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CHAPTER III

TYPES OF FINANCIAL INTERMEDIARIES

In a modern economy we may distinguish four main types of units that participate in the economic process, always remembering that the units as we find them in life are only approximations of the ideal types set up in a scheme of classification: (1) households (as consumers and as suppliers of labor services); (2) business enterprises; (3) nonprofit organizations; and (4) government.

Business enterprises as well as nonprofit and government organizations may be further subdivided according to the nature of their predominant economic activity. For this study we need to consider only one of the many possible subdivisions, that into financial and nonfinancial enterprises or organizations. This subdivision classes as financial enterprises all economic units—business enterprises as well as nonprofit and government organizations—that are primarily engaged in the holding of and trading in intangible assets (claims and equities).

Nonfinancial enterprises, of course, also hold intangible assets, e.g. cash and receivables, and have liabilities and equity which of necessity always are classified as intangible. Conversely, financial enterprises own some tangible assets, at least office equipment and often the buildings in which they operate and the land on which the buildings stand. The differences between financial and nonfinancial enterprises are, nevertheless, fairly clear-cut in practice. The tangible assets of financial enterprises almost always constitute only a very small proportion of their total assets. Although for nonfinancial enterprises the share of intangibles in total assets is usually not negligible, and in many cases quite substantial, the nature of operations usually permits the allocation of a specific enterprise to either the financial or the nonfinancial category without unduly stretching the definition used here and without doing violence to current practices of classification.

Financial intermediaries include most of the units falling within the classification of financial enterprises, but are not identical with them. (The slightly more descriptive designation "financial intermediaries" is used in this study in preference to the common term "financial institutions," because it indicates at once their position in the process of saving and investment.) Financial intermediaries are taken to include all financial enterprises with the exception of two types: (1) units whose assets consist predominantly of the securities of, or of claims against, wholly owned or majority-owned subsidiaries and affiliates (holding companies); and (2) units owned by one or a small group of individuals, or by corporations or non-profit organizations, if they make no substantial use of outside funds; i.e. enterprises identical with or similar to what are usually called personal holding companies.

A further distinction is sometimes helpful in analysis: that between primary and secondary financial intermediaries. Primary financial intermediaries are those which draw their funds from households, business enterprises, or government and make them available in turn to the same groups. Secondary financial intermediaries rely for most of their funds on primary financial intermediaries, or use their own funds chiefly to acquire the securities of or claims against primary financial intermediaries. Under this definition most financial intermediaries operating in the United States are primary. At the present time the only important secondary financial intermediaries are sales finance, personal finance, factoring, and mortgage companies, all of which obtain most of their funds from commercial banks. This group also includes some governmental organizations financed by other government-owned financial intermediaries (e.g. Banks for Cooperatives and Federal Intermediate Credit Banks) or which make most of their funds available to financial intermediaries (e.g. Federal Home Loan Banks, whose assets consist mostly of loans to savings and loan associations). In the case of some financial intermediaries, for example certain investment companies, a substantial proportion of assets consists of the securities of other financial intermediaries. However, as long as these constitute the minority of total assets, the holders may still be classified as primary financial intermediaries.

Further classification of the individual economic units that fall within the definition of financial intermediaries varies from country to country, changes over time, and depends on the nature of financial intermediaries operating at a given time and place, which in turn is greatly influenced by prevailing legal arrangements and financial customs. In the United States the definition of financial intermediaries includes for the period with which this study deals the types of institutions listed below, each of which is made up of individual units reasonably similar in the nature of their operations and in the character of assets and liabilities. In presenting the statistical material in the rest of this study, several of these groups are further subdivided, and a few are omitted from most parts of the study for lack of adequate data.

A. The banking system
   1. Federal Reserve Banks
   2. Commercial banks
   3. Savings banks
   4. Postal savings system

B. Other depositary organizations
   1. Savings and loan associations
   2. Credit unions

C. Insurance organizations
   1. Private life insurance organizations (including fraternal and savings bank life insurance)
   2. Private noninsured pension funds
   3. Government insurance and pension funds
   4. Property insurance companies

D. Other financial intermediaries
   1. Investment companies (including investment-holding and installment investment companies)
   2. Land banks
   3. Mortgage companies
   4. Finance companies (including sales finance, personal finance and factoring companies)
   5. Security brokers and dealers
   6. Government lending institutions

E. Personal trust departments (including common trust funds)

The above grouping of financial intermediaries into one to two dozen distinct types is a functional classification which has become established by time. No such grouping, of course, is entirely satisfactory, and several other principles of classification exist that are defensible from various points of view and are possibly preferable for purposes differing from those of this study.

