FINANCIAL STABILITY: CAPITAL, CULTURE AND HIGHER PURPOSE

by

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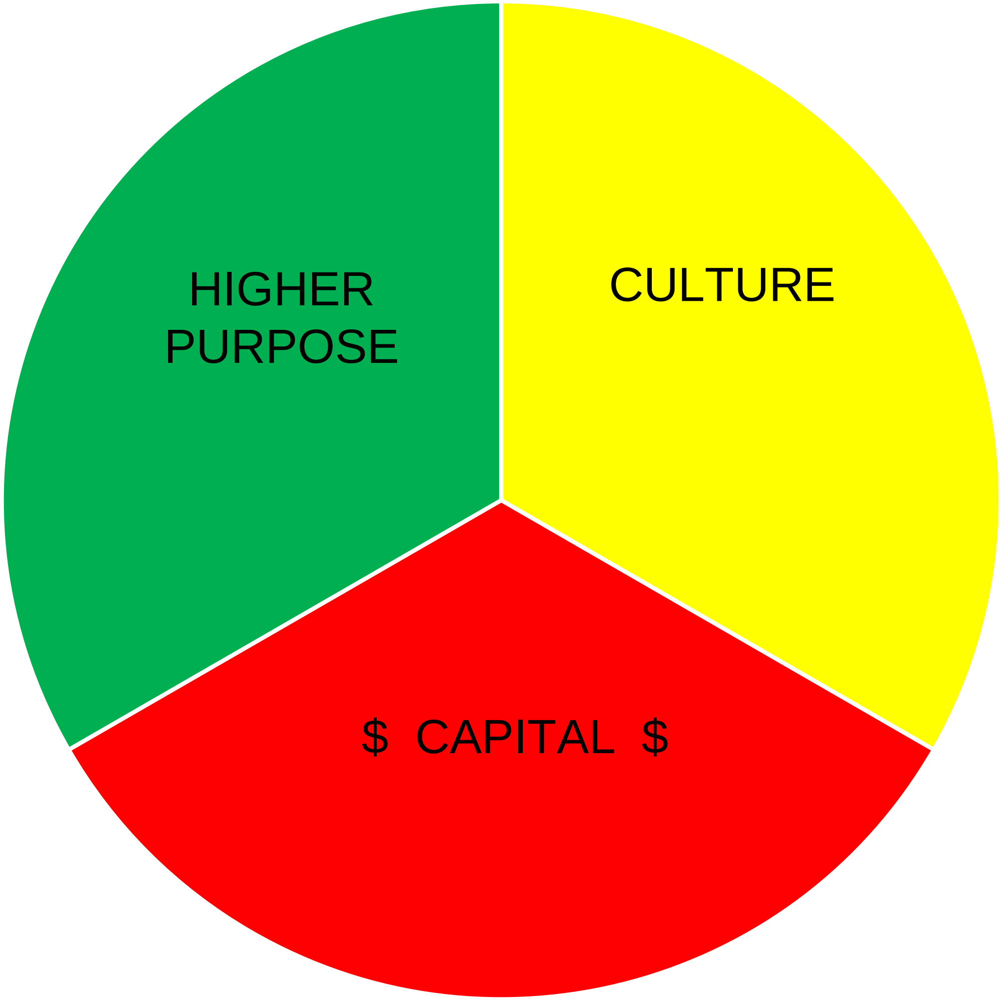
BIG QUESTION:

How do we get the right balance between financial stability and economic growth in our banking system?

As a preview, my talk will focus on a three-pronged approach …



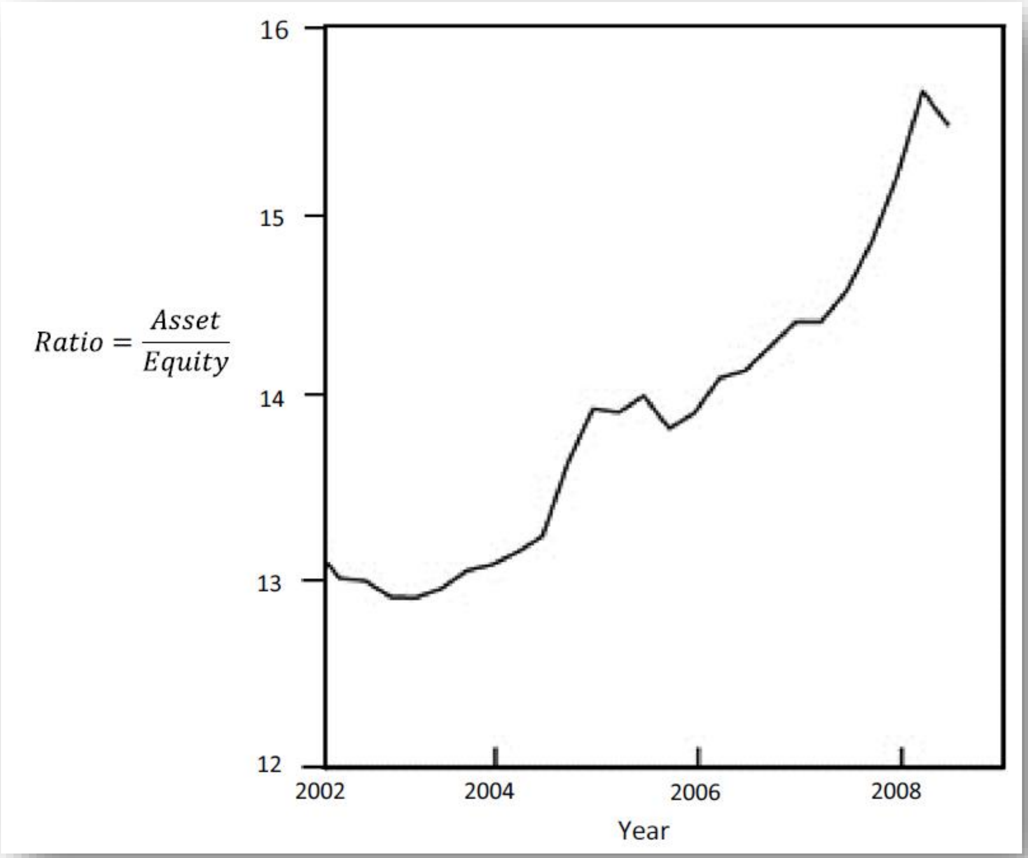
WHAT CAUSED THE 2007-09 FINANCIAL CRISIS?

