Preface

As punishment for his misdeeds, the gods condemned Sisyphus to spend eternity pushing a boulder up a mountain, only to have it roll down each day. He renewed his efforts each morning, though his task would never end. Like Sisyphus, banks also labor under an unending ritual, repeated each day, and central to the bank's existence. Instead of pushing a boulder up a hill, banks toil to finance and refund their activities, also starting their labors de novo each day.

In this book, a *bank* is a financial institution that accepts customer deposits insured by a public authority, leverages these deposits with debt and equity, and then uses the funds to make loans and to invest in other financial assets. This definition builds on the bank's most distinctive liability – insured demand deposits.

Thinking about how the bank gets its funds rather than how it uses them may seem odd because observers generally see the bank as a lender. Small wonder that public debates about banking revolve around lending practices, the subprime debate being a recent example. As a result, most measures of banking focus on their assets and income. In this view, a bank's loans and mortgages – on the left side of the balance sheet – define the bank.

This book reverses the above perspective and, instead focuses on funding, the right side of the bank's balance sheet. Understood by a small number of bankers, regulators, and academics, bank funding has received relatively little scholarly attention. To respond to this gap, I present the bank as a specialist in seeking funds, best understood in terms of how intermediation, markets, regulation, and the profit motive drive the bank's financial structure. In effect, the book proposes a financial analysis of banking – emphasizing its liabilities and short-term liquidity – with important lessons about non-bank intermediaries too.

This book's intended audience includes financial regulators, bank officials, academics and those interested in understanding bank funding and its regulation. Several rich veins of macroeconomic and financial economics literature consider funding. Bank regulators with unrivaled access to insider knowledge also publish excellent work. This book tries to expand the circle, in particular to legal and financial academics without formal training in economics who – like myself – want to understand bank funding.

I do not go very far in terms of suggesting what regulation should look like. In general, I suggest *how* to think not *what* to do. Uniquely poised to access diverse funds from a wide variety of sources, banks capitalize on their unrivaled advantages at borrowing cheaply and then either lending or investing these funds at a higher rate of return. Banks take pains to signal permanence, trustworthiness, and stability, but the bank's funds flow dynamics – the heart of its business model – are volatile and somewhat unpredictable processes that determine the bank's survival. Historically, banks borrowed short-term and lent for a longer-term, a strategy that locked in a certain degree of instability insofar as assets and liabilities did not match. To help banks manage this intrinsic instability, governments impose regulations and stand ready to rescue individual banks and, at times, the entire banking sector.

Not only is funding the heart of bank intermediation, it is where the financial crisis of 2007 started, grew, and spread outward to the real economy. At first, the crisis took regulators and central banks by surprise, especially when money markets stopped working and the usual strategies for reanimating these markets failed. Through trial and error, regulators and central banks discovered new ways to jumpstart money markets, strategies that focused attention on funding, in particular liquidity dynamics and short-term debt.

The crisis and its aftermath popularized a few buzzwords around which post-crisis reforms and policy revolve – financial stability, systemic risk, and non-bank financial intermediaries. Behind this financial-speak lie funding dynamics that call for a closer look. To trace how this conceptual shift occurred and to arm the reader with a contemporary understanding of a core banking function, this book ties together how banks make money, how this can get them into trouble, how governments regulate and rescue them, and how post-crisis reforms change the rules of the game by imposing regulatory liquidity standards. At best, regulators reach a series of provisional truces with financial markets. This book examines the terms of the current truce on funding.

My examples come primarily from the U.S. banking system, but this is also a story about multilateral entities like the Bank for International Settlements, whose Basel Committee on Banking Supervision plays a growing role in fostering and regulating an increasingly globalized banking market. Indeed, an important shift in bank supervision theory has taken place during the past 30 years. Promoted by the Basel Committee through their three major accords, a de facto global regulator – rather than national bank authorities – has become the supreme authority on bank funding, this despite the fact that the Basel accords are just white papers not treaties. As part of this process, banking regulation today rests on financial models that yield quantitative measures of a bank's financial stability that seem more persuasive than subjective judgments by regulators.

It makes sense to impose standardized, bright-line rules on globally active financial conglomerates, but some qualifications are in order. First, banking rests on the visceral experience of confidence or fear about the future, a reality that differential calculus cannot change. Second, some of these new quantitative standards reprise themes that have long been a part of banking supervision. For example, at the core of Basel III's new regulatory liquidity rule is an old-fashioned contingency funding plan, long recommended by regulators as a prudent practice. Finally, understanding these numbers means drawing on some operational context for regulation.

I thank Dean Alex Acosta of the College of Law for providing the funding and institutional stability that made this book possible. I am grateful to my talented research assistants Nathan Soowal and Johanna Talcott for doing an excellent job on citation and proofreading. I presented part of the argument at the Bank of México and at a faculty workshop at the Instituto Tecnológico Autónomo de México. After a decade of writing law review articles, I had much to learn about writing a monograph. For their excellent comments on drafts, let me thank John Schlegel, Jerry Markham, Luis Luis, Brett McDonnell, Matthias Haentjens, Charles Pouncy, Tom Hazen, Lynne Dallas, and Vivienne Taylor. Of course, all errors are my own. To Tom Baker I owe a permanent debt of gratitude for showing me how to be an academic. This book is dedicated to my friend John Henning, who introduced me to seeing life through an economic lens.