The first two groups of financial intermediaries bring together all those organizations which function primarily as depositories of short-term funds of nonfinancial economic units (plus the Federal Reserve Banks). The right-hand side of their balance sheet consists, apart from intra-group entries, primarily of short-term liabilities to households, nonfinancial business enterprises and government and nonprofit organizations, liabilities which are regarded by the owners as being ordinarily realizable at any time without delay and at a definitely known and unchanging face value. The separation of intermediaries belonging to the banking system from other depositories is made more in deference to custom than as a reflection of a genuine difference. One very important difference among the financial intermediaries in the two groups exists, but it does not separate the banking system in a broad sense from other depositories. It rather distinguishes between (1) those depositories which are able to create money (Federal Reserve Banks and checking departments of commercial banks) and which thus in their lending and investment activities are to some extent freed (not individually but as a group) from the limitations imposed by previous receipt of deposits; and (2) all other depositories, which are not able to create money and thus are limited in their lending and investment activities to the receipt of deposits and the increase in net worth.

The common feature of the financial intermediaries combined under the heading of insurance organizations is their primary purpose, the provision of a specialized service—protection against specified risks in consideration for definite payments by or for the account of the insured. Most of these organizations accumulate a considerable amount of funds in performing their basic function, and the size of the funds is essentially determined by the nature of their insurance contracts. In principle, and for the most part also in practice, the liabilities of insurance organizations are of a long-term nature, falling due only in accordance with the terms of contract. Although part of the claims of the insured may be liquidated before the originally stipulated time, the exercise of this right remains the exception rather than the rule and is precluded for a large part of the total liabilities of this type, specifically those of government and private pension and retirement funds. Thus, while the liabilities of insurance organizations to their policyholders may at some times acquire a character close to that of short-term deposits, the actual nature of most of them remains quite different as is evidenced by their much slower rate of turnover.

No similar unifying principle can be claimed for the financial intermediaries in group D. This indeed is a catch-all category. It includes intermediaries which finance themselves primarily by the issuance of their own securities (investment companies and land banks), those which draw their funds for the most part from other financial intermediaries (mortgage companies, finance companies, security brokers and dealers), and those which are financed directly by the government and thus indirectly by the buyers of government securities.

Personal trust departments, finally, have been treated as a separate group because they administer assets on the basis of a trustee relationship rather than, as do the other financial intermediaries, as debtors (or issuers of equity securities) who invest what in law are their own funds.

Grouping of financial intermediaries is not a matter of great importance for the interpretation of the data. A word, however, is necessary on the reasons for excluding from the study a few specific types of enterprises that might be regarded as falling within the definition of financial intermediaries that was adopted.

1. Investment counsel organizations have been excluded, notwithstanding their similarity in some respects to the personal trust departments of banks, because they generally do not have the power of independent action with respect to the funds they administer but are limited to advising the beneficial owners. This factor alone might not have been regarded as decisive—some of the trust funds administered by personal trust departments are subject to similar limitations—but the absence of reliable data both on the total amount of funds administered by investment counsel organizations and on their distribution (except for one rough estimate for the middle 1930's)[1] made exclusion unavoidable.

2. Trustees other than banks and trust companies have been omitted for two reasons. First, many of them are individuals who do not make a continuing and primary occupation of the activity, an argument perhaps not decisive in the case of a limited number of law firms which specialize in this type of business and are reputedly of substantial importance in some financial centers. Second, complete lack of data again forces exclusion, irrespective of whether or not the basic definition used is interpreted as including nonbank trustees.

3. Also excluded were a few groups of financial organizations which are known or believed to be of relatively small size or for which no satisfactory information was available. Commercial paper and discount houses, acceptance dealers, and title guaranty companies belong to this category, although most of their assets consist

[1] See *Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services*, Securities and Exchange Commission, 1939, pp. 8-9.

of intangibles, and their operations are not too different from those of some banks.

4. Pawnbrokers were omitted not only because of their relatively small importance and the limited information available,[2] but also because their operations combine trading in tangible assets with the holding of intangibles.

5. In excluding labor unions and foundations we are following usual practice. Notwithstanding that most of their assets consist of intangibles, the exclusion can be justified by the subsidiary character of their financial operations as compared with their activities in their main field of operation.

6. It is debatable whether the U.S. Treasury should be treated as a financial intermediary to the extent that it issues metallic or paper currency. This has not been done here, primarily because the issuance of Treasury currency has been regarded as an attribute of basic governmental power.

While accurate data about the size of the omitted organizations are generally lacking, it is safe to say that those that should or could be included within the basic definition of financial intermediaries (i.e. category 3 and perhaps also 1, 2, and 6 of the above list) have throughout the period covered by this study held assets amounting to only a small fraction of the assets of those included. The types of omitted organizations that would fall under the basic definition adopted (e.g. 3 above) are known to be negligible in size and importance as compared with the financial intermediaries covered by the study.

[2] Estimates on the receivables of pawnbrokers since 1923 may be found in *A Study of Saving . . .*, Vol. I, Table D-6 (figures for 1923 to 1937 from R. Nugent, *Consumer Credit and Economic Stability*, Russell Sage Foundation, 1939, p. 115; 1938-1949 figures are Federal Reserve Board estimates).