FINANCIAL STABILITY: CAPITAL, CULTURE AND HIGHER PURPOSE

by

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OFR-Federal Reserve Bank of Cleveland Conference
November 2019 (prepared October 18, 2019)
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 ...

- Higher Purpose
- Culture
- Capital
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

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 Purnananandam (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 HOW 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)

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 \textit{this was an insolvency risk crisis}

- \textbf{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 \textit{increased} their ST uninsured funding, and ...
      - Banks with lower capital (and poorer future performance) reduced funding.

\implies \textbf{REALLOCATION OF LIQUIDITY BASED ON SOLVENCY}

- \textbf{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?
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 4th 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!

- 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

- **COLLABORATE**
  - *Concern*
  - *Trust*
  - *Collaboration*
  - *Teamwork*

- **CREATE**
  - *Innovation*
  - *Organic Growth*
  - *New Paradigms*

- **CONTROL**
  - *Structure*
  - *Regulatory Compliance*
  - *Predictability*
  - *Risk Management*

- **COMPETE**
  - *Focus*
  - *Discipline*
  - *Action*
  - *Speed*
  - *Impact*

**INTERNAL FOCUS**
- Safety and Predictability

**EXTERNAL FOCUS, GROWTH, RISK**

- 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)

Business Goals
(profits, market share, SH value, etc.)

Higher Purpose
(pro-social contribution goal linked to economic services provided)

Intersection
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

Artwork by Geoff McFetridge

WASHINGTON UNIVERSITY IN ST. LOUIS
OLIN BUSINESS SCHOOL

Creating knowledge...Inspiring individuals...Transforming business.
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.
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!