# Is the Common Good of Banking Diversity Endangered by Regulation?

by

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# Outline

- Theoretical bases for regulating Finance vs Banking: (*)
  - Basic difference of Financial Markets vs Banks
  - Mainstream regulatory approach and treating banks as commodities
  - The great misdoings of the Big Banks
  - Mainstream regulation doesn't help customers to trust banks.

- Cooperative/Ethical banks as a concrete remedy:
  - Shareholder (for profit) Banks vs Stakeholder Banks
  - Specific mission/governance/business model of Cooperative/Ethical banks
  - Relational business model, financial inclusion, and human dignity.

(*) This part draws on Ferri & Neuberger 2014)

## Basic difference of Financial Markets vs Banks – 1

- Theory tells us that Financial Markets & Banks must be distinguished:

- Finance theory (at least mainstream one, i.e., excluding behavioral finance, which is growing: Fama vs Shiller) posits presence of complete & perfect information;
- Instead the theory of banking intermediation hinges on how to tackle information asymmetries between borrowers and lenders.

In his paper "What's different about banks?" Fama (1985) himself recognizes the comparative advantage of banks with respect to financial markets in the superior ability of banks to grant credit on the basis of private information. The theory of banking intermediation tells us that banks specialize in producing information and in defining loan contracts to prevent credit rationing to borrowers where asymmetric information prevails (Stiglitz, Weiss, 1981; Diamond, 1984; Ramakrishnan, Thakor, 1984; Holmström, Tirole, 1993).

Stiglitz & Weiss (1981) were the first to show that asymmetric information between lender and borrower justifies market equilibria featuring quantity rationing of credit.

# Basic difference of Financial Markets vs Banks – 2

- Since banks specialize in gathering and processing information on borrowers to carry out *screening & monitoring*, typically we may have three possible cases for borrowers access to external finance:

- **Maximum asymmetry of information problems** $\Rightarrow$ no external financing (only self-financing);
- **Intermediate asymmetry of information problems** $\Rightarrow$ external financing (but only from banks);
- **Minimum asymmetry of information problems** $\Rightarrow$ external financing from both banks and financial markets.

# Basic difference of Financial Markets vs Banks – 3

- But how does a bank manage to produce that information and those incentives which allow it granting credit to high-asymmetric-information customers?

- **Through contract clauses & collateral guarantees** ⇒ ***transactional lending*** hinges on hard information: accounting evidence (balance sheet, income statements) & collateral guarantees.

- **Through relationships** ⇒ establishing human and personal relations, ***relationship lenking*** allows building abilities, competence and credible promises which go well beyond what an individual can provide in terms of collateral guarantees.

- Attention: The Internet & Big Data revolution may render outmoded ***transactional lending*** but not ***relationship lending***.

## Mainstream regulatory approach: treating banks as commodities – 1

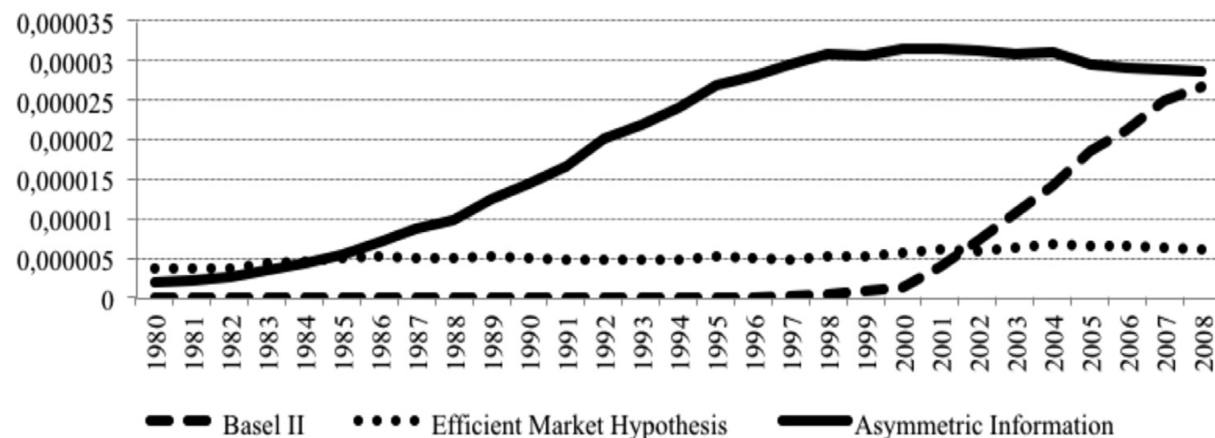
- We can document that the theory of finance prevailed over that of banking intermediation in shaping the regulation of banks:

- That dramatic contradiction is the true cause of the recent: low credit standards, heightened systemic risk at banks, and excess macroeconomic indebtedness.

