What do banks do?

On the mystery of the social benefit of financialization

Rüdiger Lang

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1 Introduction

In "Vom Ende des Kapitalismus zur Expertendiktatur"[1] the financelization of the capitalist world - i.e. the mind boggling increase in complexity of those parts of the global economy, which are supposed to support the "real" economy of manufacturing goods in a way to be explained in some detail in this essay - has played a subordinated role with respect to the discussion of the basic paradigmatic set of rules, constraints, and assumptions on which capitalism thrives. Although one has to acknowledge that during the last couple of decades the role of financial services, starting with the banking system down to the individual hedge fund manager, has played a crucial role in the spectacular events of bubbles and bursts, strategically, it has been important for me to not over emphasize in "Vom Ende des Kapitalismus ..." the contribution of the financial system with respect to the fate of capitalism in the medium to long-turn, and with respect to the generic contradictions and problems the capitalist system of the turn of the millenium is facing. Of course, from a short to medium-term perspective, there is no doubt that financialization plays a crucial role in determining the state of our momentary well-being. And so it be not only for us, in the highly developed and, above all, finacialized markets of the East and the West. But also, and even more so, for the developing countries (in terms of financial services), where a breakdown of the overall money supply by bubble burstings causes severe short-term effects on the predominantly export driven manufacturing sector based on low capital, low wages, and high short term profits, on which these countries so heavily rely on. The same is true for those parts of the manufacturing industries in the so-called "developed" countries, which suffer already since quite some time from capitalist-world contradictions (say the US car industry), whereas others, which are much better off with respect to falling prices and over-production (e.g. like the pharma-industries), suffer only relatively little.

In order to better understand the intrinsic logic of the financial system as such, in order to better understand the relative importance of its short-term effects to the long-term fate of capitalism, and in order to not misinterpret the spectacle of events in which the financial system of today likes to suffer and cheer, it is a quite enlightening task to learn from some non-leftist but nevertheless critical economists some basics on how this system actually functions, what it wants to be and achieve, which tasks it prefers to carry out, and which it rejects or deliberately ignores. And above all, and most importantly, what this system of complex financial services expects from itself in terms of the overall well-being of "The System", i.e. the economy serving the people or its respective paradigmatic assumptions (its axiomatic).

At the 17th of March 2010, Lord Adair Turner, the chairman of the UK financial service authority (FSA), a governmental organization serving as "the regulator of the financial services industry in

[1] R. Lang, Vom Ende des Kapitalismus zur Expertendiktatur - Über die Grenzen kapitalistischer Abstraktion und den Kampf um das Wissen. http://ifkt.org/Experten2.pdf

the UK"[2], gave a lecture at the renowned CASS Buisness School of the University London with the enigmatic title "What do banks do, what should they do, and what public policies are needed to ensure best results for the real economy?"[3]. Some earlier critical remarks of his on the social benefit of financialization in the aftermath of the financial crises caused some significant controversy and criticism of his point of view amongst the stakeholders of the financial industry, to which the lecture was meant as some sort of reply. For us, with a potentially quite pre-occupied leftist view on the financial system as the abyss in which the hard-working man of the factories has been forced to look into for no good reason other than the greed of some hedge fund managers, Lord Turners lecture may help to put things into perspective, although it in no way releases the *Heuschrecken* from their responsibility in significantly contributing to the deserts in front of and left behind by the *real* capitalist economy.

So, here is a summary of what we always wanted to know about the financial system of today but never dared to ask that man in suit and tie on his way to the elevator.

2 The main functions of the financial system with respect to the real economy

In the following the main focus will be on the roles banks play in support of the financial system. This focus has been chosen first of all due to the fact that the FSA is mostly concerned with banking rules over which they historically and legally have more control as over the more complex financial services derived from the original services banks used to deliver to the economy. But secondly - exactly because all modern types of complex services and complex derivatives of financial products are ultimately derived from products originally provided by the banking system to the markets - in order to understand the purpose of the banks balance sheet for serving the real economy, the role of banks in the global economy is key to our understanding of the benefits and drawbacks of the current financial system. Adair Turner summarizes the four main functions of the banking system to efficiently support the real economy as follows:

1. Pooling of risk: Each depositor in a bank has only an indirect claim on all the mortgages, loans, and credit card debt, owned by the bank. There is no one-to-one correspondence with any specific mortgage hold by the institution.

