The power of finance in the age of market based banking

Article  (Accepted Version)

Knafo, Samuel (2022) The power of finance in the age of market based banking. New Political Economy, 27 (1). pp. 33-46. ISSN 1356-3467

This version is available from Sussex Research Online: http://sro.sussex.ac.uk/id/eprint/98471/

This document is made available in accordance with publisher policies and may differ from the published version or from the version of record. If you wish to cite this item you are advised to consult the publisher's version. Please see the URL above for details on accessing the published version.

Copyright and reuse:
Sussex Research Online is a digital repository of the research output of the University.

Copyright and all moral rights to the version of the paper presented here belong to the individual author(s) and/or other copyright owners. To the extent reasonable and practicable, the material made available in SRO has been checked for eligibility before being made available.

Copies of full text items generally can be reproduced, displayed or performed and given to third parties in any format or medium for personal research or study, educational, or not-for-profit purposes without prior permission or charge, provided that the authors, title and full bibliographic details are credited, a hyperlink and/or URL is given for the original metadata page and the content is not changed in any way.

http://sro.sussex.ac.uk
The Power of Finance in the Age of Market Based Banking

Samuel Knafo

This is the pre-proofed version of an article published in New Political Economy: https://www.tandfonline.com/doi/abs/10.1080/13563467.2021.1910646?journalCode=cnpe20

Abstract

It has long been assumed that marketisation would undermine banks, a claim reflected in the common opposition of market and bank-based finance. But as recent research shows, some banks have flourished in the marketized environment of financialisation. I argue the reason they have come to dominate financialisation stems from a revolution in funding that began in the 1960s with the rise of liability management. This practice enabled some banks to dramatically leverage their operations and expand their balance sheet. The new funding practice also impacted the business model of US banks fuelling a move from lending to trading. As I show, this revolution in finance shifted the power away from lenders and towards leveraging financial agents that focused on capturing assets through predatorial strategies.

Keywords

Financialisation; Market Based Banking; Deregulation; Power; Neoliberalism; United States.

Introduction

Financialisation was supposed to usher the death of banking (Mayer, 1984). The marketization of finance, it was assumed, would generate competitive pressures and lead to the eviction of intermediaries because of the extra costs they impose on financing (Zysman, 1983). Yet banks, or at least the biggest banks, have not declined in this age of profound financial transformations. As recently pointed out by Iain Hardie, David Howarth, Sylvia Maxfield and Amy Verdun (2016), a handful of banks now dominate financial markets (see also Tooze, 2018). On the basis of this observation, they make a case for moving beyond the classic categorization of financial systems as being either market or bank based and propose instead the notion of market-based banking. This concept highlights the fact that banks have been empowered by their growing reliance on so-called market-based practices (wholesale funding and originate and distribute practices). Building on this important contribution, the literature on financialisation now commonly points to the marketization of banking, a term meant to indicate a new emphasis on trading (or dealing) on financial markets instead of the traditional emphasis on lending (Gowan 2009).

While this reconceptualization has helped identify a defining trend of financialisation, it has left us with the difficult task of making sense of what would have seemed, not long ago, as a counterintuitive claim. Scholars and politicians long believed that banks would be the big losers of financialisation and the early stages of this process seemed to confirm their fears. The 1980s were indeed marked by the culmination of disastrous trends for the US banking sector. A broad process of disintermediation witnessed corporations taking their deposits out of banks in order to manage their cash reserves themselves. As corporations became adept at circumventing banks or pitting them against one another to reduce fees, banks ‘lost and had no way to regain much of what had been their best business’ (Mayer 1984: 26). The rise of money market funds also undermined banks by diverting further deposits away from these institutions. Finally, the Volcker shock of 1979 increased interest rates in dramatic fashion and put great pressure on financial agents with fixed long-term commitments they now
needed to finance with costly short-term liabilities. The result was disastrous for banks: bankruptcy levels soared dramatically during this decade with profits margins being crushed for large portions of the banking sector. Return on equity reached a low point for the sector halfway through the 1980s; a decade in which 1037 commercial banks failed (Rogers, 1993: 15). Taking stock of these disastrous developments, Gerald Corrigan, then head of the New York Federal Reserve Board, observed in 1992 that: ‘the decade of the 1980s was surely the most difficult interval faced by the U.S. banking system since the 1930s’ (citied in Gorton and Rosen, 1995: 1377). A few years later, the eminent financial historian Ron Chernow would conclude that the ‘salient fact of 20th finance is the erosion of banker power’ (Chernow, 1997: 5).

These difficulties of the US banking sector have too often been brushed off in accounts of financialisation that highlight the ability of finance to create a favourable environment through deregulation. A few success stories are then taken by scholars as representative for the sector as a whole. It has not helped that the literature works mostly from structural perspectives that focus on aggregates, or data about the economy as a whole, but downplay in the process the uneven nature of this process within the financial sector. Yet the fact that some banks did well despite the general difficulties of the sector suggests a different line of enquiry.