- Growing body of causal empirical evidence that crisis was caused by …
- --excessive leverage in financial intermediaries

  -- excessive household leverage

  -- housing price bubble

Leverage – A Major Concern

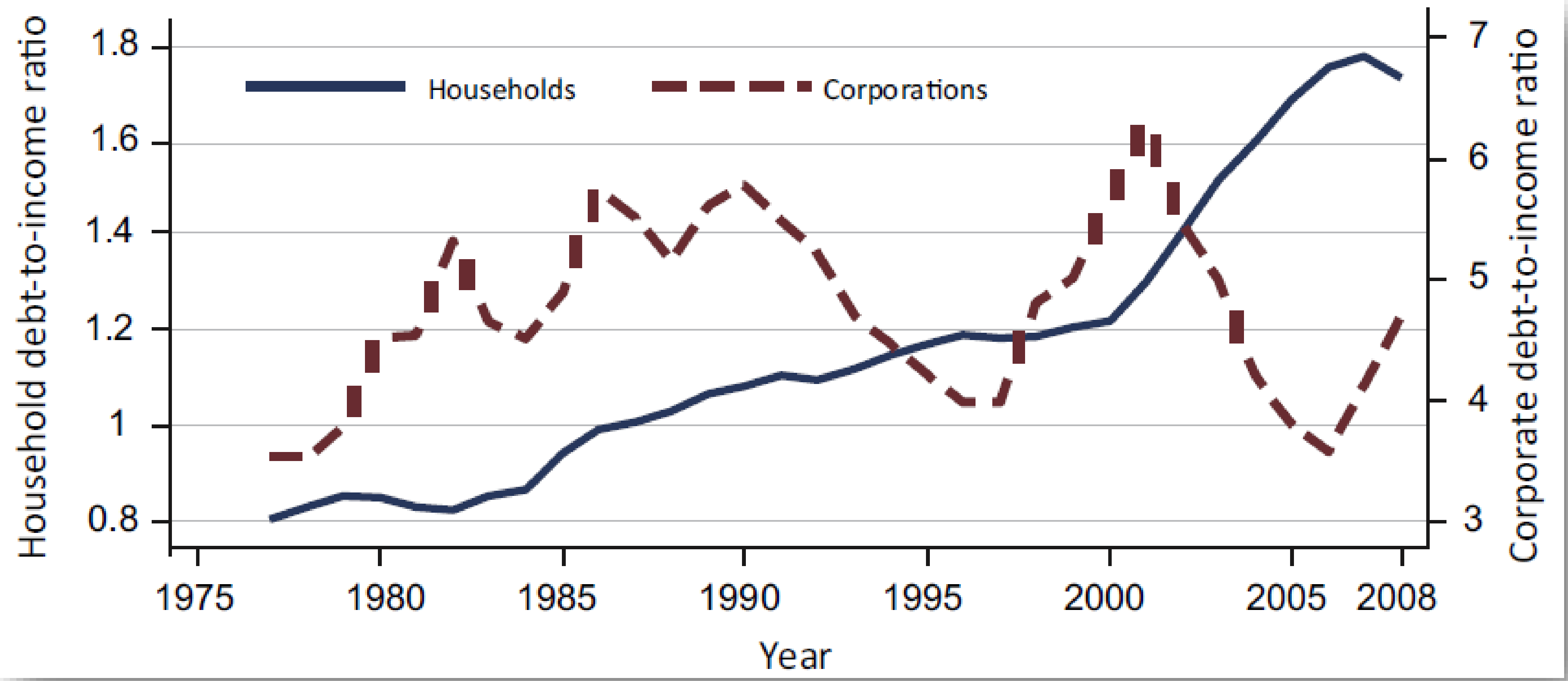


U.S. bank (commercial and investment) leverage

- *Goel, Song and Thakor (JFI, 2014): Correlated leverage exacerbated the problem*