- Returning banks to solidity without jeopardizing their functioning we need to "restore the consistency" of banking regulation with the theory of banking intermediation.

*And the debate on banking regulation was genuine or an artifact?*

PERCENTAGE INCIDENCE OF THE OCCURRENCES OF "ASYMMETRIC INFORMATION", "EFFICIENT MARKET HYPOTHESIS", "BASEL II"




*Source*: *www.books.google.com/ngrams.*

## Mainstream regulatory approach: treating banks as commodities – 2

- A sound approach requires a U turn in the regulatory logic:
- Only a small part of banks assets – e.g. investments in bonds – may be truly classified as commodity risks;
- On the contrary, the main part of banks assets – especially loans – are essentially idiosyncratic risks whose quantification demands associating to them not only their objective characteristics derived from hard information & the statistical distributions of risks but also subjective characteristics such as the bank's ability to screen & monitor those loans. This makes it essential evaluating the relationship on the basis of which each loan has been granted and is monitored;
- Reintroducing Banks Business Models in regulation;
- To adopt such an alternative approach, following Haldane (2012), we should at least recognize that a first useful step would be abandoning the Risk Weighted Asset Approach introduced by Basel 2.

## Mainstream regulatory approach: treating banks as commodities – 3

- The mainstream approach judges Relationship banking as vicious & inefficient. It treats loans as commodities whose intrinsic risk profile is believed unchangeable even if those loans exit the balance sheet of the bank that has granted them, who sells them, as they are pooled to be securitized.

- The theory of banking intermediation allows us, instead, that "informed credit" – where the loan is created within the bank-borrower relation in which the bank selects and monitors the customer-borrower – is intrinsically different from "commodity credit" – where the loan is originated to be sold.

- Moving from informed credit to commodity credit was one of the causes behind the excess credit creation, coupled with low lending standards, which brought to the Great financial Crisis of 2007-2009, in large part at the expense of vulnerable borrowers.

## Mainstream regulatory approach: treating banks as commodities – 4

- Then the key question is:
- Did regulators learn the crisis' lesson & react properly to restore sound banking?
- My answer is a qualified no.
- Some measures introduced by Basel 3 may, in fact, favor banking stability. First, asking banks to hold more & better capital should make them more resilient.
- But, banks' stability requires above all having them do well their business.
- In this respect, not much has changed with Basel 3 vs Basel 2.
- Subjugating banks to the diktats of the theory of finance, the Risk Weighted Asset approach, in general, will divert banks from appropriate business conduct.
- Thus, following the famous Zen saying of the finger pointing the moon, it looks that Basel 3 regulators focused on the finger – there was not enough capital in banks – rather than on the moon – the true culprit behind the crisis : (most) banks, also because of wrong regulation, were not doing their business correctly.

