Why do we still need middlemen in an age of instant communication?

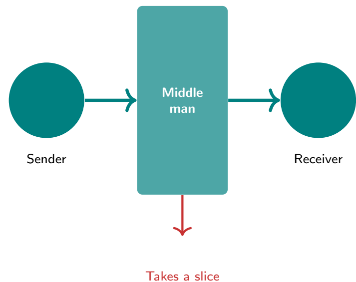
The puzzle:

- We can send messages instantly around the world
- Video calls connect continents in real time
- Yet moving money still requires multiple intermediaries
- And those intermediaries extract fees at every step

The answer lies in transaction costs:

- **Search costs:** Finding trustworthy counterparties
- **Bargaining costs:** Negotiating terms and prices
- **Monitoring costs:** Verifying compliance and performance
- **Enforcement costs:** Resolving disputes and defaults

Intermediaries absorb these costs, making transactions frictionless for users. But they charge for the service.



The middleman intercepts and extracts value. But does the value extracted match the value provided?

Intermediaries exist because trust, enforcement, and coordination are costly. Technology can reduce these costs but not eliminate them entirely.

Understanding why intermediaries exist is the first step to understanding when they can be disrupted.

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Have you ever paid a fee and wondered what exactly you got for it?

Most financial fees are invisible or unexplained. You see the charge but not the value provided. Understanding the economics of intermediation means asking: What service am I actually paying for?

Three core services intermediaries claim to provide:

1. **Risk reduction.**
   Intermediaries absorb credit risk, fraud risk, settlement risk. They screen counterparties, monitor transactions, and bear losses when things go wrong. You pay for insurance against failure.
2. **Friction reduction.**
   Intermediaries handle search, matching, negotiation, and reconciliation. They provide a platform so you do not have to find and vet every counterparty yourself. You pay for convenience.
3. **Scale and efficiency.**
   Intermediaries aggregate demand, batch transactions, and operate infrastructure that individual users cannot afford. You pay for economies of scale.

The critical question:
Are the margins intermediaries earn proportional to the value they add? Or are they extracting rents from market power and lack of transparency?

If you cannot articulate what you are paying for, you cannot judge whether the price is fair.

Intermediary margins should reflect value added, not market power or information asymmetry.

What types of financial intermediaries exist and what do they claim to provide?

Categories of financial intermediaries:

Type	Claimed Value
Banks	Liquidity, credit screening, deposit safety
Card networks	Transaction routing, fraud detection, dispute resolution
Payment processors	Format conversion, compliance, reconciliation
Exchanges	Price discovery, order matching, settlement
Clearinghouses	Netting, counterparty guarantee, settlement finality
Correspondent banks	Cross-border access, currency conversion, nostro accounts

Common pattern:
All claim to reduce transaction costs. The question is whether their fees are proportional to the costs they absorb.

Intermediary Margin Analysis

Type	Margin	Justification
Banks	Medium	Credit risk
Networks	High	Network effects
Processors	Low	Commoditized
Exchanges	Medium	Liquidity
Clearinghouses	Low	Utility
Correspondent	High	Trapped liquidity

High margins with weak justification signal disruption opportunity.

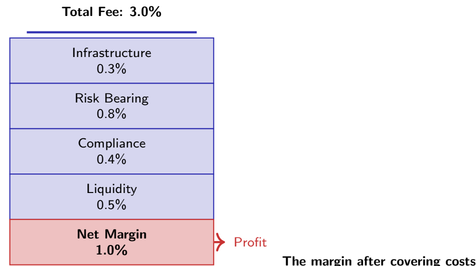
Each intermediary type claims a unique value proposition. Evaluating those claims reveals where margins exceed costs.

Intermediaries with high margins and weak value propositions are ripe for disruption.

How does an intermediary justify its cut of every transaction?