Household Debt Rose but Non-Financial Firms' Leverage Did Not

U.S. debt-to-income ratio: households and corporations

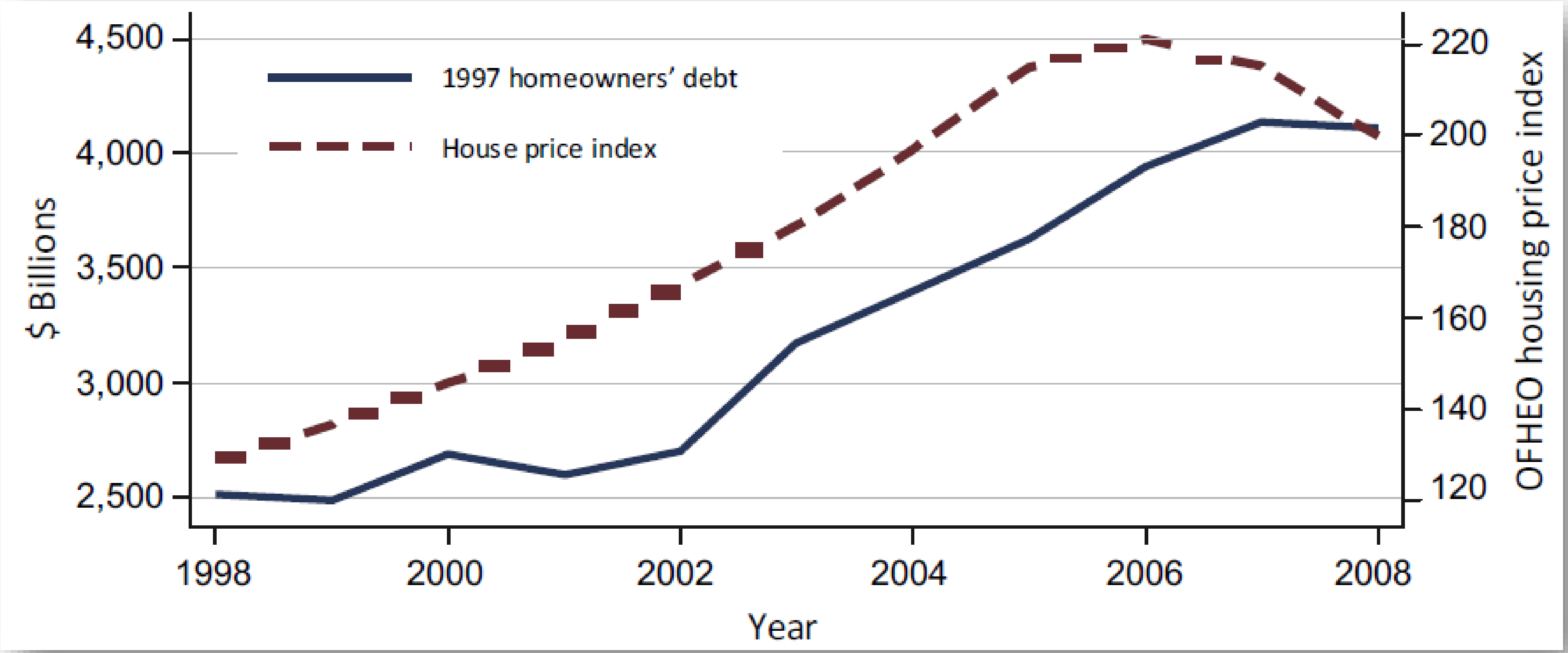


- *Goel, Song and Thakor (JFI, 2014): Correlated leverage exacerbated the problem*

High Household Leverage Was Correlated With Rise in Housing Prices that Led to Housing Price Bubble

(Picture also consistent with Landvoigt, Piazzesi & Schneider [AER, April 2015] paper on San Diego house prices)

U.S. household debt for 1997 homeowners and house prices



- *Goel, Song and Thakor (JFI, 2014): Correlated leverage exacerbated the problem*

Motivation: Capital Can Help Deal with Excessive Leverage and Price Bubbles

- ***Gauthier, Lehar and Souissi, (Journal of Financial Intermediation*, 2012)** find (using a structural model that is calibrated using banking data) that a properly-designed capital requirement can reduce the probability of a systemic crisis by 25%.

- Consistent with the **endogeneity of systemic risk** in the paper above... Research shows that ...

  a. Highly correlated asset choices by banks (during 2000-06, correlated risk-taking grew - - - **Bhattacharyya and Purnanandam (2011)** document that idiosyncratic risk in commercial banking was cut in half and systematic risk doubled during this time).

     - This interconnectedness of banks raises likelihood of idiosyncratic shocks becoming systematic.

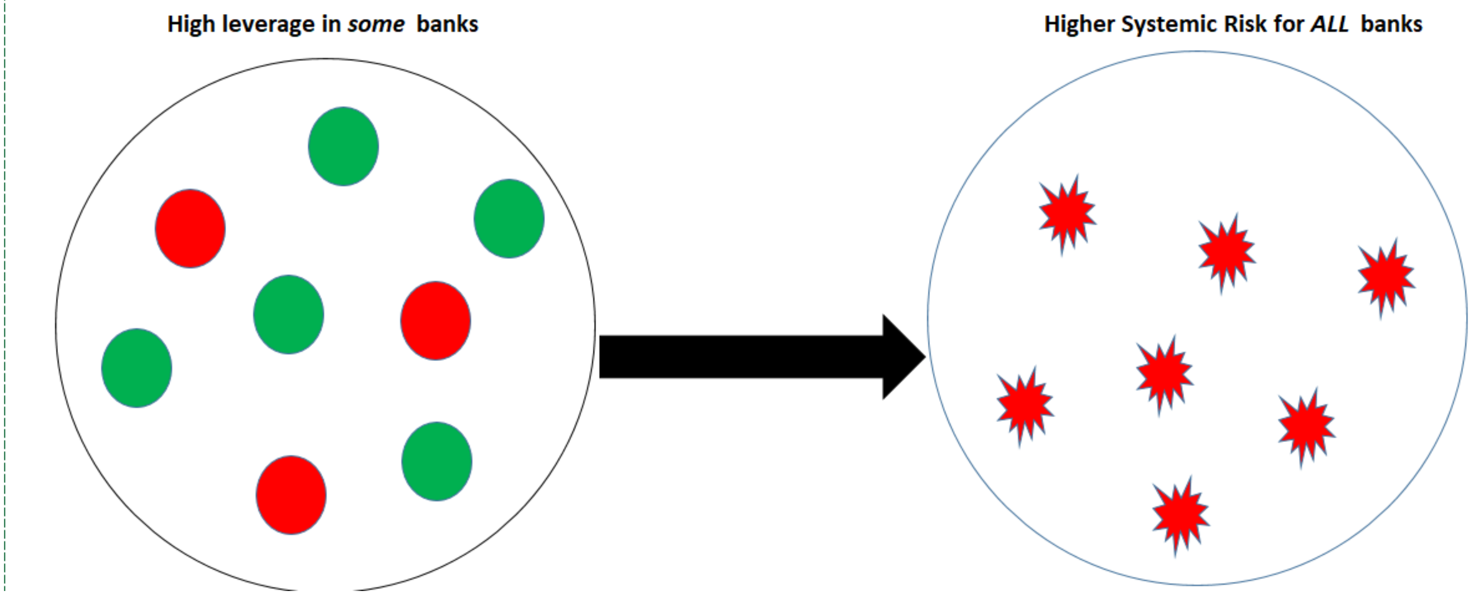
- **WHAT DO THEORY AND EMPIRICAL EVIDENCE HAVE TO SAY ABOUT <u>HOW</u> CAPITAL WOULD HAVE HELPED/CONTRIBUTED?**