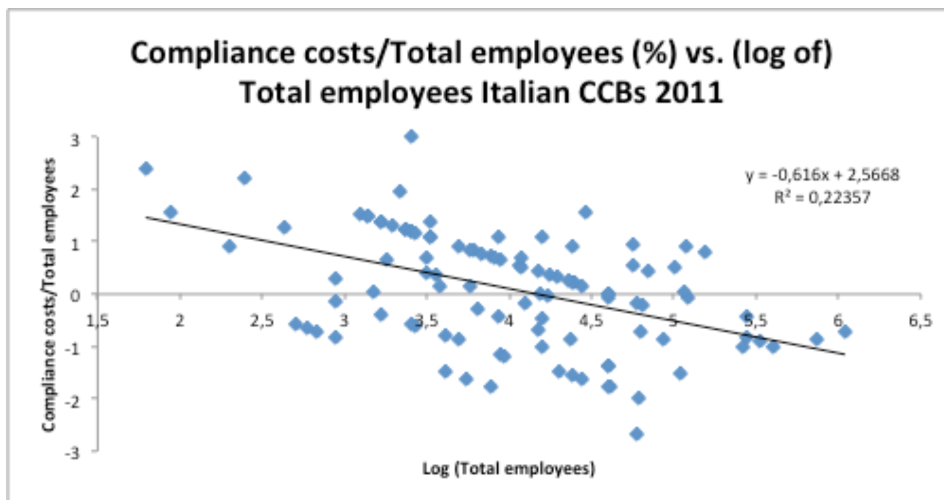
## Mainstream regulatory approach: treating banks as commodities – 5

- A big opportunity was lost to revise post-crisis regulation.
- Contrary to the early 1930s, this time around there was no Pecora Commission to guide a rapid stiffening of rules for banking and finance (Krugman, 2010a; 2010b). The Dodd-Frank Act took too long to pass (& Trump may even cancel it) and even Basel 3 & CRD IV took too long. In both cases there was no Pecora spirit – i.e. taking commercial banks back to their traditional business & limiting their exposition to financial markets risk (then via the Glass-Steagall Act).
- More than that, the present framework of Basel & the EU directives on financial services is partly obnoxious because it aims to harmonize the rules, disregarding the diversity across bank Business Models & the role of long-term relationships to benefit borrowers. So, the cost of compliance to rules thought for other bank types damages Stakeholder banks.
- Any regulation will always have to come to terms with vested interests & their lobbies, but the first required step towards sounder banking demands that regulators adopt the ‘right’ theory. Adopting the theory of banking intermediation, regulators should change their past approach and quickly move to take a very different attitude.

# Mainstream regulatory approach: treating banks as commodities – 6

- Rising *regulatory compliance* costs depend on the lack of proportionality & may damage cooperative banks (Ferri & Pesce, 2012; Ferri & Kalmi, 2014).

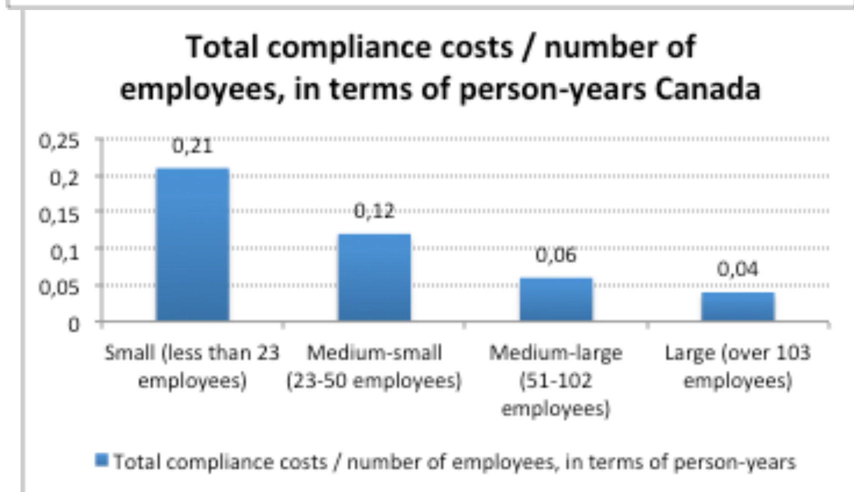
**BCC in Italy (Ferri & Pesce, 2012)**




**Credit Unions in USA (right panel top)**

**& in Canada (right panel bottom)**

**(Ferri & Kalmi, 2014)**



# Mainstream regulatory approach: treating banks as commodities – 7

- Searching for large size to lower compliance costs, many M&As among BCCs, this risks damaging their mission without clear efficiency benefits (Coccorese et al., 2017).