Four economic justifications for intermediary fees:

1. **Infrastructure investment:**
   Building and maintaining payment rails, fraud systems, compliance platforms. These are fixed costs amortized across millions of transactions.
2. **Risk bearing:**
   Credit risk, fraud liability, settlement risk. Intermediaries absorb losses when transactions fail or counterparties default.
3. **Regulatory compliance:**
   Anti-money laundering screening, know-your-customer verification, reporting obligations. Compliance is labor-intensive and expensive.
4. **Liquidity provision:**
   Pre-funding nostro accounts, providing instant settlement while batching backend transfers. Liquidity is capital that earns a return elsewhere.



is where the debate centers. Is it competitive return or rent extraction?

Justified fees cover real costs. Unjustified fees reflect market power, information asymmetry, or lack of competition.

Decomposing fees into cost components reveals where margins exceed justifiable returns.

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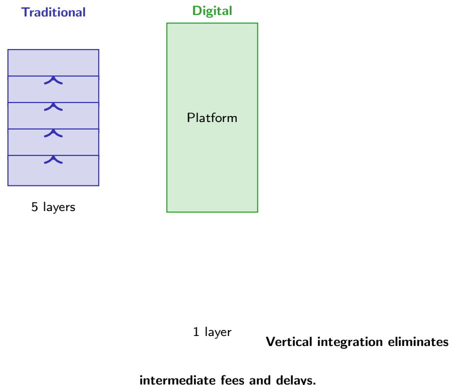
How are traditional vs. digital intermediation models structured differently?

Traditional intermediation:

- Long chains of specialized intermediaries
- Each link extracts a separate fee
- Batch processing and delayed settlement
- High fixed costs, low marginal costs
- Opacity in pricing and fee structure

Digital intermediation:

- Platform models that bundle multiple roles
- Vertical integration reduces intermediary count
- Real-time processing and instant settlement
- Near-zero marginal costs at scale
- Transparent pricing and fee disclosure



Vertical integration eliminates intermediate fees and delays.

Key difference:
Traditional models optimize for the system. Digital models optimize for the user.

Digital platforms reduce transaction costs by bundling roles and eliminating redundant intermediaries.

Platform models collapse multi-step chains into single integrated systems.

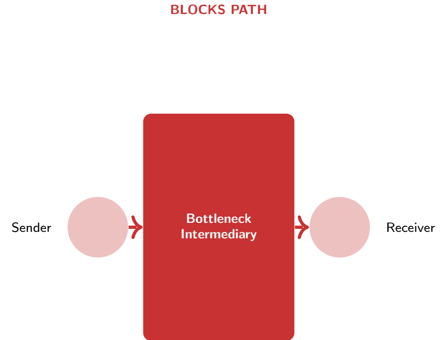
What happens when an intermediary becomes the bottleneck instead of the bridge?

When intermediaries become gatekeepers:

- Network effects create winner-take-most dynamics
- Switching costs lock in both sides of the market
- Lack of interoperability prevents competition
- Opacity in pricing hides true costs
- Regulatory capture protects incumbent position

Consequences of bottleneck intermediation:

- Fees rise faster than value provided
- Innovation slows due to gatekeeper control
- Smaller players cannot access the network
- Cross-border corridors become expensive
- Users have no alternative but to pay



When the intermediary grows so large it blocks the path, the system needs disruption.

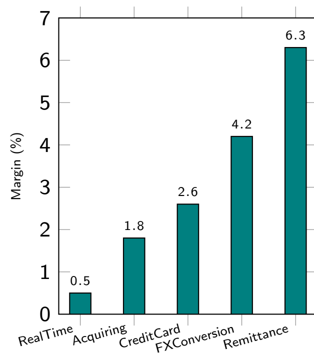
Intermediaries that were once bridges become bottlenecks when network effects and lock-in eliminate competition.

Where are intermediation margins thickest across financial services?

