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Post-Crisis Corporate Culture and Governance in Banking

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Anjan Thakor
Washington University in St Louis and ECGI

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Abstract

This paper provides a brief assessment of how ethics, culture and corporate governance have evolved in banking since the financial crisis. It concludes that we need to strengthen capital ratios and equity governance in banking to improve ethics and culture, and de-emphasize liquidity regulation. It also advocates the embrace of authentic organizational higher purpose in banking as a way to foster stability and growth.

Keywords: financial crises, bank regulation, corporate governance, compensation, bank culture

JEL Classifications: G3, G01, G21

Anjan Thakor*
John E. Simon Professor of Finance
Olin School of Business
Washington University in St. Louis
One Brookings Drive
St Louis, MO 63130, United States
phone: +1 314-935-7197
e-mail: thakor@wustl.edu

*Corresponding Author

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POST-CRISIS CORPORATE CULTURE AND GOVERNANCE IN BANKING

By

Anjan V. Thakor

ECGI and John E Simon Professor of Finance and

Director of the Ph.D. Program at Olin Business School,

Washington University in St. Louis

Abstract

This paper provides a brief assessment of how ethics, culture and corporate governance have evolved in banking since the financial crisis. It concludes that we need to strengthen capital ratios and equity governance in banking to improve ethics and culture, and de-emphasize liquidity regulation. It also advocates the embrace of authentic organizational higher purpose in banking as a way to foster stability and growth.

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I. INTRODUCTION

The purpose of this note is to briefly discuss the issues of culture and corporate governance in banking, with a focus on developments since the financial crisis. Failures of corporate culture and weakness in corporate governance were blamed as contributors to the crisis (e.g., Thakor (2015, 2016)). There were considerable efforts by bank regulators and industry groups to highlight culture as deserving of more attention to prevent a recurrence of some of the failures that preceded the 2007–09 crisis.[1] So the question is: what has to change?

In addressing this question, I comment on ethics, culture, compensation contracts, corporate governance and higher purpose[2]. These are all related ideas, of course, but they are also distinct enough to deserve being discussed separately. Each of these terms is defined and I discuss the state of affairs in banking with respect to these issues.

The rest of this note is organized as follows. In the next section, I discuss ethics and culture. In Section II, I discuss compensation contracts and corporate governance. Section III discusses higher purpose. Section IV concludes.

II. ETHICS AND CULTURE IN BANKING

Ethics: the definition of ethical behavior is that the bank behaves in a manner that not only complies with the law but also the spirit of regulation. This means not selling products to customers that may be unsuitable for them and not taking actions that abuse the taxpayer-funded safety net that protects banks. Nonetheless, the substantial fines paid by banks since the financial crisis paint a somewhat troublesome picture about ethics in banking. By early 2018, U.S. banks had paid $243 billion in fines since the

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[1] See, for example, Dudley (2014) and Financial Stability Board (2014).

[2] This focus distinguishes this paper from my earlier essay in which I focused more on regulatory and related issues, and the design of a financial system that is healthy (and not crisis-prone); see Thakor (2014a).

financial crisis,[3] and it is expected that on a worldwide basis, banks will pay $400 billion in fines by 2020. Here is a list of the top banks in terms of fines paid:

Table 1. ***Fines Paid Since Financial Crisis by U.S. Banks***	
Bank of America	$76.1 billion
JP Morgan Chase	$43.7 billion
Citigroup	$19.0 billion
Deutsche Bank	$14.0 billion
Wells Fargo	$11.8 billion
RBS	$10.0 billion
BNP Paribas	$9.3 billion
Credit Suisse	$9.1 billion
Morgan Stanley	$8.6 billion
Goldman Sachs	$7.7 billion
UBS	$6.5 billion

One has to be careful in interpreting what these fines convey. As far as I know, none of these cases went to trial, so the fines do not necessarily reflect violations of ethics or laws in every case.[4] Nonetheless, it is undeniable that the financial services industry has developed a bad reputation for ethics.

