Corporate culture : Insights from banking

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Introduction

- Banking is a heavily regulated industry, since it can be very useful, but also very dangerous, for the overall economy (bailouts, recessions).
- Here, connect banking regulation with the governance and culture of banks (control by investors and top management remuneration in particular).
- First, summarize earlier work with Jean Tirole.
- Then derive a couple of policy-relevant principles (including CSRD at the end).

Bank governance and regulation/supervision/ resolution (RSR): trading off insurance and incentives

(based on *Dewatripont-Tirole* 1994a,b and 2012, and *Dewatripont* 2024)

RSR as an incentive scheme

- Idea of idea of capital structure in nonfinancial firms: in an incomplete-contract setting, when firm performance is bad, management should face the risk that control switches from (nicer) equityholders to (tougher) debtholders.
- Indeed, (less-risk-averse) equityholders have natural tendency to want to keep firm going, while (more-risk-averse) debtholders have more incentive to stop/liquidate.

RSR as an incentive scheme

- ‘Representation hypothesis’: in banks, debt-holders are unable to exert control, so see bank RSR as a way to replicate their role in nonfinancial corporations.
- Even in nonfinancial corporations, the life of debtholders is not ‘easy’.
- However, speed is a specific challenge with banks which, when in trouble, can grow by raising interest rates to attract (insured) deposits (‘gambling for resurrection’).

RSR as an incentive scheme

- In a sense, Basel regulation has attempted to replicate role of debtholders from the start (i.e. from 1988): tries to ensure sufficient solvency (so that shareholders ‘play with their own money) and otherwise resolution.
- With 2 well-known challenges: (i) calibration (banks remain very leveraged) and (ii) credi-bility and impact of control switch (which depend on behavior of supervisory and resolution authorities).

RSR as an incentive scheme – remark on ‘macroprudential’ policy

- Third key issue: relevant performance is the idiosyncratic one, not the performance linked to aggregate shocks (Holmström, 1979).
- This issue was ignored until 2008, and now (partially) addressed in Basel III (countercyclical capital buffer), and further improved with Total Loss Absorbency Capacity (&, in EU, ‘MREL’).
- Punchline: the more stable the ‘system’, the easier the job of banks, and of microprudential authorities.

How has post-2008-crisis RSR performed so far ?

Research shows Basel III solvency rules not to be ‘excessive’. Several prominent academics argue it is even (vastly) ‘insufficient’.

- Basel III has increased the (risk-weighted) capital ratio a lot, but from a very low level. And (non-risk-weighted) leverage ratio is very low: book value of capital often less than 5%.
- See e.g. Cecchetti (2014) as well as Admati-Hellwig (2023) and others.

Recent experience

- Last years not without serious macroeco-nomic shocks : low inflation, covid, then high inflation.
- These did lead to individual problems in 2023 : Silicon Valley Bank and some others in the US, and Crédit Suisse.
- But no new Great Financial Crisis, at least until now.

Current risks : lessons from 2023

- US learnt Basel III would have been useful for SVB et al.: clear advantage for EU here, with its ubiquitous application of Basel III !
- Crédit Suisse showed the risk of procrastination, of slow-moving accounting ratios (and of 'too-big-to-manage' banks ?). But also the loss-absorbing value of 'AT1' and thus the usefulness of Total Loss Absorbing Capacity.
- Question : Banking Union has done well in 2023, but has it been 'lucky' ?

‘Market leverage ratio’ of US G-SIBs

Capital Add-on	Bank	Market cap*	Assets**	Ratio
2.5%	JP Morgan	605	4143	14.6%
2.0%	B. of America	301	3258	9.2%
2.0%	Citigroup	113	2405	4.7%
1.5%	Goldman	151	1653	9.1%
1.0%	Morgan St.	156	1212	12.9%
1.0%	Wells Fargo	184	1940	9.5%

*: on September 9, 2024; **: June 2024.

‘Market leverage ratio’ of Banking Union G-SIBs

Capital Add-on	Bank	Market cap*	Assets**	Ratio
1.5%	BNP Paribas	78	2893	2.7%
1.5%	Deutsche Bank	32	1448	2.2%
1.0%	Crédit Agricole	48	2393	2.0%
1.0%	ING	57	1116	5.1%
1.0%	Santander	74	1914	3.9%
1.0%	SocGen	20	1706	1.2%

*: on September 9, 2024; **: June 2024.