2. Maturity (Laufzeit) transformation 1: Banks are generally lending on longer terms than they receive money, since depositors usually want as short as possible maturities, whereas lenders want them to be as long as possible. The bank balance sheet is "balancing" out exactly these two contradicting needs.

3. Maturity transformation 2: The banks provide market "liquidity" by selling and re-selling (packaged) assets. Market liquidity means that the holder of a contractually long-term asset nevertheless may sell this asset to a price that is offered by a liquid market. Whenever the market is able to agree on a "realistic" price for holding such an asset (independent of the asset itself being a long-term obligation), i.e. whenever the market is liquid, the selling and re-selling of this asset does not change its ultimate long-term character, as long as the market prices are reasonably stable.

4. Risk-return transformation: The bank is holding a different mix of debt and equity investment options. Via the bank balance sheet the bank offers different levels of risk to potential buyers

[2]http://www.fsa.gov.uk/
[3]http://www.fsa.gov.uk/pubs/speeches/at_17mar10.pdf

of its shares by trading its balance sheet in different options. By this the bank is reorganizing (re-pooling) the risk of this options. Usually the reorganization of the investment options are pooled in options of subordinated dept, senior dept and deposits, which all participate at various levels in the overall, pooled risk of the banks well doing.

The financial banking system therefore provides benefits to the overall economic system by its transforming and pooling capabilities in both, time scales and risk-levels. Specifically the banking system can deliver the following beneficial functions to the economy:

1. Pooling of capital from lots of small sources in order to be able to fund large scale investments (e.g. infrastructure, real estate, etc.).

2. To enable savers to have a short term deposit (which relies entirely on a mix of pooled debt) while providing borrowers with long-term credit.

3. The capability to provide transformation options for which maturity and liquidity provides the possibility to produce a level of savings which are optimal (and are reflected by the appropriate interest rates), even if not higher, in order to arrive at the required liquidity and transformation level as needed by the real economy. As we shall see later, if this liquidity and transformation level is raised above its "optimal" level (whatever it is) the benefits of a liquid, transformative market will decrease or even become counterproductive first of all to the market itself. The optimal level of maturity transformation rates and liquidity of the market is therefore the level, which reflects best the average of individual capitalist and consumer preferences and thus maximizes capitalist welfare.

As discussed before the transformational functions in risk and maturity are at the core of the financial (banking) system. The securitization of credit is therefore the art of banking, and its complexity, due to reasons laid out in detail in, for example,, David Harvey's "Limit of Capital" and in Robert Brenner's "The economy of global turbulence", has increased over the last 15 to 20 years. In this respect, a higher level of complexity means a finer level of differentiation, of pooling, of transforming time scale differences, and finally of the securitization of the latter both transactions. Securitization of these transormative functions of the financial system can be achieved by the following strategies:

1. Pooling of previously un-pooled mortgage types.

2. Refined transformation of the risk/return characteristics of assets by tranching. Here tranching means taking, e.g. a previously un-transformed mortgage with rating (risk/security level) A and manufacturing by tranching three different types of mortgages out of one: one at risk level AAA, one AA, one BBB, and some equity.

3. Structured investment vehicles (SIVs) are pooling large varieties of different investment obligations, conduits and mutual funds[4], which are then providing the possibilities of ever higher ratios of lending to funding time scales (i.e. long-term lending, by shorter and shorter times of funding obligations through complex pooling of funds).

4. Extensive trading: Providing market liquidity (for benefits see also below), such that the holder of a contractual long-term security may sell this obligation any time, anywhere, and at a reasonably small price spread.