- **(role of capital as an ex post shock absorber—"no amount of capital would have helped absorb the shock of this crisis"—is the least interesting role of capital)**

CONTRIBUTION #1:

CAPITAL CAN HELP LOWER SYSTEMIC RISK

- There is a theory that higher leverage (lower capital) in ***individual*** banks increases ***systemic risk*** (consistent with crisis experience)…



Acharya and Thakor, "The Dark Side of Liquidity Creation: Leverage-Induced Systemic Risk and Implications for the Lender of Last Resort", *JFI*, October 2016.

CONTRIBUTION #2:

Higher capital would have reduced the number of banks that experienced funding dry-ups (liquidity shortages)

Theory: Thakor, Anjan. “Illiquidity Fog”, Wash U WP, October 2019.

- Proponents of the liquidity crisis view propose the notion that the whole market suffered from a liquidity crunch.
- However, recent empirical evidence disputes this view…and indicates **this was an insolvency risk crisis**
  - **Perignon, Thesmar and Vuillemey (*JF*, 2018)**

    : Transaction-level data on ST unsecured CDs in Europe during 2008–14 $\rightarrow$ many banks suffered funding dry-ups, but …

    - Banks with higher capital (and better future performance) actually *increased* their ST uninsured funding, and …
      - Banks with lower capital (and poorer future performance) reduced funding.

        $\Rightarrow$ **REALLOCATION OF LIQUIDITY BASED ON SOLVENCY**
  - **Boyson, Helwege and Jindra (FM, 2014)**

    : Similar evidence for U.S. banks

CONTRIBUTION #3: CAPITAL WOULD HAVE INDUCED LESS PRE-CRISIS RISK-TAKING AND HELPED BANKS SURVIVE THE CRISIS BETTER

Empirical evidence shows that banks with higher capital ratios:

- **took less risk prior to the crisis (Beltratti and Stulz (*JFE*, 2012))**; and
- **were more likely to survive the crisis and gained market share during the crisis (Berger and Bouwman (*JFE*, 2013))**;
- **had smaller contractions in lending during the crisis (Carlson, et al., (*JFI*, 2013))**.

CONTRIBUTION #4: MORE CAPITAL IN HOUSEHOLDS WOULD HAVE MADE THE CRISIS LESS SEVERE

Higher household equity capital or lower consumer leverage would have also created less of a housing price bubble, softened the impact of declining home prices, and reduced (strategic) mortgage defaults …

Mian and Sufi's *House of Debt* book shows this means:

- ⇒ **Smaller house price declines**
- \+ **Smaller decline in household consumption**
- ⇒ **Smaller reductions in production of goods and services**
- ⇒ **Less adverse impact on unemployment**

WHAT IS THE POST-CRISIS REGULATORY REFORM SUGGESTED BY THEORY AND EMPIRICAL EVIDENCE?

Research-based policy?


Colourbox

Post-Crisis Regulatory Reform

REGULATORY REFORM #1:

Increase capital requirements (or at least resist pressures to reduce them) and de-emphasize liquidity requirements (let LOLR do its job!):

- But do it gradually via dividend freezes and earnings retentions, NOT by forcing new equity issuances.

  ⇒ **Eric Rosengren (2010)** observation:

  Starting August 2007, the LIBOR rose and the LIBOR-OIS spread spiked significantly.

  But … dividends on common stock declared by the largest banks (e.g., 19 SCAP) increased in 4^{th} Q 2007 and hit a peak in Fall 2008.

⇒ Rosengren says…

"This suggests that if dividends had been halted at the SCAP banks once the LIBOR rate rose, nearly $80 billion would have been retained as capital. This represents close to 50% of the CPP funds used to recapitalize these banks in the Fall of 2008. Clearly a proactive approach to dividend retention could have substantially reduced the need for an emergency infusion of public funds"

IMPACT OF HIGHER CAPITAL REQUIREMENTS

- Popular reason for *not* raising capital requirements is that it would increase the price of bank credit for borrowers, perhaps reduce lending and lower economic growth.
- Recent evidence by **Bichsel et al** (using Swiss banking data): 1% point increase in RWA cap req increases lending spreads by 0 to 5 bp; 5-20 bp increase for 1% point leverage ratio increase. **Higher capital banks increase spreads *less*.**

BIG PUZZLE

- Higher capital in U.S. banks gives them a big advantage over European banks
- Thus, bankers' aversion to higher capital requirements is perplexing.

EMPIRICAL EVIDENCE … suggests that …

Higher capital would **benefit even the bank's shareholders**

- **Mehran and Thakor ("Bank Capital and Value in the Cross-Section,"** ***RFS*****, 2011)** theory and evidence that bank (book) capital and market value are positively related in the cross-section!

- **Bouwman, Kim and Shin: "Bank Capital and Bank Stock Performance" WP, Texas A&M, 2019.**
  - High-capital banks have higher risk-adjusted stock returns (alphas) than low-capital banks … using any AP model known!
  - Trading strategies earn 3.6% — 4.4% annually, with gains coming primarily from "bad times".
  - May explain higher post-crisis MV/BV ratios for US banks compared to European banks.

