

# Intermediaries: Past, Present and Future Role

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## **Abstract**

*The current crisis has made a significant impact and forced a reconsideration of the roles and objectives of many market participants. The changes of roles wasn't instantaneous. The role of intermediaries (financial and non-financial) has changed dramatically during the last three decades. Theories formed under different market - competition conditions are not adequate any more to describe and to assign roles and objectives to market participants. Although the market has changed, the theories remained the same. The past theories cannot explain the growth and importance of the intermediaries in the modern markets. The paper will provide an analysis of the past and present role of intermediaries and their impact on the market. New technologies, regulations, competition drivers, products, etc. have contributed to practice/theory discourse. The paper's goal is to present the historical role and theories of intermediation and to pose the question of their future role. The current crisis and the drivers that have led to it, have created a unique environment in the financial market. Finally, the paper will try to outline the potential of the future role of financial and non-financial intermediaries.*

Keywords: Intermediators, Capital Market, Efficient Market

JEL classifications: G10, G15, L22

## **Introduction**

The paper's goal is to present the historical role and theories of intermediation and to pose the question of their future role. The current crisis and the drivers that have led to it, have created a unique environment in the financial market. Intermediators must redefine their role and participation in the value chain. The paper makes some suggestion as to what this role may be.

The main theory of financial intermediation is that information asymmetry, market friction and / or transaction costs are the main reasons of existence of financial intermediaries. Allen and Santomero (1998) argue that "although transactions costs and asymmetric have declined, intermediation has increased" (p. 1461). The importance or costs of intermediation depends heavily on market size and the ability to achieve economies of scale in the transactions (Barajas et al. 2013). Hence, although the theory addresses the problems with the same solutions, in practice the markets' fundamental differences necessitate a respectively different approach. The discord of theory (theory isomorphism) and practice created confusion in the market.

In 1998 Allen and Santomero (1998) wrote that "the fact that securitization has become so important in recent years suggests that asymmetric information cannot be that important for the loans that have been securitized. If this were the case, there would be an adverse selection or "lemons" problem with bad risks attempting to

securitize more than good risks. As an empirical fact this appears not to be the case". Within the next decade the market, due to securitization collapsed twice (2002 and 2008). This clearly shows that the theoretical framework of intermediaries should be revised in order to encompass the new market structures and dynamics.

Asymmetric information and transaction cost have declined through the implementation of information systems that facilitate information flow from and to market participants (see Bhattacharya, 2012). Other researchers challenge the idea that information can have a significant impact on transaction costs (Christensen, 2010) or they challenge the limits of information technology contribution to the solution information asymmetry problem (Cordella, 2006). Information systems and deregulation have been seen as the panacea of market imperfections. The intermediaries must address the problem of their future role and existence in the market after the crises in 2002 and 2008.

### **The past role of Intermediaries**

The past role (or old role) of intermediaries according to the literature was the reduction of frictions of transaction costs and asymmetric information (Barajas et al. 2013; Allen and Santomero, 1998). These drivers or factors of existence are now in question. The theory of complete or perfect markets has dominated the literature for decades.

The complete market theory suggests that the workings of the finance market can be summarized by prices, providing the absence of information and transaction costs (Modigliani and Miller, 1958). The efficient market (Fama, 1970, 1991) has significant problems. Since the seminal work of Fama a doctrine has been created. The market itself can solve the problems and create new balance. What Fama introduced in 1970 was not new. Adam Smith had introduced the notion with notion of "invisible hand" of the market. +++

Friendman throughout the 1970s advocated the idea that corporations should be free to do business without any interference from the government. In the next decade this idea was surrogated politically by conservative parties around the world. The term "efficient market" has been used, until recently, even by the most prestigious and influencing organizations, i.e. OECD. OECD (2006, p. 14) supports the idea that the corporate governance framework should promote transparent and efficient markets". So, according to OECD efficient market is the outcome of good corporate governance and not vice versa. Hence, efficient market may not be the solution by itself. Other prerequisites exist. Corporations and governments should formulate a framework that enhances corporate governance.

The experience of the last twenty to thirty years has shown that the theory of complete or perfect markets has flaws. Information asymmetry matters and has significant implications on the structure of markets and player roles of the participants in them.

