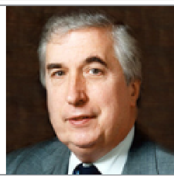

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Challenging the Financial Intermediation Myth

By Robert C. Hockett and Saule Omarova October 17, 2016

Many contemporary discussions of finance or of subjects that implicate finance – for example, federal budgetary or finance-regulatory policy – seem to be systematically colored by a seldom-examined presumption. We call this presumption the "intermediated scarce private capital myth."

Like many a myth, this one assumes or amounts to a picture. In the picture, financial institutions intermediate between private suppliers of scarce finance capital on the one hand, and various public and private end-users of this capital on the other. Unstated but always assumed in this picture is also a causal direction: the funds that intermediaries intermediate *originate* with the (again, always private) suppliers thereof, flow *to* (distinct public and private) end users, and are merely *managed*, in the course of those flows, by the intermediaries.

As managers of funds, financial intermediaries simply help optimize the volumes, directions, and productivity of privately originating financial flows in the intermediated scarce private capital picture. This they do by performing such familiar financial functions as what the orthodox view highlights as maturity-transformation (converting short-term loans from private investors into longer-term investments in distinct public and private end-users of funds), risk-allocation (among private investors with varying risk-bearing capacities), risk-monitoring (on behalf of the private investors), and the like.

Perhaps unsurprisingly, the canonical taxonomy of "intermediary" functions assumes the same causal direction of financial flows as the word "intermediation" itself tends to connote. For characterizing maturity-transformation, risk-allocation, and risk-monitoring as the principal functions of financial institutions makes sense only if one views private suppliers of scarce finance capital as the primal initiators of financial flows. If some financial flows commence with bank lending in the form of bank-opened or bank-credited borrower deposit accounts, for example, then banks *generate* the maturity structures of *both* sides of their balance sheets, rather than "transforming" those of an antecedently given set of liabilities into those of a subsequently assembled set of assets. So a particular view of where finance "comes from" and a corresponding view of what "intermediation" consists in fully mesh together in the intermediated scarce private capital myth.

Now of course, to label a particular way of thinking or picturing things as "mythic" is not in itself to label it "false." Some myths are true, at least in part, and others project noble ideals that persons, societies, or cultures are more or less dedicated to *making* true through their actions over time. There is, however, very little truth, and even less to recommend as an action-guiding ideal, in the intermediated scarce private capital picture. Indeed, this view of finance is both pernicious and profoundly misleading, whether it be deployed as an ideal or as a picture purporting to capture the structure and operation of our financial system.

In a new article available here, we show how the intermediated scarce private capital orthodoxy falsely depicts modern financial systems, explain why its falsity works mischief, and offer a new model of modern finance that more fully and accurately captures its characteristic dynamics. We call our alternative the "franchise model" of finance.

Our franchise model places center-stage that actor which stands at the core of all modern financial systems, yet somehow drops out of view in the intermediated scarce private capital picture. That is the sovereign public, whose monetized full faith and credit constitutes the principal resource that circulates throughout the financial system. We show in detail how modern financial systems in effect constitute public-private partnerships. In each such partnership, the sovereign public licenses private franchisee institutions to distribute its monetized full faith and credit throughout the broader economy so as to fuel inclusive and sustainable growth.

We begin our analysis by first mapping three possible pictures of financial flows – what we call the "one-to-one" credit-*intermediation*, the "one-to-many" credit-*multiplication*, and the "none-to-many" credit-*generation* models of finance. The intermediated scarce private capital myth, we show, simply assumes the first model. Yet if this model were an accurate depiction of modern finance, then all financial intermediaries would be mutual funds. And yet even die-hard proponents of the intermediated scarce private capital orthodoxy admit that banks, for example, are not mutual funds. So proponents of contemporary orthodoxy actually are committed, apparently without quite realizing it, to orthodoxy's falsehood. Such is the power of unexamined myth.

After laying out the three possible models of finance and highlighting banking's incompatibility with the first, we turn to showing that contemporary financial systems in their entireties, not just their banking sectors, conform to the none-to-many credit-generation model. What makes this possible, in turn, we show to be the role played by all modern jurisdictions' central banks and central governments in what we call "accommodating" and "monetizing" credit-extension decisions made by privately operated financial institutions.