I argue that the struggles of this banking sector, partly born out of a heavily regulated financial environment, are the key to explain why financialisation emerged in the US. These regulations first limited the power of lenders towards corporations (Roe, 1994) and made it easier for the latter to raise money with few strings attached (Knafo & Dutta, 2020). The same weakness, I argue, would open the door for some banks, and other agents (e.g. private equity firms or hedge funds), to take advantages of other banks or financial actors (pension funds and mutual funds) hamstrung by this same regulatory environment. The outcome was a revolution in funding brought about by a new practice called liability management (LM). It was aimed at finding ways to raise financial resources on money markets, rather than through deposits. Instead of relying directly on depositors (individuals or corporations) financiers began to systematically raise funds from other financial intermediaries, using money markets to dramatically leverage their operations. LM thus allowed some banks to exploit the vulnerabilities of the rest of the financial system. As I show, the ability of these banks to mobilize the capital accumulated by others with few strings attached provided them with unparalleled freedom to take, what often turned out to be predatory, positions on financial markets. It played a decisive role in the shift towards proprietary trading that came to characterize US banking under financialisation.

By examining this revolution in funding, this article reflects more generally on the ways in which we conceptualise power under financialization. I proceed in four steps. First, I examine the literature on bank power to show how it struggles to make sense of the rise of banks in the era of financialisation. I argue that the problem lies with a traditional conception of the power of finance (or banks) that is based on the functional role of financiers as creditors. What is essentially an old critique of usury, which focuses on how creditors exploit the vulnerabilities of others by asking for more than their dues, has thus continued to shape how we think of the power of finance (e.g. Lazzarato, 2011). However, this ‘rentier’ conception of finance is no longer adequate for understanding financialisation. In an era that is no longer defined by the scarcity of financial means, power no longer rests in the hands of creditors. As I argue, it has now shifted to borrowers who are able to dramatically leverage their strategies to fund what are often short term predatory strategies.¹

In the second section, I take a historical perspective to understand how US finance got to this point. I argue that banks, insurance firms and institutional funds in the US were ‘pacified’ in matters of corporate financing through a series of regulations that limited their ability to turn their capital into a power to command the economy. This opened the doors for US corporations to rely actively on financial markets with few strings attached and contributed to what became the financialization of the firm (Knafo and Dutta, 2020).

---

¹ While it would be an exaggeration to say that borrowers in general have been empowered by financialisation, and this is certainly not the case for most households (but see Schularick et al 2019), it is clear that in the corporate world those who can leverage in effective ways have been able to use their new found flexibility to great effects. Sgambati (2019) proposes a useful distinction to help us here between debt and leverage. The former refers to borrowing in order to settle obligations or make payments, while leverage refers to borrowing in order to invest in further assets to make a profit (leverage). In that respect, I speak of the power of borrowers to refer to leveraging.
The third section examines how some banks began to follow a similar path to the one pioneered by US corporations through the practice of LM. The same constraints that made it easy for corporations to borrow from finance, also made it interesting for banks to re-centre their operations around the money market and borrow from other financial agents instead of relying on deposits. The last section examines some ramifications of this turn to LM and how it radically transformed the business model of banks. I argue that this turn to trading was directly connected to the adoption and generalization of LM. By showing how changes on the liability side of the balance sheet impacted on the asset side of the balance sheet, I explain what enabled some banks to navigate the treacherous waters of financialisation and empower themselves in an environment that seemed initially ill suited for banks.

1. Why is the Power of Finance Difficult to Conceptualise under Financialisation?

Scholars have commonly assumed that financial systems were either bank or market based (Gerschenkron 1962; Zysman 1983). The reason for this stemmed from a difficult trade off: banks may have more knowledge to coordinate effectively the flow of capital, but having an intermediary who needs to be paid makes this form of financing more expensive. This extra cost, it was assumed, would make it difficult for banks to navigate highly marketized environment where offering a cheaper price becomes more significant. With market pressures intensifying banks would struggle to justify their place.

This explains why, by the early 1980s, it was often assumed that marketisation would undermine the power of banks and confine them to smaller niches in a broader constellation of financial activities (Zysman 1983). Such an assumption seemed largely in keeping with the widely held belief that markets, as decentralised arenas, are less prone to strong hierarchies and stable power relations (Cerny 1990). John Zysman (1983) thus lamented the limited power of US banks over corporate managers and argued that this had resulted in a limited ability for banks to direct economic development and discipline corporate managers. This weakness of banks, he thought, meant that there was no direction given to an increasingly atomised and ‘disorganised’ US economy that was already perceived as being reliant on a market based financial system.

What has transpired since the early 1980s, however, largely contradicted these assumptions about market-based finance. Far from fragmenting the financial system and reducing the profits of banks, or at least the profits of the biggest banks, financialisation seems to have produced the exact opposite. As some banks began to rise in size and power, the long-standing opposition between market based and bank based finance increasingly looked problematic (Konings 2007). Confronted with the awkward evidence about the growth of top banks and the centralisation of financial markets, Hardie and al. took the initiative to propose a third characterisation (market based banking) to capture what seemed from their perspective as a hybrid form of finance combining big banks with ‘market’ based practices. This new concept, they argued, was necessitated by the fact that even if classic forms of lending through intermediation had given way to arms-length practices based on market mechanisms, this had not diminished the importance of banks in the economy. It proved to be a timely intervention as reflected in the way in which the concept of market-based banking has since been widely taken up in debates about financialisation (Braun, Gabor and Hübner, 2018, Birk & Thiemann 2019; Walter and Wannsleben 2020).