FIGURE 2 – *M&A operations involving BCCs (Italy, years 1994-2013)*

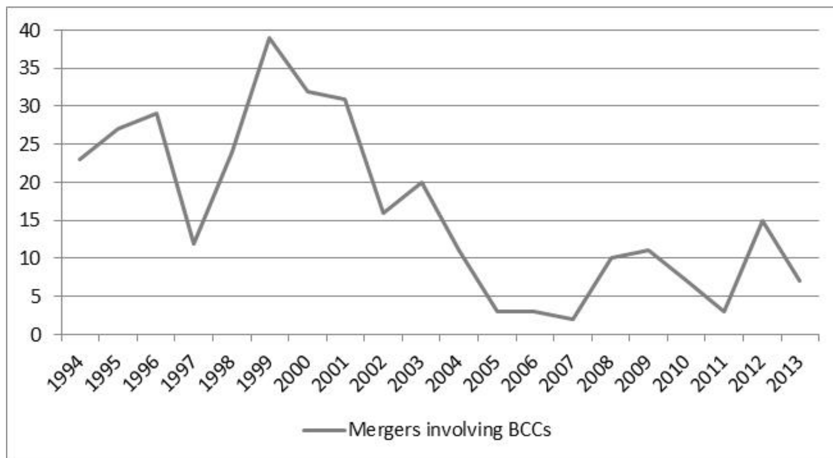
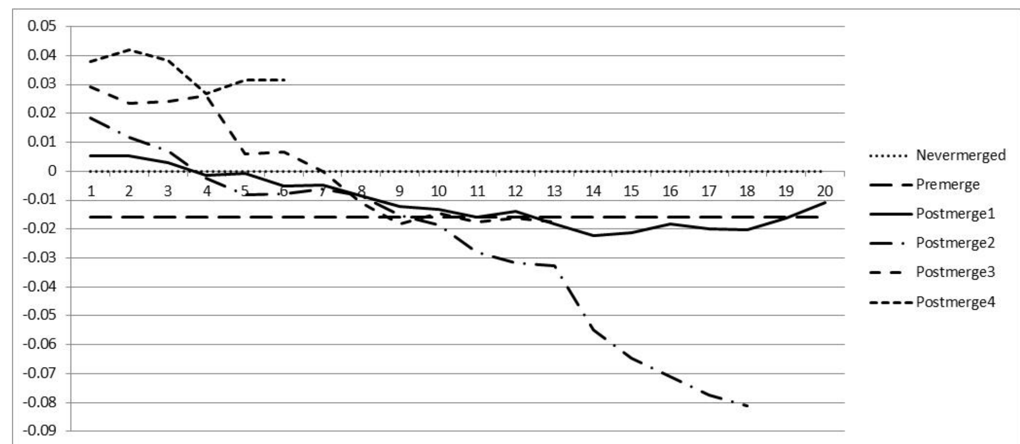