The good news, however, is that many of the big banks are now emphasizing ethical behavior and culture much more. For example, I picked the top two banks in the table above and looked at their 2018 Annual Reports. Here are some excerpts:

Bank of America:

- "Our *culture* of careful expense management…" (emphasis mine).
- "100 Best Companies to Work for".
- "…We were recognized for our employment practices and commitment to being a good place to work, our customer service…".

[3] See Goldstein (2018).
[4] There is some evidence, however, that there were numerous ethical violations leading up to the 2007–09 crisis. See, for example, Piskorski, Seru and Witkin (2015).

- "Our ability to deepen customer and client relationships is driven in part by the investment we are making to provide the best client care in the industry".

JP Morgan Chase:

- "First and foremost, we look at our business from the point of view of the customer".
- "We take care of our employees".
- "We need to continue to restore trust in the strength of the U.S. banking system…"

While it is encouraging that banks are paying more attention to ethics and culture, it is important to note that ethical behavior can be influenced, but not legislated. And even in that case, better ethics is not a free lunch. Song and Thakor (2019) develop a model which shows that when incentive contracts are designed to raise the level of ethical behavior, there is less innovation in financial products, and banks with higher ethical standards tend to attract less talented managers than those with lower ethical standards.

Bank Culture: The focus of the analysis in Song and Thakor (2019) is on how compensation contracts of bank managers can be designed to elicit the desired ethical standards. Their analysis highlights the limitations of this approach to improve ethics that it has the unintended consequences of lowering financial innovation and inducing talent migration. One possible way to improve ethics while minimizing these adverse consequences is to strengthen bank culture. While the concept of culture is somewhat nebulous, I view it as a set of explicit and implicit contracts and (often unwritten) rules of conduct that determine how people in the organization behave. As William Dudley, former President of the Federal Reserve Bank of New York said, "Culture is like a gentle breeze. You cannot see it, but you can feel it."[5]

In Thakor (2016), I discuss how one can use the Competing Values Framework (CVF) to make the seemingly nebulous concept of culture concrete and measurable. I also discussed there the lessons for regulators. The main point of that discussion is that regulators can deal with culture in a practically

[5] See Dudley (2014).

sensible way. Specifically, regulators do not necessarily need to tackle, head on, the thorny issue of how to measure culture and build a regulatory framework around it.[6] Rather, as Song and Thakor (forthcoming) show, they can get banks to focus more on developing "safety-oriented" cultures by:[7]

- Increasing capital requirements,
- Limiting interbank competition,
- Reducing the probability of bailouts.

Moreover, culture choice is contagious, so if a few large banks orient their cultures in a certain way, others will follow.

A significant challenge in inducing banks to change culture is that they may be reluctant to make real investments in doing it if it does not enhance economic performance. There has not been much empirical work done on this, but recent research by Grennan (2019) is illuminating. That paper uses a simple but clever aspect of culture to examine its effect on bank performance—the consistency with which culture is communicated. Using historical versions of websites from 2004 to 2017 for 300 U.S. banks. Grennan (2019) finds that a majority of banks communicate their values inconsistently across websites themes (i.e., tabs on websites labeled "about us", "career", "community", "culture" and "investor relations"). Her most important empirical finding is that banks that communicated their culture values consistently before the 2007–09 financial crisis experienced better operating and stock performance during the crisis. Indeed, for each additional cultural value that is miscommunicated prior to the crisis, a bank lost an annualized 2.8% to 3.3% during the financial crisis from July 2007 to December 2008.

There does not appear to be systemic evidence on *how* bank culture has changed since the financial crisis. Given the elevated regulatory focus on safety and soundness and the heavier reliance on

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[6] "Measuring" culture for regulation will likely tempt banks to manipulate their culture measures, apart from also suffering from the Goodhart critique.

[7] See also Thakor (2018).

stress tests and capital regulation, one suspects a shift toward more safety-oriented cultures. But this conjecture awaits empirical testing.

III. EXECUTIVE COMPENSATION AND GOVERNANCE

The Dodd-Frank Act created regulatory oversight of executive compensation in banking to contain risk-taking. However, regulating compensation to influence behavior is a tricky thing. As the Song and Thakor (2019) model shows, optimal compensation contracts designed to induce more ethical behavior end up reducing innovation. Clawbacks and limits on bonuses may cause bank managers to be excessively risk averse.