While we may applaud Hardie et al.’s initiatives to reset the traditional conceptual apparatus and re-align it with the evidence about banks, one may wonder whether the concept really solves the problems that beset the traditional typology (Beck, 2019). For combining two things we previously assumed to be opposed (banks and financial markets) essentially restates the puzzle. Why would banks become more important in such a market-based system?

Part of the problem is that Hardie et al. never really come to terms with the issue of bank power. If anything, they largely seem to accept Zysman’s proposition that market dynamics undermine the power of banks. As Mareike Beck points out, they make what appears to be a contradictory observation when they write that banks are growing in importance yet apparently losing in power (Beck, 2019). According to Hardie et al., the growing dependency of banks on markets has meant that they have lost the ability to serve as buffers to cushion their clients from market pressures in the way banks
traditionally could under bank-based finance. As a result, the growing importance of banks has not translated in an ability to exert control in this market environment. On the contrary, the ‘financial power to resist market pressures … has increasingly disappeared’ (Hardie and Howarth, 2013: 24).

With power out of the equation, however, we are left with a puzzling fact: If there is growing competitive or market pressures on financial markets, why are some banks to making great profits? This fact has fueled a different line of argumentation that goes against Hardie et al.. Indeed, a number of scholars emphasise that dominant banks have not in fact been subjected to growing market pressures (Crotty, 2007; Gowan 2009; Lapavitsas). Instead, these authors argue that the centralization of banking has created new cartels that allow some banks to escape market pressures and increase their profits. From this perspective, the growing competition in market based finance would be a myth, or at least a short-lived aspect of financialisation. While it could account for the difficult time experienced by banks in the 1980s, the outcome of competition would then be an increasingly centralized banking sector. With bank deregulation, the financial system would have been rationalized and consolidated leading to higher profits for those banks remaining. It would have enabled a return to a rentier logic according to which finance can ask for more than its due (see for example, Seabrooke, 2001; Lapavitsas 2013). In the words of Tomaskovic-Devey and Lin, this decline in competition has given banks the ‘ability to collect economic rents’—defined as “income above what would be realised in a perfectly competitive market”—“from society overall” (2011: 541–549).

This line of argumentation has been more recently developed by Brett Christophers who also sees the high profit rate of the financial sector as a product of a concentration in banking that enables monopoly rent. Christophers charts competitiveness by examining the levels of concentration in the financial sector. He cites waves of mergers that witnessed the four biggest banks increasing their market shares from about 20% in the late 1990s to over 50% in 2013. As he points out, the various cases of collusion which have come out in recent years (notably around LIBOR), demonstrate the level of manipulation of financial markets by these dominant banks. It set the stage for a new rentier logic.

While there is something appealing in thinking about bank power as a form of control that stems from growing market shares, it does pose problems from a historical standpoint. For what appears to be a strength and a source of power, reflected in the high profits of some banks, has often morphed into significant weaknesses. Christophers says little, for example, about the fact that the era of financialisation has witnessed a very high rate of bankruptcies among banks. 2700 banks failed during the period of 1984 to 2003, a striking number considering that bankruptcies had barely reached double digits in the decades leading to 1979 (Crotty, 2007: 8). This speaks certainly to the uneven impact of financialisation on different types of banks, as Christophers would surely acknowledge. But then why were only a few banks able to expand profits when the sector as a whole seemed to struggle? By focusing on market shares, Christophers relies on a circular form of reasoning because an outcome of financialisation is here turned into an explanation. That some banks were able to increase their profits does not explain why. It is also difficult for Christophers to account for the fact that banks which made high profits, presumably because of their greater market shares, can also be the ones that fall at the next hurdle. For example, Drexel Burnham and Lambert, Salomon Brothers and Bankers Trust all lead the wave of financialisation in the 1980s yet collapsed or were absorbed by other banks in the following decade. Similarly, Lehman Brothers, Merrill Lynch and Bear Sterns also collapsed after successful runs during the subprime bubble. Looking at the track record of banks, there is a vulnerability associated with the power of banks under financialisation that is not well-captured by the concept of monopoly power.

