Financial Intermediaries: A Network View*

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April 28, 2011

Abstract

I develop a model of financial intermediaries in which their primary role is to create and maintain networks of buyers and sellers. When trading opportunities are limited because of sparse linkages between buyers and sellers and linkages are costly to establish and maintain, the ability to trade via intermediaries with extensive buyer and seller networks increases efficiency. At a cost, intermediaries provide potential sellers (buyers) access to additional buyers (sellers). I show that in equilibrium, when the costs of intermediation are sufficiently small, trade is largely facilitated by intermediaries but that assets are on average underpriced. I also characterize the optimal intermediary structure and find that intermediation is typically characterized by oligopoly rather than monopoly. I apply this model to examine pricing of new issues of securities by investment banks. The main prediction, that new issues are on average underpriced, is broadly consistent with the empirical evidence.

*I thank my advisors Thor Koeppl, Frank Milne and Jan Zabojnik for their patience and numerous valuable suggestions and comments. This research has been supported by the Ontario Graduate Scholarship (OGS) awards program, and The John Deutsch Institute (JDI). All omissions and errors are my own.