A more fruitful approach may be to align compensation design with incentives for banks to be better capitalized. There is still far too much emphasis in banking on return on equity (ROE). We do not fully understand why,[8] but the rewards bank managers receive for increasing ROE encourage them to minimize capital and resist regulatory calls for more capital. It is Finance 101 that maximizing ROE is *not* the same as maximizing shareholder value, so discouraging the use of ROE in the determination of bank managers' bonuses is not asking them to de-emphasize shareholder value. The ROE emphasis leads to excessive leverage, even possibly to the detriment of bank shareholder value.[9] Moreover, as Acharya and Thakor (2016) showed, bank leverage has negative systemic risk implications, as higher leverage by some banks leads to higher fragility not only for those banks, but also other banks. The whole system suffers from grater fragility when systemically important banks choose to be very highly leveraged.

Executive compensation is only one aspect of corporate governance. Governance in banking has three pillars: regulation, market discipline from the bank's shareholders, and market discipline from the

[8] See Pennacchi and Santos (2018) for a recent theory.

[9] Mehran and Thakor (2011) showed theoretically and empirically that the relationship between bank capital and value in the cross-section is positive. That is, banks with more capital are worth more to their shareholders and also have higher total values. In other words, not only does the Modigliani and Miller leverage indifference theorem in the no-tax world not hold, but the Mehran and Thakor (2011) finding is the exact opposite of the Modigliani and Miller theorem that firms are worth more with more leverage when there are corporate taxes. Thakor (2014b) provides an extensive review of this literature. Bouwman, Kim and Shin (2019) document that high-capital banks deliver returns (positive alphas) for their shareholders.

bank's uninsured creditors. Regulatory discipline comes in many forms, including stress tests and capital and liquidity requirements. I have pointed out that post-crisis adoption of liquidity requirements did not address the right problem, and that the focus should be on strengthening capital requirements.[10] Stress tests and higher capital requirements are both good tools of prudential regulation.

Market discipline from uninsured creditors, one of the Basel II pillars, is one reason why there has been some hesitation in some quarters in pushing for higher capital ratios because the consequent lowering of leverage may weaken market discipline. A theoretical way to deal with this was proposed by Acharya, Mehran and Thakor (2016). They develop a model in which there are multiple sources of moral hazard in a bank, some dealt with more effectively by debt and some by equity. They show how the disciplining effects of both debt and equity can be harnessed while having relatively high capital ratios in banks. Thus, the market discipline of debt can no longer be used as a rationale for keeping leverage at excessively high levels.

Empirically, however, there is little support for the proposition that bank debt provides *effective* market discipline, That is, in practice, debt discipline has proved to not be very useful. This is for three reasons. First, possibly because they expect to be bailed out by the government, these creditors have not monitored banks the way bondholders typically monitor non-financial firms. These implicit bailout guarantees are reflected in the bond ratings of banks—rating agencies give them a two-to-three notches ratings advantage due to this.[11] Second, when bank creditors do see signs of trouble, they do not appear to attempt corrective action. Rather, as we saw during the crisis, they keep shortening debt maturity and eventually cut off funding, precipitating a funding freeze. Third, because of common asset holdings across banks, the actions of the creditors of one bank lead to similar actions by the creditors of other banks. As Acharya and Thakor (2016) showed, this can make idiosyncratic insolvency shocks at some banks cause systemic bank failures.

[10] See Thakor (2018).
[11] See Thakor (2015).