As I show below, coming to terms with the growing power of banks under financialisation requires a more profound change in the conceptual framework we use. For recent financial developments challenge traditional conceptions of bank power that rely on the role of financiers as creditors or lenders. Yet this emphasis no longer fits a world in which capital is, as Chernow points out,

---

2 An early contribution along those lines was made by James Crotty. Writing in 2007, he accepted that the globalization of banking had intensified competition, but believed that various forces were mitigating these competitive pressures. Four factors in particular, he argued, allowed banks to maintain healthy margins in a context of financialisation: the rise in demand for financial products and services which countered the pressure on the supply side, the rise of wholesale financial markets, the increased risk and leveraging that compensated for lower profit rates in the economy and the shift towards OTC that are less regulated and thus competitive.
‘no longer a scarce resources’ but a banal commodity (Chernow, 1997: 5). The dramatic increase over the past decades in the supply of financing, or investables (Lysandrou, 2011), has considerably limited the ability of lenders to use lending as a means to exert power and impose harsh conditions on corporate borrowers. This fact seems to be borne out by the secular decrease in interest rates, but also by the fact that this loosening has allowed agents previously shunned by the financial establishment to get funding (e.g. junk bond financing). Indebtness is thus increasing across the board with no apparent end to the process. It is then difficult to characterise the power of banks by reference to the power that lenders exert when many of the effects we usually associate with a dominant position for suppliers (rising costs to borrow, narrowing the access to capital to the best borrower, etc) seem to be dissipating, at least when considered from the historical standards of financial practices.

It is another telling fact that financialization has witnessed a tremendous leveraging of the financial sector. The latter has turned into a huge consumer of financial resources and now represents the most indebted sector of the economy. Bellamy Foster and Magdoff point out (2005: 48) that it accounted for only 10% of all US debt in 1975, far behind government, corporate or household debt, but this increased to about a third of all US debt by 2005. This suggests, as I will argue, that the power of banks (and other financial agents) has come to rely increasingly on their ability to position themselves on the other side of the equation. It is no longer their power as lender that matters most but the one they derive from borrowing. In a financial world increasingly defined by leverage, the ability to raise capital and use it to take positions on capital markets has become much more decisive than the ability to lend capital to others.

Building on this point, the rest of this article emphasizes two aspects of this power equation regarding banks and their leveraging strategies. First, I highlight the importance of financial practices. For the question of power is not simply an economic relationship that pertains to the supply and demand of credit or to the distribution of market shares. It depends on the capacities that financial agents can deploy through the technologies they use, and more generally their practices. The importance of leveraging. I will argue stems from key innovations that have made it possible for US banks to do something no other banks had done before them. More specifically, I argue that a revolution in the way banks fund themselves, with the rise of LM in the 1960s, rapidly transformed the nature of banking and created new opportunities for bank empowerment that would become the defining feature of financialisation.4

Secondly, I highlight that the significance of the rise of LM can only be understood if we replace it in the context of power relations within the financial system. These internal dynamics are too often lost from sight in studies of financialization that frame the power of banks as a matter pertaining to the relationship between finance and the rest of society. Instead, I show that the rise to power of dominant banks has become predicated on their ability to take advantage of other financiers. As I show in the following section, this power was directly tied to regulatory constraints. Contrary to the classic story of deregulation, it was the ability of banks to take advantage of regulatory constraints that apply to creditors which opened the door for them to borrow from other financial intermediaries with very few strings attached. This will lead me to argue that it is in fact the weakness of US finance in corporate matters that accounts for the dramatic explosion of financialisation in the 1980s.

2. Why is Financialisation a US Story?

Financialisation emerged out of a long history of regulation in the US that created significant limitations for the way American financial agents could translate their control over capital into an ability

---

3 Starting with my first point about practices, I build here on the work of Stefano Sgambati to argue that we should conceive of the power of banks fundamentally as a matter of leverage, that is the ability of banks to do more with what they had. In an innovative series of articles, Sgambati (2016; 2019) argues that the ability of banks to exert power does not come from their role in channelling resources of the community towards profitable uses, but more fundamentally from their ability to issue debt use loans as a means to leverage their activities.

4 While banks usually operate as both borrowers and lenders on the money markets, the dynamics of empowerment in today’s financial markets are increasingly predicated on the process of leveraging rather than lending. The big sources of profits for banks through the years have not come from their role as market makers and liquidity providers.
to command the economy. This regulatory infrastructure goes back to a long tradition in the 19th century of populist attacks on finance. Mark Roe and Martijn Konings have each showed in their respective work how these motivated US regulators to systematically reduce the power of financial actors (Roe 1994; Konings 2011). The main target for these regulations were initially the banks. Populist movements were keen to stop resources in capital from flowing towards big economic centres, such as New York, depriving regions of much needed loans, notably for farmers. The Second National Bank Act adopted in 1864 blocked branch banking. Regulators also prevented banks from discounting bills; a practice which was assumed to divert money towards commerce, which would otherwise finance agriculture (Konings, 2011). Further regulations prohibited banks from holding industrial assets and put a limit on the size of the loans that banks could make to corporations (no more than 10% of a bank’s capital to a same borrower). Limitations on banks were further expanded following the crash of 1929 and the ensuing banking crisis. The adoption of the Banking Acts of the 1930s separated retail from investment banking by prohibiting commercial banks from being able to underwrite securities and playing a role on capital markets, thus considerably reducing the influence banks could exert on corporations (Calomiris & Ramirez, 1996: 156). It also placed limits on the ability of banks to compete for funds by putting a ceiling on the interest rates they could offer.