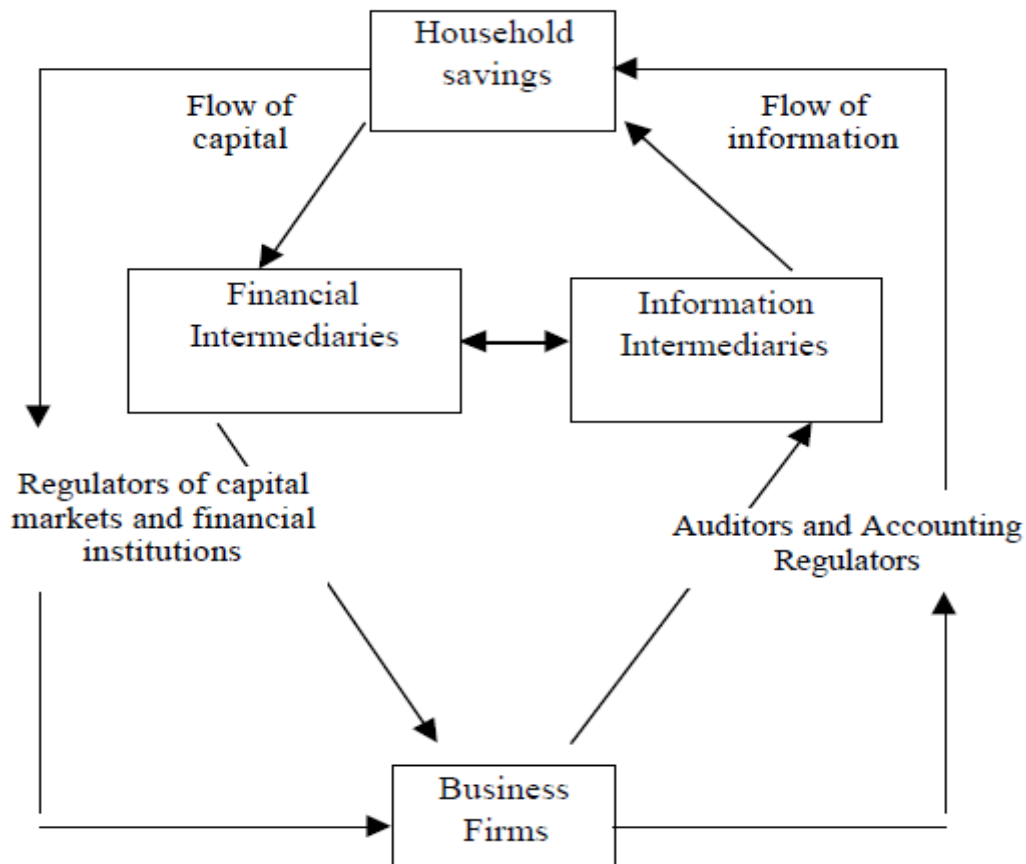
"Corporate disclosure is critical for the functioning of an efficient capital market. ... The credibility of management disclosures is enhanced by auditors, standard setters and other capital market intermediaries" (Healy and Palepu, 2000). Market participants do not have the same amount and quality of information (asymmetric information). This fact creates different classes of market participants with different behaviour to risk aversion and abilities

to assess their position in the market. Asymmetric information may take the form of cash flow information, intrinsic value of the security (Mitchel, 2005).

Information technology and its application in the capital markets was seen as the solution to the problems of transaction costs and information asymmetry. Hence, the causes that explained the existence of intermediaries should be eliminated and with them intermediation should decline. The fact is that the opposite happened (Allen and Santomero, 1998). Intermediation literature is trying to explain this phenomenon. A simple reason may be enough. Intermediaries control the information systems.

Financial intermediary will usually have more information than other investors (see Figure 1). Figure 1 shows that intermediaries are at the core of the market and they control the flow of information from and to other market participants. According to Claus and Grimes (2003) financial intermediaries can play an important role in reducing the costs of information analysis and decision making for the uninformed investors. What is a paradox is that financial and non-financial intermediaries may be the source of asymmetric information and at the same time asymmetric information may be the source of their entrenchment in the market. The other participants join financial intermediaries just because they control the flow of information and they have a privileged relation with the originators of the securities, and as Chen (1983) has pointed they are "informed agents in a market with imperfect information".

As Babus (2012) notes: "Two forces drive agents' decisions to form relationships. First, gathering information about counterparties is costly. Second, if agents intermediate transactions between others, they require to be compensated for it. A trade-off between forming many relationships and trading through intermediaries arises. Although agents are ex-ante symmetric, in equilibrium a central broker-dealer intermediates all the trade in the market. In addition, I show that the benefit... of trading through relationships decreases with the relative difference between the expected return of the assets and the opportunity cost of collateral, and increases in liquid markets".