To substantiate our claims, we first carefully map the mechanics of commercial bank lending transactions – transactions which, ironically, orthodoxy takes to be paradigmatic of financial intermediation. The mechanics of bank lending, we show, are not dependent upon antecedent depositing activity on the part of private suppliers of putatively scarce finance capital. (Deposits do not make loans so much as loans make deposits.) Rather, what determines bank lending activity is the combination of (a) banks' assessments of the likely profitability of lending under prevailing economic conditions, (b) central bank recognition of payments made out of bank-opened or bank-credited demand deposit accounts, and thus (c) bank deposits' – including deposits opened or credited in the name of borrowers by lending banks – counting as spendable money within the national payments system.

Factor (a) is primarily a function of regulation and broader economic conditions, as the abundance even of "liar loans" in the poorly regulated, capital-glutted mortgage markets during the housing bubble years demonstrated. Factors (b) and (c) are what we have just called public accommodation and monetization of bank-created private liabilities.

From the banking sector, we proceed to the capital markets and "shadow banking" systems that functionally link capital markets to ordinary banks. Here too we show the critical role played by endogenous credit-generation, performed against the backdrop of central bank accommodation and monetization, in driving and indeed constituting financial flows in the capital markets and shadow banking system. We trace the operation of these fundamentally bank-reminiscent dynamics in the *non-bank* financial markets both functionally and institutionally. That is, we map the structures both of the principal kinds of shadow bank loan transactions and of the institutional affiliations that have enabled such transactions – and have themselves been enabled by legal and regulatory changes over the past decade and a half.

After demonstrating the conformity of the financial system as we presently find it to our franchise view of finance, we look to new developments now shaping the future of finance. We examine the disruptive growth of the brave new world of fintech, covering both marketplace lending platforms and cryptocurrency ecosystems (including but not limiting ourselves to Bitcoin). Perhaps not surprisingly, here as with shadow banking we find a pattern whereby what starts seemingly outside of (and even in self-professed opposition to) the franchise arrangement quickly finds itself commandeered by established institutions – and thereby brought into the franchise arrangement. Access to the sovereign public's full faith and credit, in other words, turns out to be just as critical in the young and exciting world of fintech as it is in the "boring" old world of traditional banking.

From the frontiers of fintech and its emerging place in the franchise arrangement, we turn to the normative implications of that "paradigm shift" which our new model of finance represents. Developing a new picture of the architecture and dynamics of modern finance as a public-private franchise for the generation and distribution of publicly-accommodated and -monetized credit turns out to yield potentially transformative implications. Among other things, our more realistic depiction of modern finance allows for a fresh, more systemic approach to diagnosing and remedying that dysfunction which has come to be called the "financialization" of the real economy.

In our account, financialization results from and reflects a systemic breakdown in the operation of the franchise arrangement. In effect, it stems from an acute case of franchisor absent-mindedness and consequent absenteeism, whereby the public franchisor effectively abdicates its key functions of modulating and overseeing the allocation of credit flows generated by its private franchisees. Insufficiently mindful of our constitutive role at the center of our financial system, we the sovereign public have come mistakenly to believe that *rentiers* and franchisee-institutions are the sole originators and drivers of finance, who will withhold "loanable funds" and thereby starve our economy of capital in the event that the policies we adopt fail to meet with their approval. Twenty years of capital glut and associated serial asset price bubbles and busts should have sufficed to undercut that fear; our franchise model of finance shows precisely why it's unsound.

Of course, if the problem of financialization is rooted in such misconceptions, then the solution begins with correcting our understanding of the proper roles of the public and private in our financial system. Recognizing the true nature of that system and the central role played by the sovereign public therein is the crucial first step to full recognition that the sovereign whose resource the financial system distributes must take a more active role in the related tasks of both modulating and allocating that resource.

This means more, in our account, than the adoption of long-overdue macroprudential finance-regulatory policy. It also means identifying the many recursive collective action problems and other market failures that plague the process of capital allocation when it is left solely to private parties acting in their individual capacities. And it means counteracting those dysfunctions through concerted collective action – including action along the lines we have proposed in associated work.

Like any fundamental change of *Gestalt*, the franchise view of finance and its far-reaching implications will take some getting used to. Virtually by definition in a world still dominated by a contrary myth, our "countermyth" will at first ring *counterintuitive*. We are confident, however, that once open-minded readers have worked through our painstaking mapping and tracing exercise, they will see for themselves the descriptive power of the finance franchise view, as well as it's prescriptively liberating potential.

This post comes to us from professors Robert Hockett and Saule Omarova of Cornell Law School. It is based on their recent article, "The Finance Franchise," available here.