Banks were not the only agents to be singled out by measures designed to limit the ability of holders of capital to command the economy. As new financial intermediaries emerged, they became themselves the target of regulations. By the early 20th century, insurance firms were gradually taking over as the largest financial institutions. The biggest New York insurer, for example, was twice as large as the largest bank (Roe 1994). Flushed with resources, insurance firms moved onto the turf of bankers to capitalise on their advantage, not being subjected to the same constraints. They started underwriting securities, accumulated bank stocks to control large banks, and became increasingly active as investors.

This provoked a strong counter reaction, notably from banks. Bankers lobbied to place limits on their rivals with some warning that the insurance sector would own a large share of the economy if nothing changed. Following a scandal in 1905 related to the misappropriation of funds by insurance companies, regulators responded by imposing constraints on the insurance sector. The Armstrong report of 1906 put forward a series of regulatory proposals which were then adopted to block insurers from owning stocks, controlling banks and underwriting securities (O’Sullivan 2016). It forced insurance firms to shift their operations. Now unable to exert power as stockholders in the boardrooms of large corporations, insurers targeted bonds, and became big players on the placement market (the informal corporate bond market) (Roe, 1994: 123). When insurers were later allowed back onto the stock market, it was only with severe restrictions on how much of a firm’s stock they could owned.

Similar constraints were placed on institutional funds from the 1930s onwards. Just like insurers, these funds had begun playing an active role being involved in underwriting securities, bankruptcies and management. Yet here again new laws adopted in the late 1930s put an end to this involvement. The newly created SEC, in particular, was keen to push these institutional funds off any managerial role by stopping the directors and employees of funds to sit on the boards of the firms they invested in. Restrictions were placed on the portion of their portfolio that could be dedicated to the stock of a single firm (no more than 5%) and the amount of a firm’s stock that could be owned by a single fund (no more than 10%) (Fink, 2008). As Roe (1994) points out, this was usually justified on the grounds of ensuring diversification in the funds to manage risk, but it was clearly motivated by a desire to disable any potential control which could be exerted by mutual and pension funds.

Working in this environment, insurance firms and institutional funds often found it necessary to commit explicitly to a passive strategy of investment for fear of prompting further regulations against them. They became wary of interfering too strongly in the business of corporations to which they lent money. The Armstrong report, mentioned above, became an important standard later invoked by insurance companies to reaffirm their passive approach of investment. It would set guidelines for what became a dominant idea in the post war era: institutional investors should sell their stock when unhappy with management, instead of moving towards more active forms of pressures. Before the late 1980s when shareholder activism became more significant, this regulatory structure produced a relatively passive financial sector especially when it came to corporate governance.\(^5\)

---

\(^5\) The rise of shareholder activism in the late 1980s somewhat changed the dynamic, although not as much as often believed (see Knafo and Dutta, 2020). It is important to point out that it was the corporate raiders (i.e. other
Scholars have traditionally seen these regulatory constraints as spurring innovations to evade regulations. I argue however that more important here is the fact that these regulations radically changed the dynamic between borrowers and creditors. Most notably, they made it easier for some agents to raise substantial sums from what were relatively passive financiers. The first to take advantage of the limitations placed on finance, were unsurprisingly the corporations. Indeed, the distinct trajectory of corporate governance in the US was largely predicated on the regulatory environment that empowered corporations in their negotiations with financiers. With limited financial oversight and the inability of financiers to be actively involved in boardrooms, corporations were able to raise money with limited strings attached. It emboldened some firms to rely extensively on financing in order to amass vast resources in capital and launch mergers and acquisitions that would have previously seemed beyond their means.

Already in the 1920s, corporations raised significant amounts of capital from the stockmarket without fear of losing control in what came to be read as the separation of ownership from management. The further constraints imposed on banks in the 1930s only hastened this dynamic. It led to the process of disintermediation in the 1950s that saw corporations develop financial capacities to tap directly money and capital markets without having to rely on commercial banks for loans or on dominant investment banks for underwriting their securities (Konings 2011). The culmination of this process was the early financialisation of the firm in the 1960s when conglomerates developed financialised strategies to raise capital on financial markets that could be used to buy other corporations (Knafo and Dutta, 2020). By that point, the market for commercial paper became very active with large sums of money being raised by corporations. Some learned to dramatically leverage their operations leading to what Sahil J. Dutta and I have labelled financialised management (Knafo and Dutta, 2016).

This early regulatory history thus suggests that contrary to what we may assume, it was in fact the structural weakness of US finance that would be decisive to the rise of financialisation. The classic story of deregulation too often places the emphasis on the permissive economic environment fostered by powerful financiers able to do whatever they wanted. Yet this misses the point that US regulations posed significant problems for financiers in the early stages of financialisation and created new opportunities in the process for those looking for financing.

In the next section, I argue that financialisation was largely predicated on banks essentially following a similar path as the one taken by corporations: they began exploiting the vulnerabilities of the financial system to leverage their strategies on the back of other financial intermediaries hamstrung by regulators. Financialisation was thus foremost a revolution in the way financial institutions fund themselves, rather than a speculative turn in the way they invest.

