Banking: Intermediation or Money Creation

R. Hockett & S. Omarova, What Do Banks Intermediate?

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Robert Hockett, Cornell Law School
Saule Omarova, Cornell Law School

Apparently there still are people who believe that the principal role of commercial banks is to 'intermediate' between depositors and borrowers – lending the funds of the former to the latter at a premium, conveying a portion of that premium to the former, and pocketing the remainder.

Why would anyone think this?

One reason might be the frequency with which we are told it's the case. Open most any website or law school, business school, or economics course casebook or textbook, and you'll find a near-ritual incantation of what we call 'the intermediated scarce private capital myth.' ('Surplus units' place 'loanable funds' into banks, which then 'lend them out' to 'deficit units' at a profit, etc.) And that's not to mention the oft-heard assertions and asides of the politicians, pundits, reporters and columnists whose words fill our heads every week – people who themselves simply assume the truth of the myth and then pass it along.

A second reason for belief in the depositor-borrower intermediation story might be a certain 'materialist' or 'physicalist' cast to our idioms, and hence to our thoughts, about money – cultural holdovers, perhaps, of the days when the most often encountered or otherwise salient money-forms were metallic or paper. If money is physical substance, the unconscious thought would presumably run, then surely its lenders must first have piled it up. It must have been 'taken in' before it can be 'lent out.'

A third reason might be a passing acquaintance that some people have with ‘fractional reserve banking’ or ‘reserve requirements’ – a legal necessity (as discussed below) that might be mistaken for a natural or metaphysical necessity. But this one, we’ll see, cuts more than one way.

Finally, a fourth reason for the persistence of the depositor-borrower intermediation story might be the temptation to draw a false conclusion from a perfectly legitimate premise. That premise is the numeric equality between the sum of quantified liabilities and equity on one side of any bank’s balance sheet, on the one hand, and the aggregate value of assets on the other side of that balance sheet, on the other hand. It is remarkable how often this tautologous equality is taken, sometimes by otherwise quite able minds, to reveal the necessity of pre-accumulation.

Of course, a regulatory stricture like a reserve requirement is no natural or metaphysical necessity. And a conventional accounting identity that literally mandates the balancing of both sides of a bank’s balance sheet says nothing about causal direction. What determines regulatory stricture and causal direction alike in this case is the same thing that determines regulations and accounting conventions themselves – social and legal practice. And pursuant to contemporary practice, ‘loans make deposits,’ not vice versa. No pre-accumulation required.

How can that be? The answer, as laid out below, shows something ‘big.’ It shows that those between whom banks ‘intermediate’ are, if anyone, not depositors and borrowers, but ‘us’ in our joint public capacity and ‘us’ in our individual private capacities. That might sound abstract and philosophical at first, but this characterization captures the deepest reality of contemporary finance – a reality that grows eminently recognizable when you follow us down a short path that starts broad and ends narrow.

Broadly speaking, social and legal practices of the kind just mentioned ‘make’ our money, banking, and finance. And these practices, as currently conducted, do not make banking into private intermediation. They make banking into public credit-dissemination – or, if you prefer, public-private intermediation, in a sense just now hinted at and which we’ll explain. They do so, moreover, not through the institution of banking alone, but through the broader institutional landscape that is our *payments* system – of which banking is only one part.

Let’s start with money…

A money is, at its core, simply ‘that which pays’ in a system of paying and ‘that which counts’ in a system of accounting. Payment and accounting systems are in turn sets of conventions, often hardened into positive law administered by a state, that determine who owns what and who owes what to whom, both before and after particular transactions. Once you let that sink in, it is not at all difficult to see why banks, which are publicly licensed both to lend and to maintain the accounts that constitute the core of contemporary payments systems, would not have to pre-accumulate money to lend money.

Imagine, for example, a system of commerce and finance in which people make payments by inserting chips, swiping strips, or key-punching blips that debit their accounts and credit the accounts of their payees. Imagine further that which particular chips, strips, and blips ‘count’ in the making of such payments are determined by public authority. If this same authority likewise permits the institutions that *administer* the mentioned accounts also to ‘lend money’ by *crediting* those accounts, then there is simply no need for those institutions to pre-accumulate anything at all. Not absent some separate legal pre-accumulation requirement, at any rate.

In imagining what we’ve just asked you to imagine, you have not imagined anything fictitious or fanciful. You have imagined the American payments-cum-banking-cum-credit-money system. It is that simple. There is little more to it – nor need there be.

To see this, turn now from money to 'moneylending' …

When you step into a publicly licensed bank to 'borrow money,' what you are doing is seeking to swap, temporarily, your private promissory note for the equivalent of a public promissory note, known as a 'Federal Reserve Note.' You likely are doing so because your note will not be accepted in payment – that is, as money – anywhere other than at this publicly licensed institution itself. By contrast, the public notes whose equivalent you wish to borrow – also known as 'dollars' – are accepted everywhere.

