in circulation will be taken out by the FIs. This will be done by increasing the interest rates of deposits and increasing the loans' interest rates. It will pull money out of the market and keep it with the FIs or with that central banks.

They also help the government implement the policies that help in the financial inclusion of the poor into the system. The FIs will do it by different measures that they have access to, like an extensive network to push other financial products into the market. Hence, unbanked will have access to FIs. FIs also help the government in pushing their policies and helping the poor in having access to money and help in the upliftment. They also lend money to the poor and people below the poverty line by different means, like micro-financing for the farmers or the self-sufficient groups, at low-interest rates and thus help them develop financially. The FIs also help the poor in financial literacy by pushing different products.

We have seen different scams and frauds done by the FIs, including the NBFCs. One of the main reasons for higher scams and fraud in banks than NBFCs is a significant capital in banks compared to the NBFCs and a more extensive customer base besides auditors and operational processes. It includes oversight by banks, low diligence, a lengthy fraud detection process, and incompetent staff. Overall we have covered different perspectives from which FIs in the country can be seen and both the positive and negative sides of them.

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