What Are Financial Services?

How consumers and businesses acquire financial goods such as loans and insurance

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IN the aftermath of the global crisis, there has been a call for tighter regulation of financial services. But what is a financial service?

Among the things money can buy, there is a distinction between a good (something tangible that lasts, whether for a long or short time) and a service (a task that someone performs for you). A financial service is not the financial good itself—say a mortgage loan to buy a house or a car insurance policy—but something that is best described as the process of acquiring the financial good. In other words, it involves the transaction required to obtain the financial good. The financial sector covers many different types of transactions in such areas as real estate, consumer finance, banking, and insurance. It also covers a broad spectrum of investment funding, including securities (see box).

But distinctions within the financial sector are not neat. For example, someone who works in the real estate industry, such as a mortgage broker, might provide a service by helping customers find a house loan with a maturity and interest rate structure that suits their circumstances. But those customers could also borrow on their credit cards or from a commercial bank. A commercial bank takes deposits from customers and lends out the money to generate higher returns than it pays for those deposits. An investment bank helps firms raise money. Insurance companies take in premiums from customers who buy policies against the risk that a covered event—such as an automobile accident or a house fire—will happen.

Intermediation

At its heart, the financial sector intermediates. It channels money from savers to borrowers, and it matches people who want to lower risk with those willing to take on that risk. People saving for retirement, for example, might benefit from intermediation. The higher the return future retirees earn on their money, the less they need to save to achieve their target retirement income and account for inflation. To earn that return requires lending to someone who will pay for the use of the money (interest). Lending and collecting payments are complicated and risky, and savers often don't have the expertise or time to do so. Finding an intermediary can be a better route.

Some savers deposit their savings in a commercial bank, one of the oldest types of financial service providers. A commercial bank takes in deposits from a variety of sources and pays interest to the depositors. The bank earns the money to pay that interest by lending to individuals or businesses. The loans could be to a person trying to buy a house, to a business making an investment or needing cash to meet a payroll, or to a government.

The bank provides a variety of services as part of its daily business. The service to depositors is the care the bank takes in gauging the appropriate interest rate to charge on loans and the assurance that deposits can be withdrawn at any time. The service to the mortgage borrower is the ability to buy a house and pay for it over time. The same goes for businesses and governments, which can go to the bank to meet any number of financial needs. The bank's payment for providing these services is the difference between the interest rates it charges for the loans and the amount it must pay depositors.

Another type of intermediation is insurance. People could save to cover unexpected expenses just as they save for retirement. But retirement is a more likely possibility than events such as sickness and auto accidents. People who want to cover such risks are generally better off buying an insurance policy that pays out in the event of a covered event. The insurance intermediary pools the payments (called premiums) of policy buyers and assumes the risk of paying those who get sick or have an accident from the premiums plus whatever money the company can earn by investing them.

Providers of financial services, then, help channel cash from savers to borrowers and redistribute risk. They can add value for the investor by aggregating savers' money, monitoring investments, and pooling risk to keep it manageable for individual members. In many cases the intermediation includes both risk and money. Banks, after all, take on the risk that borrowers won't repay, allowing depositors to shed that risk. By having lots of borrowers, they are not crippled if one or two don't pay. And insurance companies pool cash that is then used to pay policy holders whose risk is realized. People could handle many financial services themselves, but it can be more cost effective to pay someone else to do it.

Cost of services

How people pay for financial services can vary widely, and the costs are not always transparent. For relatively simple transactions, compensation can be on a flat-rate basis (say, $100 in return for filing an application). Charges can also be fixed ($20 an hour to process loan payments), based on a commission (say, 1 percent of the value of the mortgage sold), or based on profits (the difference between loan and deposit rates, for example). The incentives are different for each type of compensation, and whether they are appropriate depends on the situation.

Regulation

Financial services are crucial to the functioning of an economy. Without them, individuals with money to save might have trouble finding those who need to borrow, and vice versa. And without financial services, people would be so intent on saving to cover risk that they might not buy very many goods and services.

Moreover, even relatively simple financial goods can be complex, and there are often long lags between the purchase of a service and the date the provider has to deliver the service. The market for services depends a great deal on trust. Customers (both savers and borrowers) must have confidence in the advice and information they are receiving. For example, purchasers of life insurance count on the insurance company being around when they die. They expect there will be enough money to pay the designated beneficiaries and that the insurance company won't cheat the heirs.

The importance of financial services to the economy and the need to foster trust among providers and consumers are among the reasons governments oversee the provision of many financial services. This oversight involves licensing, regulation, and supervision, which vary by country. In the United States, there are a number of agencies—some state, some federal—that supervise and regulate different parts of the market. In the United Kingdom, the Financial Services Authority oversees the entire financial sector, from banks to insurance companies.

Financial sector supervisors enforce rules and license financial service providers. Supervision can include regular reporting and examination of accounts and providers, inspections, and investigation of complaints. It can also include enforcement of consumer protection laws, such as limits on credit card interest rates and checking account overdraft charges. However, the recent sudden growth in the financial sector, especially as a result of new financial instruments, can tax the ability of regulators and supervisors to rein in risk. Regulations and enforcement efforts cannot always prevent failures—regulations may not cover new activities, and wrongdoing sometimes escapes enforcement. Because of these failures, supervisors often have the authority to take over a financial institution when necessary.

The role of mortgage-backed securities in the recent crisis is an example of new financial instruments leading to unexpected consequences. In this case, financial firms looking for steady income streams bought mortgages from the originating banks and then allocated payments to various bonds, which paid according to the mortgages' underlying performance. Banks benefited by selling the mortgages in return for more cash to make additional loans, but because the loan makers did not keep the loans, their incentive to check borrowers' creditworthiness eroded. The mortgages were riskier than the financial firms that bought them anticipated, and the bonds did not pay as much as expected. Borrowers were more likely to default because of their lower income, which reduced the amount bondholders took in—both of which hurt gross domestic product growth. Mortgage-backed securities were initially intended to help mitigate risk (and could have done so under the right circumstances), but they ended up increasing it.

What do they do?

These are some of the foremost among the myriad financial services.

Insurance and related services

- *Direct insurers* pool payments (premiums) from those seeking to cover risk and make payments to those who experience a covered personal or business-related event, such as an automobile accident or the sinking of a ship.
- *Reinsurers***,** which can be companies or wealthy individuals, agree, for a price, to cover some of the risks assumed by a direct insurer.
- *Insurance intermediaries*, such as agencies and brokers, match up those seeking to pay to cover risk with those willing to assume it for a price.

Banks and other financial service providers

- *Accept deposits and repayable funds and make loans:* Providers pay those who give them money, which they in turn lend or invest with the goal of making a profit on the difference between what they pay depositors and the amount they receive from borrowers.
- *Administer payment systems:* Providers make it possible to transfer funds from payers to recipients and facilitate transactions and settlement of accounts through credit and debit cards, bank drafts such as checks, and electronic funds transfer.
- *Trade:* Providers help companies buy and sell securities, foreign exchange, and derivatives.
- *Issue securities:* Providers help borrowers raise funds by selling shares in businesses or issuing bonds.
- *Manage assets:* Providers offer advice or invest funds on behalf of clients, who pay for their expertise.

Productive uses

Financial services help put money to productive use. Instead of stashing money under their mattresses, consumers can give their savings to intermediaries who might invest them in the next great technology or allow someone to buy a house. The mechanisms that intermediate these flows can be complicated, and most countries rely on regulation to protect borrowers and lenders and help preserve the trust that underpins all financial services. ■

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