FIGURE 3 – *Yearly efficiency differentials with respect to never merged BCCs*



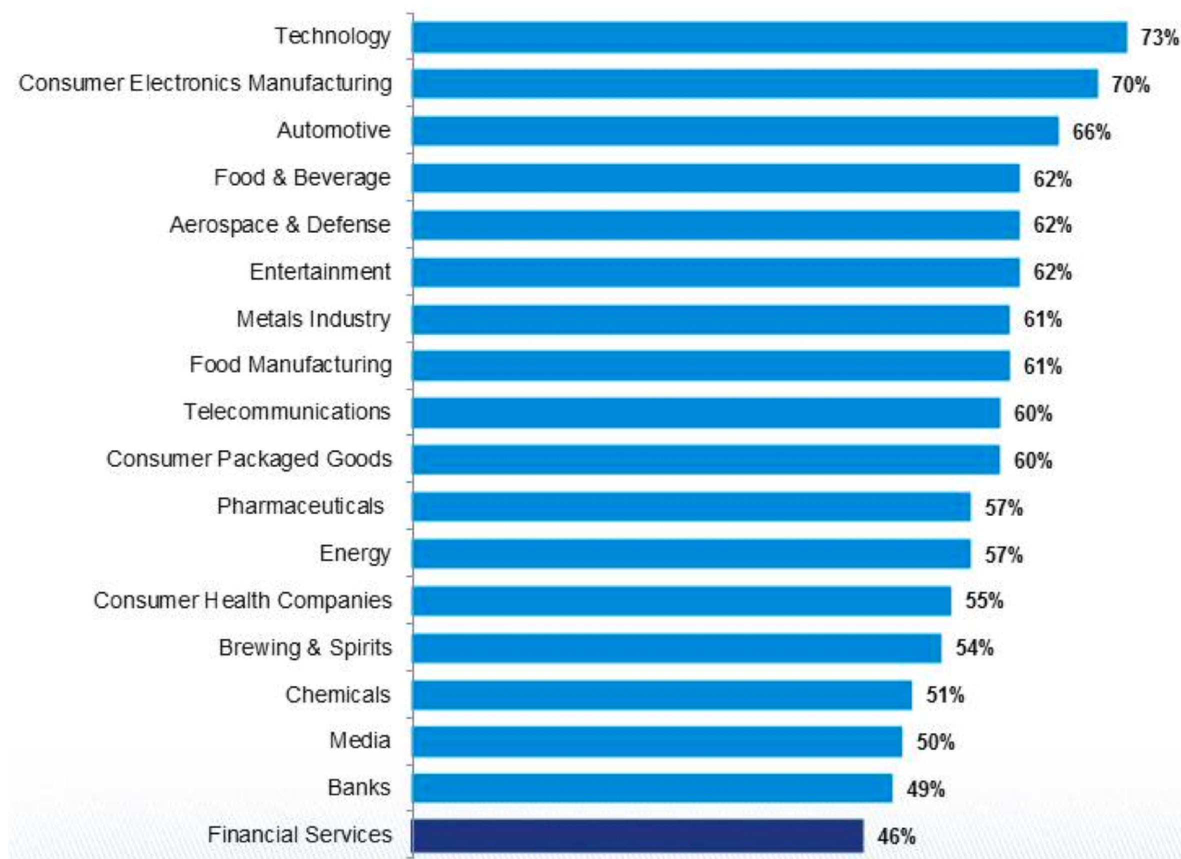
## Mainstream regulatory approach: treating banks as commodities – 8

- If we want to see them, there are all the signals that banking regulation must change approach to return banks at the service of society.

- 81 years ago Robert Musil published his masterpiece Der Mann ohne Eigenschaften (Man without quality).
- that was the result of the dominating thought of the time, the Man without quality is alienated from the real world, has no interest and is immerged in the anti-humanism & nihilism of Nietzsch.
- We must wake up from our sleep before the new nihilism of our time leads us to the Bank without quality.