3. The Rise of Liability Management and the Leveraging of Finance

The liability side of banking activities has largely been neglected in discussions of financialisation that commonly focus on the asset side or the speculative investments of banks.6 In this section, I make the case for conceiving financialisation as the product of a revolution in the practice of funding. This transformation, I argue, came with the development of liability management, a revolution in the strategy of funding that was developed by some commercial banks from the late 1950s onwards. It represented a shift away from the traditional reliance on deposits as the main source of funds. Instead, banks developed different tools to borrow capital from money markets. Essentially, these markets became a channel for banks to borrow from other financial intermediaries to get the funds they needed instead relying on depositors.

Liability management stemmed from a series of banking experiments to open up the liability side of the balance sheet. Historically, banks were relatively conservative when it came to liabilities

---

6 Endogenous theories of credit, which highlight the ease with which banks can create money, have only reinforced a tendency in the literature to neglect the question of funding, or treat it as secondary matter for understanding the dynamics of finance. Although recent literature influenced by the money view and the work of Perry Mehrling has brought liabilities back into focus (Mehrling, 2010, Tooze, 2018), funding is still mostly discussed as a function of risk taking by banks, rather than as a capacity in its own right.
(Hotson, 2017). Their energy was focused on the asset side of the balance sheet with the assumption that investment strategies were the main determinant for the profits of an institution. More importantly, a stable source of liabilities was seen to be key to help banks leverage. For a bank to take risks and commit to an investment strategy, it needed to feel confident about its liabilities (e.g. that it would not suddenly lose its deposits). As a result, decisive innovations in the history of banking were often tied to creating new ways to secure the liability side (Knafo, 2013; Sgambati, 2016). In that respect, banks were more concerned with stabilising their liabilities than actively managing them.

This concern contributed directly to the rise of deposit banking since the late 19th century. Accumulating the deposits from clients, who were generally reluctant to move their accounts from one bank to another, seemed an effective way to shore up the finances of a bank. Deposit banking promised a large and stable source of assets that could turn the liability side of the balance sheet into a relatively fixed variable.

The tight regulatory apparatus imposed on US banks, however, created various problems for deposit banking and forced commercial banks to rethink the liability side of their operations. The biggest problem was that Regulation Q. hampered the ability of commercial banks to offer competitive rates on deposits. As a result, different actors took their deposits out of banks to invest them on money markets in what came to be interpreted as a process of disintermediation (Seabrooke, 2001; Konings, 2011). It resulted in a funding gap that forced some commercial banks in the late 1950s and early 1960s to look to money markets for funding instead of traditional deposit banking (Vielma et al., 2019).

The turn to LM is commonly traced back to the decision of the First National City Bank to issue Certificates of Deposits (CD) in the early 1960s to address this shortfall in funding (Nadler, 1979). These certificates of deposits represented a short-term promise to repay a given sum at a certain date. They were attractive because banks could use them to offer higher rates than what they could offer on normal deposits. Since these CDs were designed for corporate clients and high wealth individuals (being of high denominations), the Fed accommodated this development to allow banks to recapture the funds previously lost through disintermediation. It was believed initially that this would not affect the rest of the banking sector.

What started as an emergency expedient to recoup lost funds, however, soon turned into a systematic strategy to raise funds and fuel bank growth. By raising funds on the money market, banks could greatly expand their assets and dynamically adjust their funding to their needs. Owing to the new possibilities of LM, most of the main commercial banks quickly followed suit as banks multiplied the tools they could use to raise money on money markets (Fed funds, CDs, commercial paper and repo borrowing) (Baker, 1978). Particularly important in this regards was the rise of Euromarkets which became a platform for US banks to deploy liability management and raise funds (most notably because there was no limit on the interest they could offer). This new focus on funding helped US banks stand out on Euromarkets (Dutta 2019; Beck 2019), as reflected in this quote from a US banker from Morgan Guarantee: ‘we spend all our time looking for deposits, the British banks are out looking for loans’ (cited in Mayer 1974: 466).

While scholars tend to focus on the ability of finance to escape regulation (Veilma et al, 2019), it is important to emphasize that the success of liability management was directly predicated on the ability of banks using LM to exploit regulatory constraints that affected others in order to gain traction with their money market instruments. The systematic borrowing from other financial agents would have been unthinkable for banks in an era where lending was a big a source of power. It would have meant risking subjecting themselves to the dictates of lenders and was usually seen as a sign of weakness.

Factoring regulation in this way helps us bring into focus the politics of finance. The 1970s were defined by a struggle opposing the dominant commercial banks to the rest of the banking sector, as the former took advantage of constraints imposed on deposit banking in order to channel resources onto the money markets for their own use. Harry Keefe, an important bank stock dealer at the time, captured this disparity when saying that ‘of the fourteenth thousand chief executives of banks, maybe forty really know what’s going on” (cited by Mayer 1974: 45). The dominant commercial banks were joined by other financial institutions (notably investment banks) in the 1970s working to craft new money market instruments, such as NOW accounts and repo lending.. Agents committed to LM thus explored various ways to impart ‘deposit’ features to assets (i.e. making them secure and liquid so that they could be cashed in when needed) as a means to exploit the cash management imperatives of others to fund their own operations. These developments illustrate how financialisation was initially driven by
the attempts to capture funds. In the process, commercial banks were deliberate in their attempt to target the funds of others and to exploit discrepancies in regulations. It led to the dramatic development of the money markets, most notably with the rise of money market fund, which allowed smaller depositors to invest in high denominations CD or Treasury bills by pooling their resources.

