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Financial Intermediation as Delegated Monitoring: A Simple Example

FRB Richmond Economic Quarterly, vol. 82, no. 3, Summer 1996, pp. 51-66

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Date Written: 1996

Abstract

Using a simplified version of the model developed in his 'Financial Intermediation and Delegated Monitoring,' the author explains why investors, instead of lending directly, first lend to banks who then lend to borrowers. His model does three things. It identifies the financial technology that allows banks to serve as middlemen, it explains the key role of debt contracts in bank finance, and it highlights the importance of diversification within financial intermediaries. It therefore helps analysts to understand the organizational form of intermediaries, the role of banks in capital formation, and the effects of policies that limit bank diversification.

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