Margin concentration by service type:

- **Cross-border remittances:** Highest margins due to correspondent chains, foreign exchange markups, and low competition in thin corridors
- **Credit card interchange:** High margins funding rewards programs and credit risk
- **Foreign exchange conversion:** Opaque spreads above mid-market rates
- **Merchant acquiring:** Moderate margins due to competition
- **Domestic real-time transfers:** Lowest margins due to simple infrastructure

Pattern:
Margins are thickest where complexity is high, transparency is low, and competition is weak.



Thickest margins appear in cross-border services, foreign exchange, and credit card interchange. These are prime disruption targets.

High margins signal either high value or rent extraction. Analyzing cost structure reveals which.

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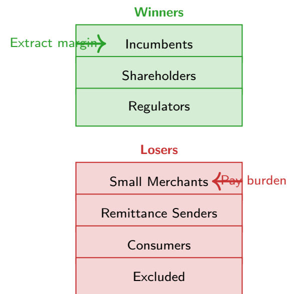
Who benefits and who suffers when intermediation costs rise?

Beneficiaries of high intermediation costs:

- **Incumbent intermediaries:** Banks, networks, processors earn higher margins
- **Shareholders:** Capture excess returns from market power
- **Regulators:** Extract fines and fees from intermediaries

Losers from high intermediation costs:

- **Small merchants:** Cannot negotiate fees, bear full burden
- **Remittance senders:** Low-income workers paying six to ten percent
- **Consumers:** Pay indirectly via higher prices
- **Excluded populations:** Cannot afford account minimums or fees
- **Innovation:** Startups cannot compete with entrenched networks



The poorest and smallest pay the highest fees as a percentage of transaction value. This is a market failure.

High intermediation costs are regressive, hitting those least able to afford them hardest.

Four tests to judge whether an intermediary earns its margin

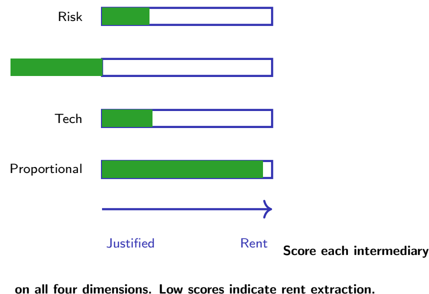
The Intermediary Scorecard:

1. **Does it reduce risk?**
   Measure fraud rate, default rate, settlement failure rate. If risk drops measurably, the intermediary earns a risk premium. If not, the fee is rent.

2. **Does it reduce friction?**
   Measure time to settlement, reconciliation cost, user effort. If friction drops significantly, the intermediary adds value. If friction remains high, the fee is unjustified.

3. **Could technology replace it?**
   Evaluate whether software, APIs, or protocols could provide the same service at lower cost. If yes, the intermediary is vulnerable to disruption.

4. **Is the fee proportional to value added?**
   Compare margin to cost savings provided. If margin far exceeds value, the intermediary is extracting rent from market power.



Score each intermediary on all four dimensions. Low scores indicate rent extraction.

These four tests distinguish value creation from rent extraction. Apply them to every intermediary.

Your Challenge

Activity: Evaluate an intermediary you use.

1. **Choose a financial service you use regularly.**
   Savings account, payment card, money transfer service, insurance policy. Pick one you interact with at least monthly.
2. **List every intermediary involved.**
   Banks, processors, networks, custodians, reinsurers. Trace the full chain from you to the end service provider.
3. **Score each intermediary on the four criteria from slide nine.**
   Does it reduce risk? Does it reduce friction? Could technology replace it? Is the fee proportional to value added? Assign a score from one to five for each.
4. **Calculate the total margin extracted across all intermediaries.**
   Add up all the fees you pay directly and indirectly. Compare that total to the value you receive.

Reflection question:
Which intermediary scored lowest? That is the weakest link and the most likely target for disruption. If you were building a startup, where would you attack?

This scorecard reveals which intermediaries earn their margins and which extract rents. Low scores signal disruption opportunities.

Understanding intermediary economics is the foundation for identifying where digital finance can create real value.