The rise of LM and the growing reliance of big commercial banks on money markets to fund their financial activities shows that the dramatic leveraging under financialisation was not simply a sign of the growing risks taken by banks. It reflected their growing capacities. However, LM was an expensive strategy because it was initially a means for banks to offer better rates to investors. The result was that funding became increasingly costly as banks competed over funds through LM. This was reflected in the steep rise of interest rates from the early 1960s until the early 1980s (Kaufman, 1986). Furthermore, LM was a risky strategy because it meant dealing primarily with financial intermediaries who, as financial specialists, knew more about finance than the usual corporation or individual. For this reason, they tended to quickly shift their money around looking for better deals. As I show in the next section, the costs and volatility of LM forced profound adjustments in the business model of banks. As banking crises mounted in the 1970s and 1980s, it became necessary to re-align the asset side with the liability side.

4. The Turn to Proprietary Trading

The iconic feature of financialisation is the turn of banks towards proprietary trading which began in the 1980s. Proprietary trading refers to the growing tendency of banks to invest on their own account instead of doing so for their clients. It has often been seen as a manifestation of the era of ‘greed is good’ with banks regularly exploiting the vulnerabilities of others as reflected in the numerous scandals that plagued the sector. From this perspective, proprietary trading would be the product of a licentious culture promoted by deregulation that encouraged bankers to become manipulative and self-serving. By contrast, I argue that the turn to proprietary trading was directly connected to the previous shift to LM. More specifically, I argue that many of the outcomes associated with proprietary trading (the dramatic explosion of the balance sheet of banks in the 1980s, the new patterns of originate and distribute, the move towards risky loans such as junk bonds and later subprime lending; the predatory strategies that became characteristic of this period) were all related to the way LM impacted banks and pushed them towards trading.

To grasp this connection, it is important to understand the distinct imperatives and opportunities that were associated with LM as a mode of funding. Previously, banks had operated in an environment where interest rates remained relatively stable. This made it easy to secure the spread between the rates they paid on deposits and the rates they received on the loans they made. Banks could then be confident that their income would cover their costs. With interest rates mostly fixed, banking decisions were straightforward and driven by a simple calculus with few trade-offs. As the stereotype goes, the post-war period was the era of 3-6-3 banking: bankers took deposits in at 3% and finished working at 3pm because the job was quickly done (Nesvetailova, 2018).

LM profoundly transformed this banking model. As I mentioned, it emerged in the 1960s as an attractive option for banks to fund expansions, notably into consumer lending. By making it possible to easily increase the amount of funds at their disposal, LM initially enabled banks to dramatically increase their investments. It was (wrongly) experienced as a liberation of the asset side of the balance sheet from funding concerns, fuelling a rapid expansion of balance sheets (Mayer 1984: 194). However, growing competition over funds in the money markets combined with inflation fuelled the rising costs of funds (Kaufman 1986). With interest rates climbing steadily throughout the 1970s, banks experienced a painful reality check as their profit margins were crushed. Rising rates not only impacted the cost of funding for banks, but it also affected the ability of their clients to service their debt. Loans to states, large investments in consumer lending/mortgages, as well as lending to middle and small firms all underperformed to put further pressure on banks. The collapse of a few banks in the early 1970s thus foreshadowed a mounting crisis that would hit the sector in the 1980s.

In response to these new pressures, commercial banks were forced to make various innovations to re-align the asset side of their balance sheet so that investment strategies would be more in tune with the new constraints of liability management. The outcome of this realignment was a new trader’s perspective on banking that emphasised buying and selling assets on financial markets instead of
lending and cultivating client relationships. What had previously been relegated to a secondary status as a risky business with thin profits margins would now become the bottom line for a new business model based on managing new forms of risks.

Liability management was, by definition, a trader’s activity. It required savvy bets on the direction of interest rates and active management of the opportunity costs of using different ways to raise money from money markets. Depending on the predicted trajectory of interest rates, it would make sense to either reduce or extend the terms of funding or to look for different types of instruments to raise these funds. Locking in funding early before a predicted increase in interest rates, for example, would later make the liabilities more valuable. By putting the onus on liabilities as a source of profit, one was thus necessarily getting involved in a bet on the future of money markets and the divergent trajectories of different instruments/money markets. The upshot of this turn to LM was to encourage a shift to trading. If funding was based on a trader’s framework, the asset side needed to be realigned with this approach. Assets, and more specifically loans, would also have to track the market.