You will have to meet certain publicly imposed conditions for your proposed private note / public note swap – that is, your loan – to be approved. We'll return to those conditions in a moment, but for now assume that you've met them… Once the bank's loan officer determines that you have met all the conditions and approves the requested loan, the bank will now 'lend the money.' It does this in one or more of three ways: it (1) opens and credits an account in your name, (2) credits an account that you already have, or (3) conveys to you a cashier's check with which you can credit some other account.

The 'credit' just mentioned comes in monetary form, just as you wished. (That is why some speak of bank loans as 'bank money' or 'credit-money.') What makes it monetary is the fact that you can now either 'withdraw' it in the form of public promissory notes (Fed Notes, dollar bills), 'draw *on*' it in the form of dollar-denominated checks to yourself or to others, or deploy it more quickly in making dollar-denominated payments to others by using a chip, strip or blip of the kind mentioned above.

The check, chip, strip, or blip is associated with the publicly licensed institution with which you hold your account. (Take a look.) And because the institution in question is publicly licensed and publicly integrated into the publicly administered payments system, your check, chip, strip or blip will ‘count’ in the making of payments.

We, the authors of this post, are not a publicly licensed banking institution publicly integrated into the publicly administered payments system. Hence although we could purport to lend to you as a bank would, by putatively opening an account in your name and conveying to you an impressive-looking checkbook or chip card or strip card, you would be in for an unpleasant awakening were you to try to use these as payment media. They simply won’t ‘count’ anywhere. There is but one way for us to ‘lend money’ to you: by pre-accumulating Fed Notes or their equivalent, then lending *them* to you. This is the case precisely because we are not banks.

And there is the key. The pre-accumulation, depositor-borrower intermediation story would be true of us, the two authors of this post, as unlicensed lenders unauthorized to issue – to generate or ‘create’ – publicly recognized payment media. But it is not true of licensed bank lenders that are authorized to issue – in effect, to bring into existence – such payment media. It is not true, in other words, of *banks*.

Why is it not true of banks?

The reason it is not true of banks is because ‘we’ – not the authors now but the public – have chosen not to make it so. We have chosen instead to allow licensed banking institutions, the authorized issuers and distributors of our monetized public full faith and credit – again, our public promissory notes, our Fed Notes, our *money* – to go about their business in manners that aid with *our* business. ‘Our’ business, in turn, is to issue and channel claims upon resources – again, dollars – in manners that optimize the production of yet further resources. That is precisely what productive lending does.

Our banking and broader financial system in this sense constitute a species of public-private partnership, a partnership we believe best interpreted as a franchise arrangement. The franchisor is the public in this conception. The franchised good is its monetized full faith and credit – its money supply. The banks and other financial institutions authorized to lend are the franchisees – authorized purveyors of our money. And the licensing and broader regulatory regimes to which we subject these franchisee institutions are the quality standards to which we hold them, of a piece with the standards that we find enforced in all franchise arrangements.

We set our 'money quality' standards with a view to encouraging and facilitating productive activity and associated economic growth, while simultaneously discouraging misallocation and over-generation (a.k.a. 'inflation') of our money. We also aim to preserve the 'safety and soundness' of the franchisee institutions themselves, in light of both (a) their status as parts of our money-disseminating and payments infrastructures, and (b) their capacities to communicate their own maladies, virus-like, systemically to other institutions.

It is that latter imperative which prompts the reserve requirements that often enter popular and academic discussions and sometimes mislead. What many such discussions miss is that these requirements are merely liquidity-maintenance measures, nothing more. They only kick in once a high aggregate deposit threshold is met, and even then stipulate only small fractions of summed deposit liabilities. Their very 'fractionality,' moreover, ironically suffices to discredit the intermediated scarce private capital myth: for an institution that can lend ten or more times what it pre-accumulates is an institution that needn't pre-accumulate at all.

If we must speak of 'intermediation' where banks are concerned, then, let us get the terms of the relation right. Banks' essential function is not to intermediate between depositors and borrowers. It is to intermediate between our *public political* selves and our *private commercial* selves. That is the deep truth – the plain and unmediated truth – of our public-private finance franchise.

Further Reading:

Robert Hockett & Saule Omarova, *The Finance Franchise*, 102 Cornell Law Review 1143 (2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2820176.

Robert Hockett & Saule Omarova, *The People's Ledger: Citizen Central Banking, National Investment, and a Digital Dollar* (working paper, 2018-19).

Robert Hockett, *Rousseauvian Money* (working paper, 2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3278408.