More attention needs to shift, therefore, to market discipline by bank shareholders. Here regulators need to do more. Traditionally, equity discipline in banking has not been very strong, in part because of restrictions on ownership of banks. Hostile takeovers are rare in banking. Of course, reliance on equity discipline has two potential drawbacks. One is that, for publicly traded banks, *overvalued equity* introduces its own agency problems, as Jensen (2005) argued. In the case of banks, the resulting distortions in managerial decisionmaking can also have safety-net consequences, so regulators need to take equity valuation into account in their regulatory function. Second, the incentives of bank shareholders are not necessarily to maximize total bank value, due to agency costs of debt (Jensen and Meckling (1976)). This problem is particularly acute in banking due to the very low capital ratios compared with non-financials. Nonetheless, opacity and *relatively* weak corporate governance tend to make bank equity more expensive than it should be. So strengthening governance and reducing opacity should facilitate better capital ratios in banking[12]. The paradox here is that low capital ratios in banks create a debt overhang problem and actually *weaken* shareholder incentives to improve corporate governance. So the causality runs both ways—impediments to effective equity-based governance make equity more costly and encourage low capital ratios, whereas lower capital ratios lead to poorer equity governance. On this front, regulation needs to go a lot further.

The private and social costs of having an undercapitalized banking system are enormous. Recent empirical evidence has highlighted these costs. For example, Blattner, Farinha and Rebelo (2019) provide evidence that a weak (undercapitalized) banking sector in Europe has led to a slow post-crisis recovery and has had a negative effect on productivity growth.

IV. HIGHER PURPOSE

Quinn and Thakor (2018) introduced the notion of organizational higher purpose. They define it as a prosocial contribution goal that transcends the usual business goals—profits or shareholder value—but

[12] Moreover, higher capital ratios will even help in reducing the likelihood of financial crises caused by financial innovation. See Thakor (2012) for a theory of the link between financial innovation, bank capital and financial crises.

yet intersects these goals. Thus, a higher purpose is a prosocial goal that is *connected* to the firm's business. It is *not* charity. Thakor and Quinn (2019) provide a formal model in which an authentic higher purpose can sometimes lead to higher profits. What does this imply for banking?

As I discussed earlier, attempting to improve ethics in banking through the usual channels of compensation, capital requirements and regulatory jawboning has its limitations and runs the risk of reducing innovation. It may be worthwhile encouraging banks to articulate an authentic higher purpose as a complement to these approaches. We do not as yet have a formal theory of higher purpose in banking, but in Thakor (forthcoming), I point out what higher purpose could mean in banking. Specifically, I argue that it could help to achieve the twin goals of financial stability *and* economic growth in the real sector through the actions of banks, goals that many believe conflict with each other. Moreover, visible pursuit of higher purpose will also contribute to a rebuilding of trust in banks. See Thakor and Merton (2019) for a theory of the role of trust in bank lending.

Banks have begun to think about higher purpose. I looked at the financial statements of the top two banks in *Table 1* and found the following in their 2018 Annual Reports:

Bank of America:

- "We did this by living our purpose, which is to help make our clients' lives better through the power of every connection we can make"

JP Morgan Chase:

- "We lift up our communities".
- "[We started our] *Advancing Cities* initiative to support wage and job growth in communities most in need of capital"

The authenticity of these purpose statements is a matter for future research to determine, but the empirical evidence is there that an authentic higher purpose communicated with clarity improves operating and shareholder value performance in firms.[13] I believe that in banking it will improve stability

[13] See Gartenberg, Prat and Serafeim (2019).

without sacrificing economic growth. As far as I know, regulators have not done anything on this front. To be clear, I do *not* believe higher purpose should be legislated or regulated. Rather, I am proposing that bank regulators ought to understand its power and make it a part of their dialog with banks.

V. CONCLUSION

This paper has provided a brief assessment of changes in ethics, corporate culture and corporate governance in banking since the financial crisis, and has indicated that organizational higher purpose is an area deserving of greater recognition and emphasis by banks. While much has improved in banking since the financial crisis, more needs to be done to strengthen capital ratios and (equity) corporate governance in banking. Moreover, the current regulatory emphasis on liquidity regulation is misplaced and stems from an incorrect identification of the 2007–09 crisis as a liquidity crisis. It was *not*. Rather, it was an insolvency risk crisis caused by a multitude of factors that resulted in investors cutting off funding to opaque banks they viewed as insolvent. Strengthening capital ratios and corporate governance, reducing/eliminating liquidity requirements, focusing on bank culture and encouraging the pursuit of higher purpose will not only improve ethics in banking but will also foster financial stability and economic growth.

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