**Figure 1****Financial and Information Flows in a Capital Market Economy**

Source: Healy and Palepu (2000)

### The present role of Intermediaries

Claus and Grimes (2003) argue that policy makers should be vigilant and timely when they are taking decision to implement policies in the economy. Intermediaries helped banks and other non-banking firms to leverage their portfolio and hence instead of reducing risk they helped to elevate it to higher levels with the promise of higher performance. Their errors or negligence had a very negative effect on the whole market. The policy makers failed to understand the role and influence of financial intermediaries. The house of cards collapsed and the high leverage firms fell with it.

There is the fact that the basic principal - agent problem (that originally is used to describe the relation between shareholders and managers) is present at the relation between borrower and intermediaries (Levitin and Wachter, 2012). The usual solution to the problem is to provide an incentive scheme that will help to align their interests. In the case of intermediaries the incentive in management fee and capital gains by the securitization of the loans.

"The fee-based business model of private-label securitization encouraged greater supply of mortgage credit in order to generate mortgages for securitization to generate fee income for financial-institution intermediaries" (Levitin and Wachter, 2012). The problem with the fee and the securitization incentive is that intermediaries are not connected or affected by the potential insolvency problems of the borrower. Any problems are passed to the ones that bought the securitized title and the borrower. Hence, hedging the problem and passing to a different market participant, created a behavioural pattern that promoted the exit option. The fact that the core business model of intermediaries today is based on products that are not directly connected to the financial health of the intermediary is the source of the problem. A house of card can be constructed. When a major change in the system or an unpredicted accident takes place, the house of cards can fall down rapidly. That is what happened in 2008.

When Mitchell (2005) stated: "The structure finance (FC) market has grown dramatically in recent years. Given the benefits conferred by SF products on both issuers and investors, this growth may be expected to continue in the future", she didn't know that these products will contribute greatly to the 2008 financial collapse. Although Flood (1991) has signalled the importance of the theory of complete for the value of many modern financial instruments (i.e. futures, options), the collapse of the market didn't reduce the value of the theory per se. The implications of this market collapse are still felt until now all over the world. The fact that the European banks were exposed to risk of these products has quickly moved the crisis from USA to Europe.

The new financial products were the initiators for the new role of intermediaries in the capital markets. The merging of markets like capital, money and real estate markets and the expansion of these markets in value, listing companies, assets, etc. has increased the importance of the intermediaries in the market. Simultaneously, "new types of intermediary such as non-bank financial firms like GE Capital have emerged which raise money entirely by issuing securities and not at all by taking deposits. In short, traditional intermediaries have declined in importance even as the sector itself has been expanding" (Allen and Santomero, 1998, p. 1464). This new type of intermediaries have made their core business intermediation. The reasoning for that was that higher leverage equals higher gains and hence higher remuneration for the managers and shareholders.

Although risk management is at the core of intermediaries business cycle, managing the risk can be a risky business. Two major propositions have formulated (Basel I and II) and a third is formulating to mitigate this risk. Khan(2012) argues that there is a necessity for the third framework. An indication of the importance of this framework is that the G20 summit has been involved in its formulation. Khan (2012) concludes that in order not to have any other collapses in the future a risk management regulatory system that monitors the risk management business must be enforced.

In their empirical study Delis and Tsionas (2012) found that the bank risk was slightly increasing from 1985 to 2001, while since 2001 up to 2007 the increase is higher than 200%. The researchers pinpoint the causes of this increase to various economic and political forces that shaped an environment that risk-taking increased substantially. While Delis and Tsionas (2012) do not elaborate on the details of these forces, they provide a detail account of the factors that didn't help market participants to be informed. They argue that "accounting - based ratios that are widely used by researchers and policy - makers

as measures of bank risk fail to show this substantial increase in bank risk since 2001" (p. 24).

Other researchers "claim that market-based financing suffers from the vulnerability of not having a clear mandate for intermediaries to monitor. The indirect mechanisms, namely auditing and rating services, corporate governance principles, disclosure requirements, do not fulfil the informative and monitoring role of the intermediaries in market-based financing though this role is inherently assumed in bank-based financing" (Yavas and Gurbuz, 2011). The fundamental problems of the past exist in the present and the possibly in the future. Market problems may be systematic and hence a rapid change is needed to ensure their elimination.

The cases of Fannie Mae and Freddie Mac are characteristic of the inefficiencies of the market. In reality tax payers were called to bail out financial and not financial intermediaries fearing that without the bailout the values that they had in their portfolio will be diminished close to zero (they feared an another episode of 1929 crash). Intermediaries failed to signal, to assess and to analyse the information to other market participants. For example:

"Top on the list of regulatory failures is the failure to regulate Fannie Mae and Freddie Mac. Pinto (2008) has estimated that about \$1.6 trillion or about 47 percent of the toxic mortgages were purchased or guaranteed by these GSEs, and the government is now on the hook for these mortgages" (Tarr, 2009).

