Bank Funding, Liquidity, and Capital Adequacy: A Law and Finance Approach

José Gabilondo
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Maziar Peihani[*]

Bank Funding, Liquidity, and Capital Adequacy is a book about how banks get their money rather than how they use it. To put it in more technical terms, this book looks at the items which fall on the left side of a bank's balance sheet, namely liabilities and equity capital, as opposed to loans and assets on the right side of the balance sheet. Why this reverse perspective? The author points to the lack of scholarly attention to bank funding and the critical role it plays in the financial systems and stability. To remedy this gap, José Gabilondo advances a "funding relevancy argument" which goes in the opposite direction of the famous capital irrelevancy theorem advanced by Modigliani and Miller.[1] Gabilondo draws upon the legendary contributions of Hyman Minsky who highlighted the crucial role that debt and financing play in economic crises.[2]

Looking at how firms raise money for their investments, Minsky distinguished between three types of financing. The first type is "hedge financing", where the company relies on its future cash flows to pay all its debt. The second is "speculative financing", where the firm can rely on its cash flow to pay interest but has to rollover its debt to pay back the principal. The third is "Ponzi financing", where the cash flow can cover neither the interest nor the principal and the firm is just speculating that underlying assets will go up in value. From this list, the first type, hedge financing, offers the safest investment strategy while the other two, particularly Ponzi financing, are quite risky. Extending this typology to a larger scale, a financial system is most stable when dominated by hedge financing; that is, when the economy shows low levels of debt and strong cash flows. On the other extreme, a financial system dependent

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[*] Maziar Peihani is a research fellow, International Law Research Program, Centre for International Governance Innovation.

[1] Franco Modigliani & Merton H. Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment" (1958) 48(3) *American Economic Review* 261.

[2] See, e.g., Hyman P. Minsky, "The Financial Instability Hypothesis" (Levy Economics Institute, Working Paper No. 74, May 1992); Hyman P. Minsky, *Stabilizing An Unstable Economy* (New Haven: Yale University Press, 1986); "Financial Stability: Minsky's Moment, *The Economist* (30 July 2016), online: <https://www.economist.com/news/economics-brief/21702740-second-article-our-series-seminal-economic-ideas-looks-hyman-minskys>.

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on Ponzi financing is the most vulnerable. If, contrary to investors' beliefs, asset prices fall, over-leveraged firms cannot pay back their debt and have to sell their positions. This would then further undermine asset values, creating a knock-on effect and causing other firms to default as well. Minsky pointed out that financial stability breeds financial instability in the sense that firms tend to move away from hedge financing to Ponzi financing when the economy is booming and the temptation to borrow is irresistible.

Putting on a Minsky-esque lens, Gabilondo argues that the global financial crisis (GFC) of 2008 can be best understood from a bank funding perspective. Leading up to 2007, low interest rates encouraged banks to take on more debt. Securitization amplified the leverage cycle by allowing banks to turn long-term assets into liquid products that could be sold on the secondary market. Banks then used the proceeds from the sale of these securities to finance new loans. However, when the housing market took a downturn, and mortgagers started defaulting, securitization stopped working as a liquidity machine; the demand for mortgage-backed securities declined and banks could no longer finance their positions. Large and complex banks could no longer continue operating and if it had not been for government bailouts, they would become insolvent. In Gabilondo's view, it was the liability structure of the banks and their volatile and fragile funding practices which was at the heart of the GFC. A funding perspective can therefore better explain the crisis than an asset-class view, which focuses on the creation of high-risk assets and the failure of their price discovery.

The book proceeds in three main parts: a comparative discussion of the bank funding model; an account of the how bank funding featured in the recent crisis and how the crisis changed the contours of bank funding; and, a discussion of the post-crisis regulatory reforms. Part I puts the bank funding model in context by illustrating the financing challenges that banks face and how banks' funding compares to other competitors. The challenge comes from the asset-liability mismatch which banks seek to manage through their unrivaled access to funds including government funds. To provide a comparative perspective, the book sketches the funding portals of three classes of non (commercial) bank institutions: dealer banks, income assurance entities (i.e., pension funds and insurers), and passive investment vehicles (i.e., asset managers and special purpose conduits). Part II highlights the funding lessons of the 2007-2008 GFC, with a focus on the breakdown of securitization practices. The GFC and the ensuing unprecedented public intervention and stabilization measures led policymakers, regulators, and academics to change their view of banking. This conceptual shift led to a myriad of post-crisis regulations on bank capital and liquidity which the author reviews in the last part of the book. The book ends with an appendix which provides a short case study of Acme, a hypothetical bank, in light of the insights offered in the book.

The book is certainly an informative treatise, particularly for those without a background in banking who would like to know more about the field. As the author puts it, the book's main target audience are the legal and financial

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academics who do not have a training in economics but are interested in understanding how bank funding works. The book is not, however, a critical manuscript; it largely relies on a mere description of bank funding, and the various challenges and failures bank funding has encountered to date. There is no critical discussion on how banks can have more resilient funding or the post-crisis regulatory reforms that have been initiated in response to the GFC. The author's Minsky-esque argument appears briefly in the beginning without being further developed in the ensuing discussions. His reading of Minsky can also be questioned as Minsky's theory of financial instability goes beyond a singular focus on bank funding to include broader dynamics of the financial system, including asset booms. In fact, Minsky noted that banks add on to the economic booms by loosening their underwriting standards and lending more. So, his theory accounted for both the right and left side of the balance sheet, without focusing on just one at the expense of ignoring the other. Indeed, it is only such a comprehensive account that can explain the dynamics of the recent GFC. The author's contention that bank funding has not received enough systemic attention is also open to question as the post-crisis literature on banking has heavily investigated the issue and, as the author acknowledges, the most significant regulatory response to the GFC has come in the form of new capital and liquidity regulations.

In spite of these limitations, the book is an interesting read, especially for those interested in a structured, well-written explanation of bank funding, and a myriad of technical concepts that can appear daunting to the non-specialist.

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