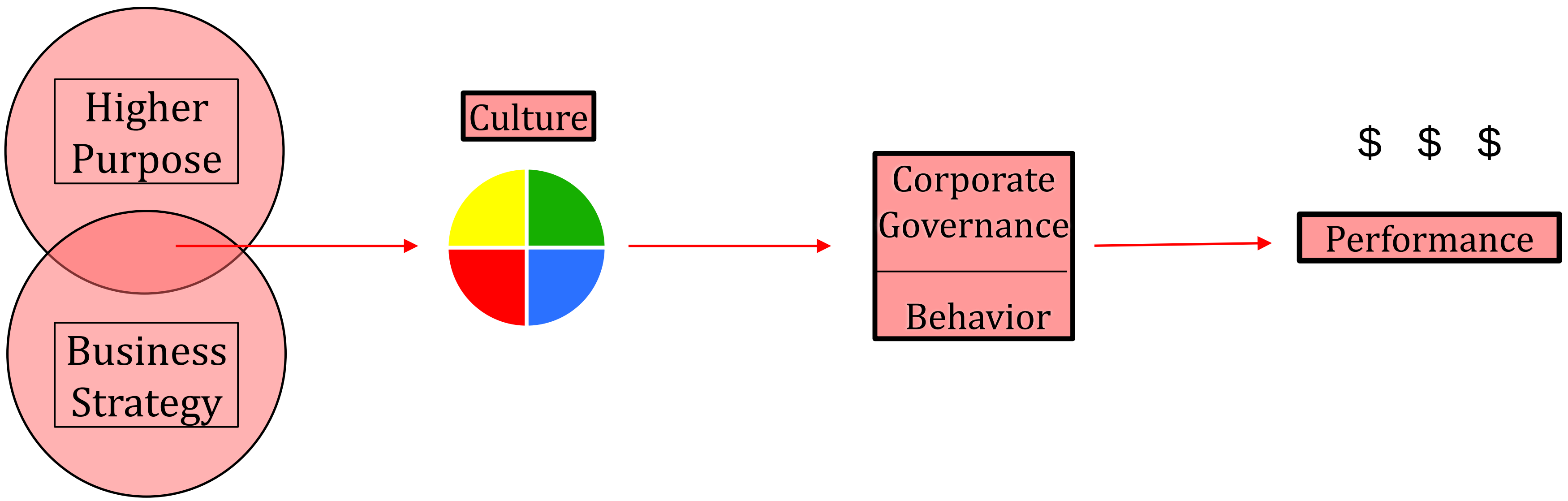
REGULATORY REFORM #2:

Restrict consumer leverage (that exacerbated asset price bubble and amplified effect of house price decline during 2007-09 crisis)

REGULATORY REFORM #3:

Encourage (don't legislate) development of stronger safety-oriented *bank cultures*.

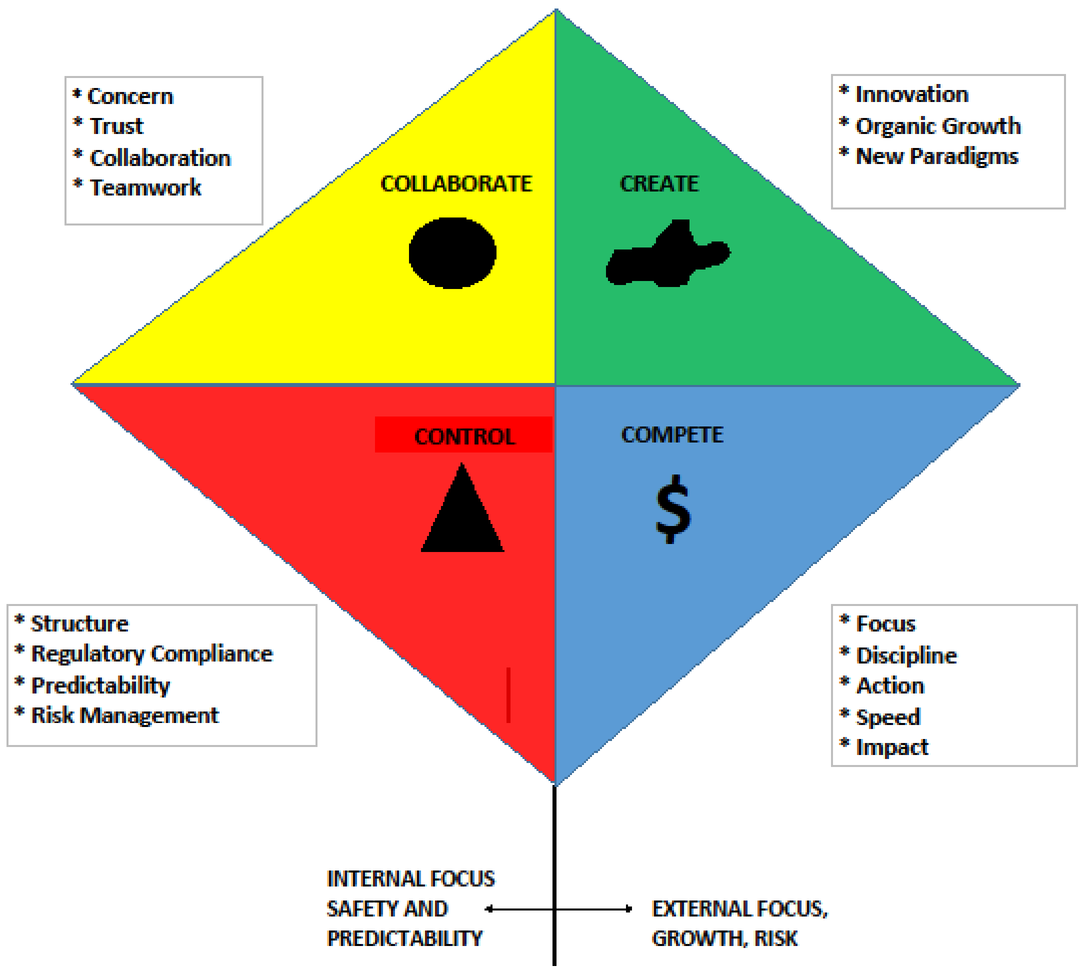
- **Corporate governance is hugely impacted by culture …**



