### 2. Financial intermediation.

Financial intermediation is an activity of financial intermediaries. A financial intermediary is an institution that links lenders with borrowers, by obtaining deposits from lenders and then re-lending them to borrowers. The role of financial intermediaries in an economy, such as banks and building societies, is to provide means by which funds can be transferred from surplus units in the economy to deficit units. Surplus units are those economical agents, which have more money, than they need for their immediate needs. Deficit units are those, which have less money, than they need in order to fund their current activity.

Financial intermediaries help to reconcile different requirements of borrowers and lenders.

They provide obvious and convenient ways in which a lender can save money. Instead of having to find a suitable borrower for his money, the lender can deposit his money with a bank etc. All the lender has to do is decide for how long he might want to lend money, and what sort of return he requires, and choose a financial intermediary, that offers a financial instrument of the fitting conditions.

They can package up the amounts lent by savers and lend on to borrowers in bigger amounts.

They provide for a risk reduction. Provided that the financial intermediary is itself financially sound, the lender would not run any risk of losing his investment. Bad debts would be borne by the financial intermediary in its re-lending operations.

They provide a ready source of funds for borrowers. Even when money is in short supply, a borrower will usually find a financial intermediary prepared to lend some.

Most importantly they provide maturity transformation, i.e. they bridge up the gap between the wish of most lenders for liquidity and the desire of most borrowers for loan over longer periods. They do this by providing investors with financial instruments, which are liquid enough for the investors’ needs, and by providing funds to borrowers in a different longer-term form.