[4]An investment vehicle that issues securities based on pools of mortgages it holds in trust or a proposed fund financed by private banks to support structured investment vehicles.

To summarize, complex securitization of credit is supposed to increase the possibilities by which assets of various kind can be reconstructed, transformed, and in their cost and maturity be tailored to the need of any potential buyer around the world. Before the start of the financial crisis in 2008, the proponents of complex securitization asserted its benefits for the general economical well-being of the capitalist system and by this for the society as such.

As a rule of materialistic thumb, we may claim that the efficiency and sustainability of any of these transformative functions may foster the position of the manufacturing part of our economy; the one which eventually drives the crucial question of everything, the social well-being of everybody, up and down throughout any societies, whos identity are determined by the specter of capitalist value (see "Vom Ende des Kapitalismus..."). The crucial question on the benefits of the current financial system, with respect to the social well being of the overall society, must therefore be posed within the capitalist logic itself and within its reference framework of a direct or indirect cost/benefit balance equation for the manufacturing sector. In contrast, extraordinary benefits to both, the financial system itself (via increased profits within the financial sector or increased fees in the world of funds) or consumer and real-estate cycles, which do not lead to a direct benefit of the manufacturing sector (like increased consumption because of lower prices or ever higher values on real-estate, i.e. re-selling of equity) need to be tagged as counterproductive for the general, capitalist economic well-being.

As a matter of fact, the dramatic increase we see in non-governmental dept to GDP over the last two decades is, however, clearly dominated by the commercial real-estate sector. As a consequence the majority of lending to the corporate sector is explained by lending to commercial real-estate with the manufacturing businesses being only a marginal net borrower from the banking sector, borrowing less today then 1998[5]. Even though the highly charged and adored service sector is indeed a net depositor to the system (for understandable reasons, because of its relatively low investment prerequisites) there is still a huge gap, largely due to the high demands of the real-estate sector, present in the system. For example, the striking features of the UK funding system over the last 45 years are:

1. A significant financial deepening with strong increases in both loans and deposits as a percentage of GDP.

2. A significant increase of indebtness of the household and corporate sector relative to GDP, and thus to any income increase.

3. A significant increase in the amount of securities of leverages, which are backed up by residential housing and real-estate and not by the manufacturing sector.

3 The pros and cons of financialization

We may therefore come to conclude on the advantages and the disadvantages of increased financialization and ever more complex securitization for the overall well-being of not only the global capitalist economy but also the general capitalist welfare in the following way:

Increased liquidity of the market enables consumers to trade at a lower bid-offer spread all over the world, as with respect to closed or highly protected, and highly differentiated market systems.

[5]Here a good example is Solar Millennium. A company that invests heavily in thermal solar power plans in Spain and the US. Solar World is offering interest rates of 8% for private investors when they by a share of their fonds supporting only the companies investment in power plans (no pooling, no tranching, no transformation of time scales). They offer this one-to-one mortgage completely independent of any bank balance sheet or of using the financial system for doing the job and sell it to the interested buyer. So the Solar Millennium financial practice is a good example where all of the original benefits of the bank balance sheet to the manufacturing sector are abandoned

By providing the capability of trading on very different time-scales with shares on goods and equity, on mortgages and leverage which are essentially non-mobile (since their value is fixed in real objects and real estate), the financial system provides the means to measure and compare in one (global) market the value of any asset around the world with the "same" asset at any other place using basically the same tools and applying the same categories on reasonably short time scales. By this, these asset prices (say the price of brick in Argentina and in Russia) get in competition with each other at long-distances but on short time-scales. This finally leads to their value being dragged towards an average market value which holds globally. In effect predictability and consumability of these assets and their values becomes easier for any consumer or trader in the world, i.e. the asset undergos a low bid-offer spread by trading.