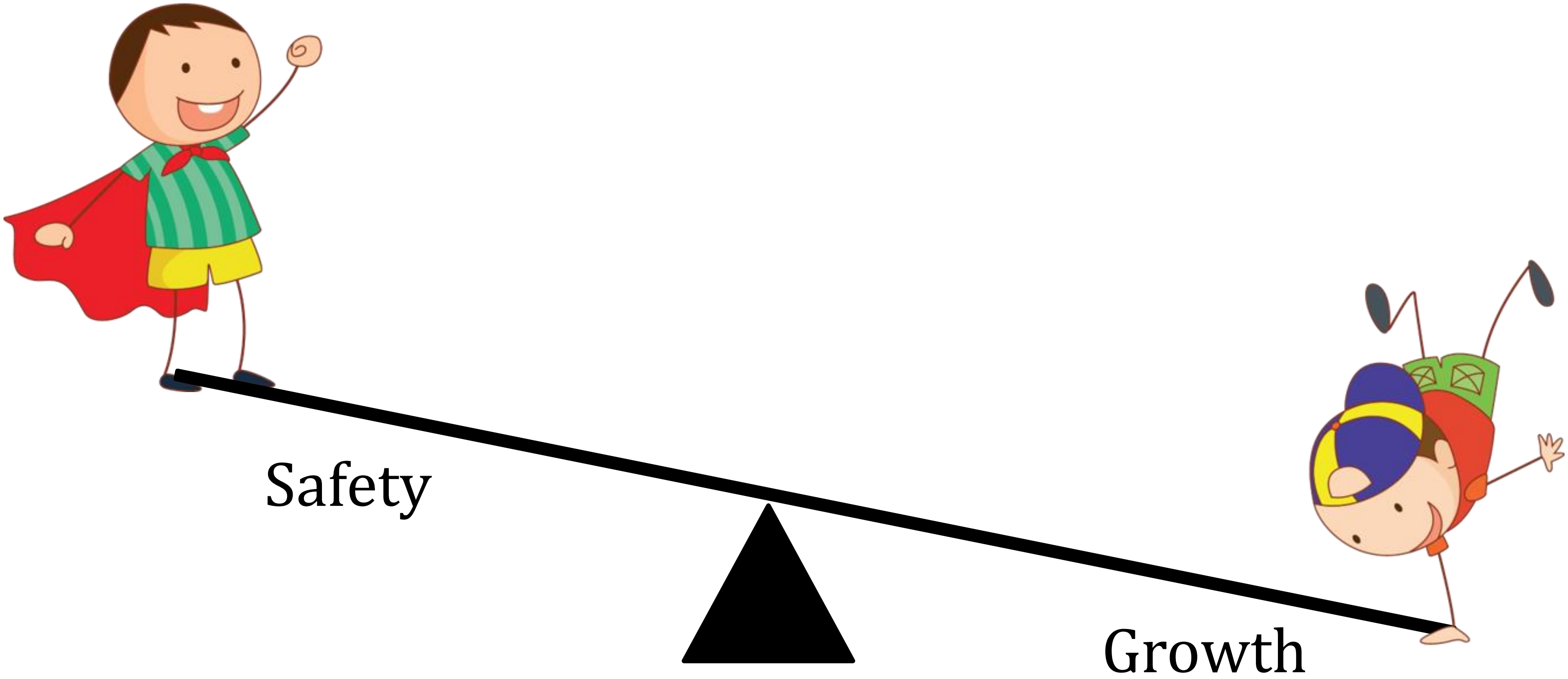
What is Corporate Culture?

- Explicit and implicit contracts that govern behavior in the organization.
- Nebulous and hard to measure.
- Competing Values Framework (CVF) helps.

COMPETING VALUES FRAMEWORK



“Bank Culture”, Fenghua Song and Anjan Thakor, *Journal of Financial Intermediation*, 2019.



- **Culture supports strategy**
- Bank strategy always emphasizes growth more ⟹ **culture always induces “overallocation” of resources to growth**.

Culture Versus Ethics and Prosocial Behavior

- However, ...
  When I talk to regulators, they are more interested in one specific aspect of culture ... ETHICAL BEHAVIOR.
  Why? ... Spectacular lapses when it comes to ethical behavior in financial services.
- Much publicized and written about.
- Perhaps excessive focus on growth encourages ethical lapses, connecting culture to ethics.

Ethical Lapses by Some ….

- Create a big negative externality for well-managed banks and erode confidence in our financial system.

- They also create negative perceptions about our entire economic system (which is a potentially HUGE threat).

THREE DISTURBING STATISTICS

- Gallup Survey found (for the first time) that a majority of U.S. millennials favor socialism over capitalism.
- 60% of employees express a need for purpose … but don't get it from work.
- A large percentage of employees in U.S. companies feel that the company they work for does not care for them.

“Need for purpose”?
“Caring”?

What do these terms mean? Economics lacks a vocabulary for them.

QUESTION: What should we do?

?

? ? ? ?