Towards a 'risk-focused supervisory culture'

- Situation of biggest Eurozone banks consistent with ECB Supervisory Board Chair Claudia Buch's speech in June 2024: capital ratio increased from 12.7% in 2015 to 15.6% 2023 but leverage ratio only from 5.3% in 2016 to 5.6% in 2023.
- Useful therefore to tighten the screws on Eurozone biggest banks by focusing on their 'internal models'.

Governance & (shareholder) culture

- General debate these days about shareholder value versus stakeholder value.
- Specificity of banking: VERY high leverage, and thus potentially big difference between firm value and shareholder value, which in turn influences bank culture. Should we introduce more private debt control, next to regulation?
- Paradox: everybody complains about excess-ive banking leverage … but the tax system subsidizes debt relative to equity: should it for banks? Or should we go for ‘consistency’?

Control, remuneration and culture

- Next to solvency and liquidity ratios, role for less equity-oriented control (including w.r.t. managerial incentives).
- Esp. since some of these weaker big EU banks are 'universal', with most probably a compensation structure which favors invest-ment banking rather than the key 'missions' of deposit-taking institutions ('organizing the payments system and lending to house-holds and SME's').

European Banking Authority High Earners (HE) 2017 (pre-Brexit)

	BE	DE	FR	UK
Total number HE	22	390	233	3.567
Average Comp. (M€)	1.4	1.6	1.7	2.0
% Investment B.	23	27	61	58
% Retail B.	14	5	3	3
% Asset Man.	5	5	11	12
% Other bus. areas	58	63	25	27

Control, remuneration and culture

- Would be interesting to evaluate impact of EU Parliament rule that variable compensation be no more than 100% of fixed comp.
- Does not seem to have made changes w.r.t. previous slide: in France, in 2022, we had 467 HEs (88% male …), of which 40 in the mgt board (2 in superv. functions, 38 in mgt functions), 342 in investment b. (73% …), 17 in retail b., 33 in asset mgt, 21 in corp. functions and 9 in 'independent control functions' (see EBA 2024).

Further debates in banking

- While hitting long-term claimholders in case of bad performance makes sense, one should not forget about top management: do we suffer from the 'too big to jail' syndrome? Idea of fining the bank, i.e. current (possibly recent) shareholders is not first-best.
- Many complaints about complexity of regula-tion (incl. many 'principles', on governance et al.). Including by banks which want to keep their (very complex) internal models …

Final general remark : on the banker-supervisor relationship

- Supervisors always at risk of being less well-informed than bankers.
- There is evidence of correlation between importance of CRO in bank hierarchy and amount of risk-taking during GFC. And compensation in general is key in this respect too.
- Opportunities to make at least some bank employees 'allies' of supervisors (also true for uninsured creditors) ?

Some banking lessons for CSRD

- Banking RSR is difficult, despite its ‘modest’ objective: avoiding financial instability and bailouts. So, can offer useful experience.
- ESG is much ‘broader’ and thus more ‘ambitious’, so some challenges come ‘naturally’, e.g. complexity (with complaints that can be more or less valid) & ‘streamlining’ will be good.
- Keep ‘big picture’ in mind: for banking, tax system (debt vs equity) & macropru buffers, here carbon taxes/clean subsidies. Good to ‘align’ incentives and ‘stabilize’ the system.

Some banking lessons for CSRD

- The ‘elephant in the room’: if we (legally) allow firms to serve shareholder interests, to what extent should we expect them to deviate from that (beyond respecting the law) ? Shouldn’t we move to other corporate legal forms ?
- This depends on the nature of the market: in some cases, thanks to transparency (and CSRD ☺), stakeholders can exert useful ‘discipline’, in others much less so, and other legal forms, like Benefit corporations or even not-for-profit status, may be required.

Some banking lessons for CSRD

- But before going that route, key is to trans-form 'big concepts', like ESG or culture, into more concrete (ideally simple) indicators.
- Authority within the organization and remune-ration are central instruments in this respect.
- Some recent, and less recent, (non-banking) research on this: Dewatripont et al. (1999), Fischer et al. (2019), Dewatripont and Tirole (2024) and Dewatripont (2023).

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