SEC Commissioner Kathleen Casey has said that these credit rating agencies (CRA) have acted much like Fannie Mae, Freddie Mac and other companies that dominate the market because of government actions. When the CRAs gave ratings that were "catastrophically misleading, the large rating agencies enjoyed their most profitable years ever during the past decade.

Diamond (1989) argued that firms with long-standing high credit rating can borrow directly in the open market and high credit rating is required to borrow without monitoring (Diamond 1991). This argument implies that if intermediaries can signal effectively, the cost of intermediation will be minimal and the market participants will be safer. The mentioned cases and many others in the literature are evidence of the opposite. The inefficiencies of the market and the behavior of intermediaries are the main factors that their existence is dubious. The fact that intermediaries are the source of new financial resources may not be enough.

### **The future of Intermediaries**

The fundamental question is which and how much is the risk of a financial intermediary (Delis and Tsionas, 2012)? The answer to this question is the key to the future of intermediaries. The risk for the market, for the intermediary, for the market participants must be estimated in order to evaluate the value of the role of the intermediary in the future market structure.

A team of researchers (Mendoza, Dekker and Wielhouwer, 2012) argue that a factor that affects and continue to affect the future of financial intermediaries is strict regulation of the market. They also argue that the fact that there is no universal behavioural response towards compliance to financial market regulation. Breton (2011) suggests that the legal systems could be thought as legal protection

of informational rents. This perspective is different from the one that intermediaries are the protectors of information integrity and quality, and they are the ones that assure the main factor of efficient market.

While the past and present role of intermediaries (financial and not financial) was not quite clear, their future is equally is equally not clear. They continue to hold a privileged position in the market but the need for the role they play may diminish in the long run. Financial markets are at a crossroad. The plea for less or more regulation, less or more effectiveness in forwarding into the future values, has been expressed by almost all market participants. The conflict will provide the victor and the victor will determine the structure, products, processes and prerequisites for the financial market. This conflict is crucial for the future of the global economy and all participants are aware of the stakes.

One future role for the intermediaries could be the role of signal providers to both good and bad investments. "Ramakrishnan and Thakor (1984) and Allen (1990), amongst others, have shown that financial intermediaries can mitigate the reliability problem by lowering the cost of signalling" (Breton, 2011). The problem with signalling is that in order the signal to be effective, it has to be timely and the information signalled has to be of a good quality (through the proper channels, format, accuracy). The experience of the last decade has shown that intermediaries have failed in this role.

Intermediaries can play a role in providing services of analysis and management of information and products. The real threat for them is information technology that makes analysis valueless and management services obsolete. The opportunity for them is that they may control the information systems themselves and hence they may become the masters of the game simply by controlling the real factor of value in the markets: information. Allen and Santomero (1998) argue that intermediaries could continue to occupy the key area of risk management. As more dynamic markets get, the risk is ever greater for the market participants. Risk mitigation for market participants is important because the complex market systems and products can produce significant costs of management. Hence they may ensure the services and expertise of intermediaries in order to minimize costs.

Yavas and Gurbuz (2011), argue that intermediaries could change their role in the market and "produce efficiency and productivity in the long-run rather than the profits for somehow short-sighted option holders either be in the corporate boardrooms or within the cadres of intermediation businesses". Instead of seeing the information technology as an impediment, intermediaries could see information technology as an opportunity to entrench themselves in the market by controlling the controlling systems.

## **Conclusions**

Financial intermediaries have shifted from one role to the other through the last decades. The theory is evolving to explain the drivers of change. The new roles are still formulating but the place and importance of intermediaries in the market has not been questioned by the academia, the regulators and market participants. Regardless of the new role or roles for the intermediaries their value in the market is apparent, just because they have become the leaders of the market per se (McKinnon, 1973 as cited in Allen and Santomero, 1998).

A market without intermediaries, under the current market structure, is impossible to be perceived. Although this is true, the need for change exists as well. The two crises (2002, 2008) has proven to regulators, policy makers, and other participants that the current structure is long term inadequate. The main problem is whether the change, any change, can happen voluntarily or must be enforced via regulation. Market participants' acceptance of the solutions provided by the academia, authorities, policy makers, etc. is a prerequisite to a successful and without frictions implementation. One thing is certain: the future of intermediaries is directly connected with the future of the issuers of securities and the market itself. If the new system is inadequate or inefficient the new role or roles of the intermediaries will have no worth to them at all.

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