A SIMPLE INSIGHT

Short Answer:

- **Banks need to embrace a higher purpose that goes beyond just behaving ethically.**

REGULATORY REFORM #4:

Encourage (do not legislate) a discussion of what higher purpose means in banking.

LEADERSHIP AND HIGHER PURPOSE

- **What is "higher purpose"?**

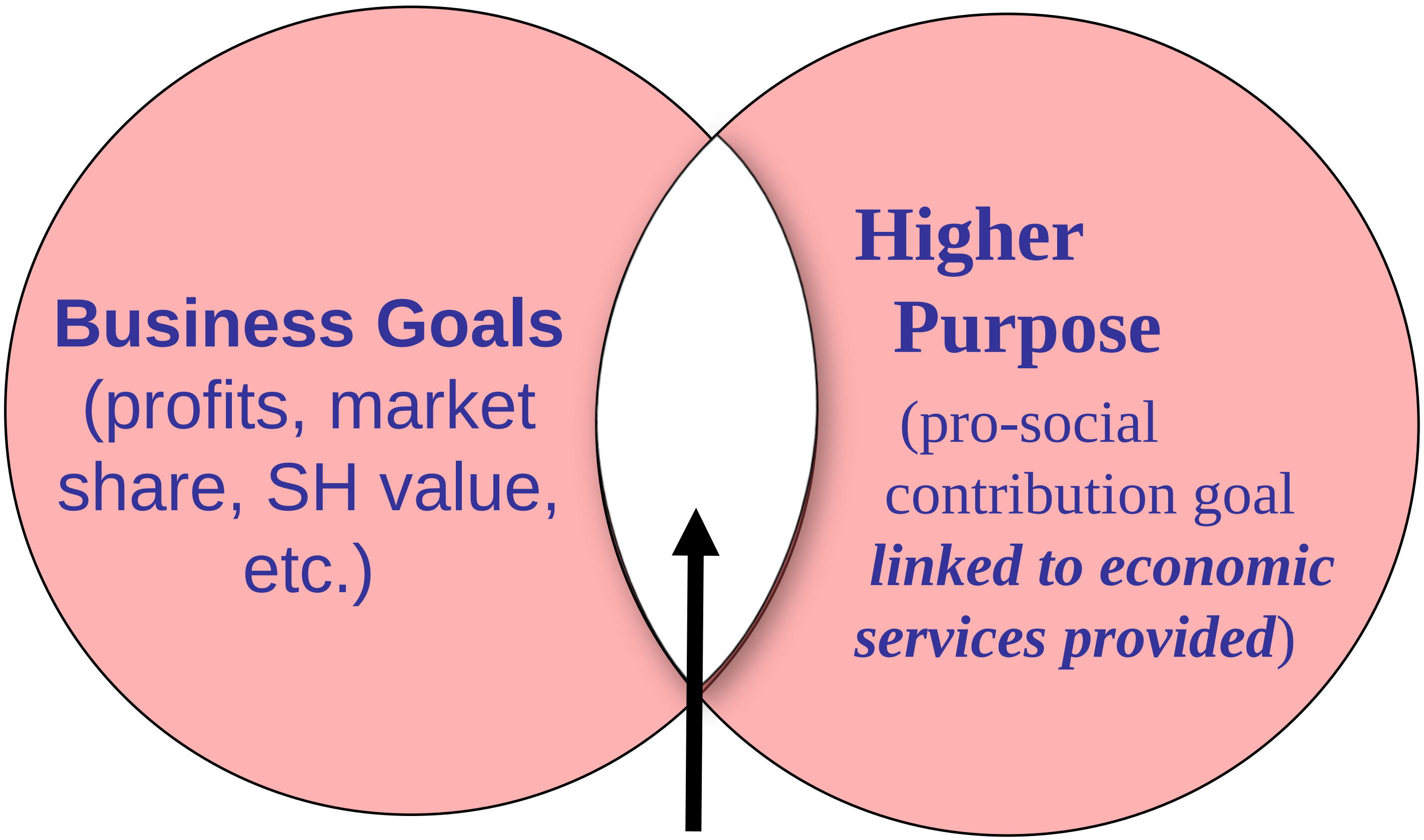
—A purpose that motivates you to engage in business practices that fulfill a need for *purpose in life* within you and transcend money/promotions or other purely business goals.

Leider: "Purpose is the deepest dimension within us—our central core or essence—where we have a profound sense of who we are, where we came from and where we're going. Purpose is the quality we choose to shape our lives around. Purpose is a source of energy and direction."

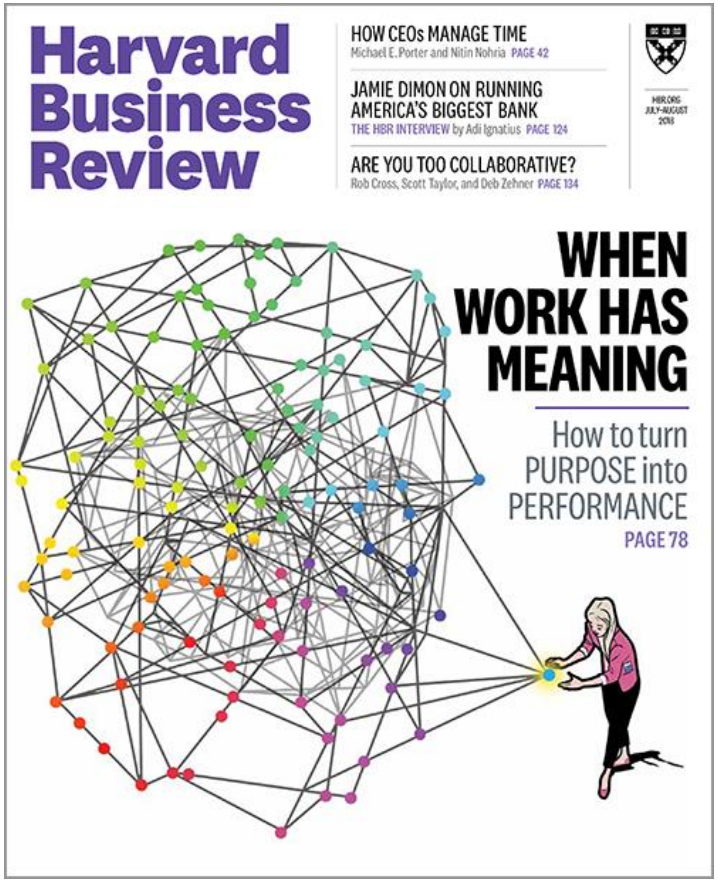
Definition of HP (**Quinn and Thakor: *The Economics of Higher Purpose*, 2019 Barrett-Kohler Publishers**).