One of the concrete ways in which this was played out was through the rise of new risk management systems, such as RAROC, that favoured a mark to market approach of the asset side. RAROC was initially pioneered at Banker’s Trust to deal with its new funding strategies. It was then gradually imposed on the lending operations of the bank despite strong internal opposition in order to facilitate a more integrated form of management of the bank (Guill, 2009). It proved a key turning point. Revaluing loans according to what they could fetch on the market and the cost of financing them cast many of these loans under a bad light. It highlighted the costs and vulnerabilities associated with funding a bulging balance sheet through LM. Partly as a result of this, banks started systematically selling loans and developing originate and distribute practices, with Banker’s Trust, once more, leading the way with great success in terms of profitability (Loomis, 1992).

The managerial incentives for this realignment of the asset side were further reinforced by the striking gains of banks which first committed to trading. In particular, LM played a vital role in facilitating the predatory capture of assets from household, corporations or weaker financial agents. The funding flexibility it provided was decisive for the dramatic rise of corporate raiders using junk bonds in the 1980s, to the purging of Savings and Loans banks and, later, to the turn to subprime lending and the equity stripping of households. These developments all illustrate how LM dramatically shifted the power of financiers favouring dynamic forms of leveraging that supported short term, and often predatory, forms of trading. While exploring the nature of this connection would require more space that I have here, it suggests that there is more scope than often realised to examine how banking innovations were connected to a broader paradigmatic shift in banking practices, rather than being the product of linear evolution in practices brought about by financial deregulation.

**Conclusion: Financialisation and The Cannibalisation of Finance**

I argued that our difficulties in accounting for the curious rise of giant banking consortiums in what many have called the age of market-based banking stems from the ways in which we often think about finance through concepts such as the market or marketisation (Knafo 2020). Proponents of the concept of market-based banking point to the growing reliance of banks on wholesale funding and securities trading to highlight that banks are increasingly subjected to market pressures. But while the reliance on wholesale funding has created new imperatives for banks, the situation can look quite different when examining capital markets. There, fragmentation with the explosion of over-the-counter trading has meant that banks have increasingly taken their trading ‘in house.’ In the process, dominant banks have undermined public markets, such as the New York Stock Exchange (Sgambati 2019; Mattli, 2019; Sissoko 2017). Far from bringing greater transparency and competition to financial markets, these developments (along with the multiplication of opaque derivatives and securitisation streams) have multiplied the opportunities for banks to take advantage of counterparties. The result has been a systematic trend towards malpractice (Partnoy, 2003; Macartney 2019) as banks focus on buying cheap and selling dear rather than simply taking commissions or basic fees.

Some have concluded from these developments that financialisation undermined financial markets with banks increasingly controlling monopoly positions (Christophers, 2008; Gowan, 2009; Mattli, 2019; Lapavitsas, 2013). Yet inverting our take on marketisation fails to solve the problem. For
while these authors may be right to point to the fact that banks have exerted greater control over trading because of the sheer volume of business they handle, they partly misunderstand what is the source of this power. It is not the lack of competition, but more fundamentally a transformation in the nature of trading, following the rise of LM, that is at stake. This explains why some banks did well while much of the sector suffered. For the emphasis on trading has put great emphasis on the ability of some financiers to capture the cheap assets of others which they can then recycle. From Salomon Brothers’ carving out of the Saving and Loans sector in the early 1980s (Lewis, 1989), to the one-sided swaps that Bankers Trust or Morgan Stanley set up with various corporate, public treasuries, and Japanese banks (Partnoy 1999) to the dubious Abacus deals of Goldman Sachs with smaller German banks, LM has made it possible to magnify the rewards of predatorial strategies. In all these cases, the problem was not that some banks imposed high costs on their counterparties because of their control of market shares, but on the contrary that they could pounce on cheap assets which they would often repackage to make them look more attractive than they really were.

This highlights why it is important not to conflate trading with marketisation or to analyse the former from the perspective of the latter. Financialisation first took place in the US; a country where monopoly positions were harder to achieve than in other countries dominated by universal banks. It suggests that what is at stake is not the market shares of banks, but their financial practices and the regulatory environment that gave traction to these practices. In a leveraged world, it is difficult to stop bigger financial agents from mediating the process of financing and taking control, because there fewer are financial limitations on the assets these banks can capture and control.

However, financialisation is a game of high stakes for banks leveraging through LM to expand their balance sheets and feed trading strategies. Those that seem to be leading the race can fall at the next hurdle. Such a cyclical movement still does not undermine financialisation. On the contrary, the recurrent financial crises we witnessed have instead fuelled it. They account for much of the great profit booms in banking over the past four decades. Indeed, dominant banks, and other leveraging agents, profit greatly from the aftermath of financial crises, not necessarily because their market shares have increased with the collapse of some banks, but more importantly from their ability to carve out the remains of those that have failed and pounce on assets whose value have been deflated by the crisis. In that respect, finance has become increasingly cyclical as sabotage became the name of the game (Nesvetailova and Palan 2020).

Acknowledgements

I would like to thank Mareike Beck, Sahil J. Dutta, Michael Hamilton, Erin Lockwood, Nils Peters and Stefano Sgambati for their comments and helpful suggestions.

Bibliography