Here the obvious downturn is that the system only works in a "fair" way under completely artificial conditions. It is obviously much easier to quake vegetables at comparable quality in the south of Spain than it is in, say, Scandinavia, and so is the price to sustain a living for those who manufacture the goods in both of these places of the world, simply due to climatic conditions. The market force to lower the bid-offer spread is however mostly ignorant with respect to theses subtle differences, since it focuses only at the comparable price of the same goods independent of their manufacturing conditions.

It is indeed true that in a "perfect" trading system, in which only those would be allowed to trade with asset values who have a profound knowledge of the underlying "idealized" manufacturing processes of each individual good they trade, and therefore would be capable to make an educated, realistic estimate of the global mean price of any asset, it is true that in such a perfect world of financialization the benefit of increased liquidity of the markets by trading would be their significantly reduced volatility. That will say that these individual traders would spot any divergences in prices from their realistic, even "fair", mean and would, by their speculation on this out-of-balance situation, drag all the existing individual prices of this asset towards their "rational" mean level.

Such is the basic argument of the conventional wisdom of the last couple of decades that market assumptions are based on rational expectations and therefore lead to efficient and self-equilibrating markets. The basic problem with this maxim of orthodox finance is twofold. First, the larger the growth of the complexity of the assets and systems the financial system has to oversee or is concerned with the less likely that there is a trader around with a profound knowledge of a realistic price of any asset of the market. Second, and this has been put forward first by Keynes, the fetish of ever increasing liquidity of the market (basically trying to make anything what there is as goods and derivatives of goods and trading tradable) is doomed to saturate. This means that there is a limit in liquidity of a market up to which the market may be able to benefit from it. After that, greater liquidity triggers the contrary of what was anticipated: it reduces stability and introduces sustained cycles of over and under valuation, most of which are caused by "behavioral" economics, the human tendency to be swept along with herd psychology.

So from the viewpoint of a functional and sustainable capitalist system, what needs to be concluded? For sure, an ever increasing liquidity of the market, i.e. an ever increasing complexity in the layering, tranching, transforming time scales of financialization, is harmful to the capitalist market and therefore to the capitalist state of affairs, who, as we already know from the legal system point of view, actually is in need of stability in the sense of predictability on a much higher level than is usually anticipated. The key question then for a reformist approach to fix the system is therefore (as has been for Keynes) to find the optimal level of liquidity of the markets such that the financial system is able to really serve the needs of the real economy instead of destroying it.

The problem capitalist reformers like Adair Turner and generally all Keynesian followers face is, however, that the crucial point of beneficial liquidity levels is basically impossible to define with any precision, since it varies with the individual market in many complex ways for which we have highly imperfect instruments to measure their state of affairs. And, like with any other artificial system (or game) humans came up with so far to call their "Wirklichkeit", also the capitalist system of financialization can be deliberately (not only unconsciously) be misused, e.g. by carry-trade activities, riding an obviously unsustainable trend in the hope that you will be clever enough to get out just ahead of the crash. A practice which has been widespread in the onset of the bubbles and bursts we had over the past couple of decades.

Independent of its overall performance with respect to the general well-being of the capitalist system as such and which always needs to be characterized by the manufacturing sector, the spectacle of the financial systems monstrous bubbles and bursts, eras of over confidence and severe depression, may only accelerate its destruction through its inner contradictions. These contradictions are the contradictions of the real economy[6], since financialization, as we have discussed, only provides benefits to a system which functions well on a highly abstract level. In addition, what would be required looking at these inner contradictions in order to fix the capitalist system, is a real transformation of its basic assumptions and its logic driving the real economy[7]. The financial sector, however, like any Keynesian approach, will always be unable to initiate such a transformation without giving birth to something completely different. A side-effect even critical economists like Lord Adair Turner will desperately trying to avoid.

[6] See D. Harveys and R. Brenners, Limits to Capital and The Economy of Global Turbulence.

[7] This is exactly why the manufacturing sector and the conditions it produces for the real state of affairs of the people, needs to remain the main target of anti-capitalist attack, and NOT the financial system.