> ***"Purpose is a reflection of higher intent. It's the most meaningful thing—beyond economic transactions and outcomes—that an organization has to give."***

Higher Purpose and Business Goals (Not charity)



Intersection



https://hbr.org/2018/07/creating-a-purpose-driven-organization

FEATURE CREATING A PURPOSE-DRIVEN ORGANIZATION

CREATING A PURPOSE-DRIVEN ORGANIZATION

HOW TO GET EMPLOYEES TO BRING THEIR SMARTS AND ENERGY TO WORK
BY ROBERT E. QUINN AND ANJAN V. THAKOR

PAINTINGS BY GEOFF McFETRIDGE

2 HARVARD BUSINESS REVIEW **JULY–AUGUST 2018**

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Case Study 1: Organizational higher purpose (customers)

- **Development Bank of Singapore**

Case Study 2: Organizational HP (employees and society): DTE Energy and Gerry Anderson

- 2006: How to improve from bottom 10% in employee engagement and productivity, union relations, customer satisfaction…?
  - Solution: Tighten performance metrics and measurements
  - Some improvement but … increase in fear
- 2008: First "junk bond utility"
  - The higher purpose journey: survive to continue serving community

DTE Energy: Post-Survival Challenge

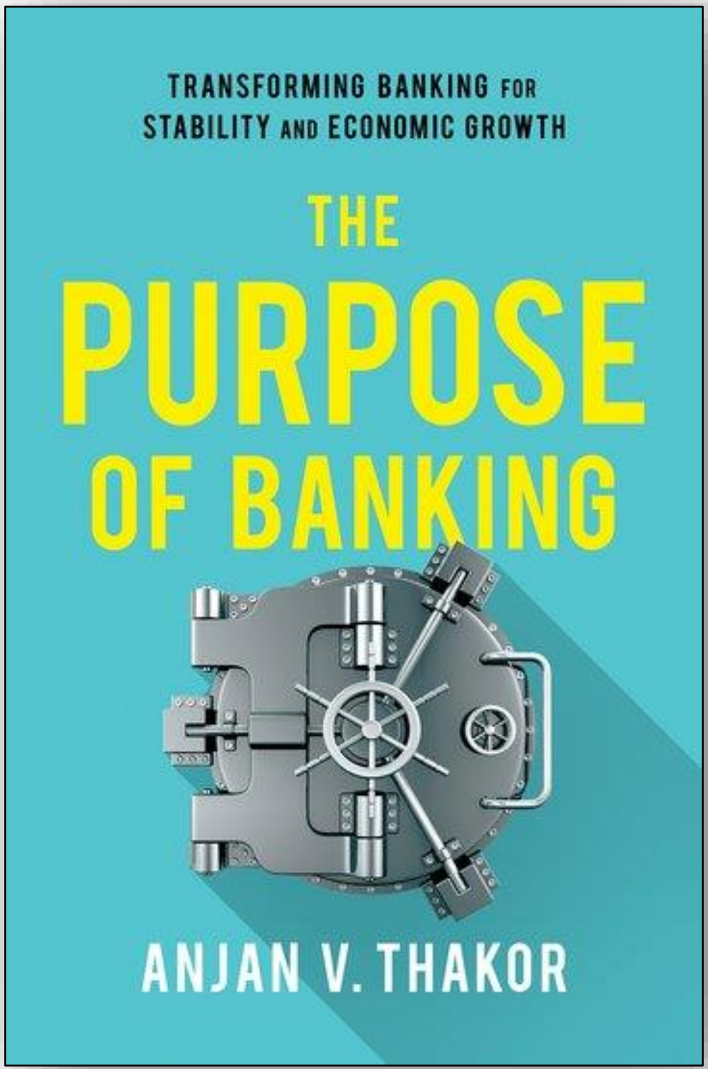
- **2010: survival and prosperity**

  Now what?

  - **Preservation to inspiration (contribution to development and prosperity of communities we serve): HP shifts from employees and survival to pro-social contribution to community**
  - **Question: if regulated utility can practice authentic HP, why can't banks?**

Results

- Safety #1
- Customer satisfaction: Bottom to top.
- Gallup employee engagement: Top 3%
- Union relations: Top 10%
- Operating Costs < 10 years ago.
- Top 25% in industry in financial performance.
- Stock price: $48 to $122 from 2011 to 2019.


TRANSFORMING BANKING FOR
STABILITY AND ECONOMIC GROWTH
THE
PURPOSE
OF BANKING
ANJAN V. THAKOR

SUMMING UP— POST-CRISIS REGULATION SHOULD FOCUS ON:

- **Capital, not liquidity, requirements.**
- **Limiting Consumer Leverage and improving financial literacy.**
- **Bank culture.**
- **Exploring higher purpose in banking, connecting it to what matters to *people,* ensuring *authentic* practice of higher purpose by banks, *and publicizing it*...absent his, we may risk losing it all!**