## Mistrust in Banking/Financial Services Providers: Cross-Industry evidence [(*)]

**Figure 1.** *Trust in industries – Global index for 2013*

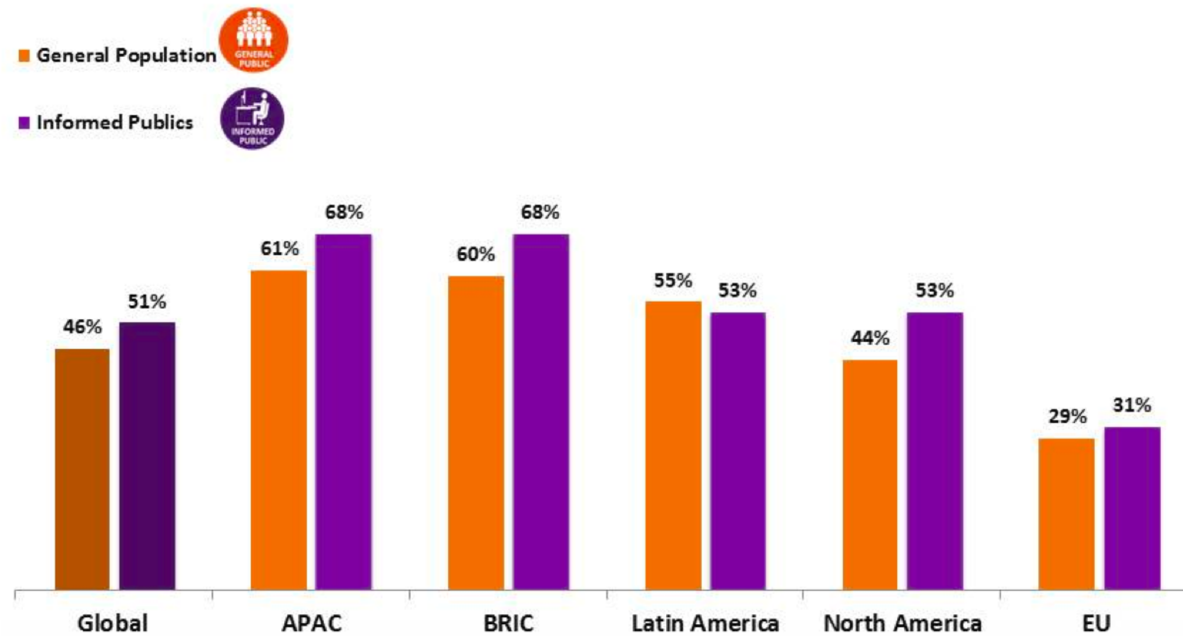



*Source: Edelman (2014).*

This part draws on Ferri (2015)

# Mistrust in Banking/Financial Services Providers: Cross-Area evidence

**Figure 2.** *Trust in industries by region – index for 2013*




*Source: Edelman (2014).*

## Learning from the Fines they pay: The Size of the Fines is not trivial

- The friendly rules of the 'light-touch' regulation of finance were reportedly violated in a blatant way, to the point that regulatory and courts' actions inflicted fines and/or settlements able to dent close to 10% of the Tier 1 capital of the twelve largest western banks.

- Indeed, one way to quantify the misdoings of finance is by looking at the fines issued on the liberalized financial intermediaries by regulators and courts. Through an internet search we collected information from disparate sources to quantify a total approximate amount of $114.25 billion over the period January 2010 – October 2014, something like the entire GDP of Angola or Morocco.

**Table 2. Misdoings related regulatory fines and settlements by bank's share (January 2010 -- October 2014) and incidence on tier 1 capital (Q2 2013)**

| | (A) | | (B) | |
|---|---|---|---|---|
| | Settlements | | Tier1 capital Q2 2013 (from FDIC) | (B)/(A) |
| | $ billions | % | $ billions | % |
| Bank of America | 32.33 | 28.30 | 157 | 20.60 |
| JPMorgan | 14.43 | 12.63 | 164 | 8.80 |
| BNP Paribas | 8.90 | 7.79 | 100 | 8.90 |
| Citigroup | 7.09 | 6.21 | 144 | 4.92 |
| UBS | 5.53 | 4.84 | 42 | 13.15 |
| Deutsche Bank | 3.60 | 3.15 | 71 | 5.07 |
| HSBC Holdings | 2.72 | 2.38 | 150 | 1.81 |
| Wells Fargo | 1.76 | 1.54 | 133 | 1.33 |
| Goldman Sachs | 1.75 | 1.54 | 71 | 2.47 |
| RBS | 0.98 | 0.86 | 89 | 1.10 |
| Barclays | 0.75 | 0.66 | 80 | 0.94 |
| Societe General | 0.70 | 0.61 | 52 | 1.35 |
| American Express | 0.19 | 0.16 | | |
| Not allocated | 33.50 | 29.32 | | |
| Total | 114.25 | | 1253 | 9.12 |

*Source: own calculations on data derived from official announcements on the web (see the Appendix for details).*

**Table 3. Misdoings related regulatory fines/settlements by allegation (Jan 2010 – Oct 2014)**

| | $ billions | % |
|---|---|---|
| misselling MBS to investors | 39.05 | 34.18 |
| discriminatory lending + foreclosure abuses + fraud on consumers | 35.10 | 30.72 |
| misselling MBS to Fannie Mae/Freddie Mac | 18.33 | 16.04 |
| breaking US sanctions + money-laundering + fraudulent tax shelters | 12.25 | 10.73 |
| rigging markets (interest rates; forex; municipal bonds; electricity) | 6.85 | 6.00 |
| others | 2.67 | 2.34 |

*Source: own grouping on data derived from official announcements on the web (see the Appendix for details).*

## Two alternative “tales”: the 1930s vs. the Post-Lehman

- Hawkish Pecora vs Lenient Wolves:

- The telling story of Ferdinand(o) Pecora  vs the recent re-regulation fiasco.

- Different macroeconomic policy approach:

- The turning point form laissez faire to interventionism.

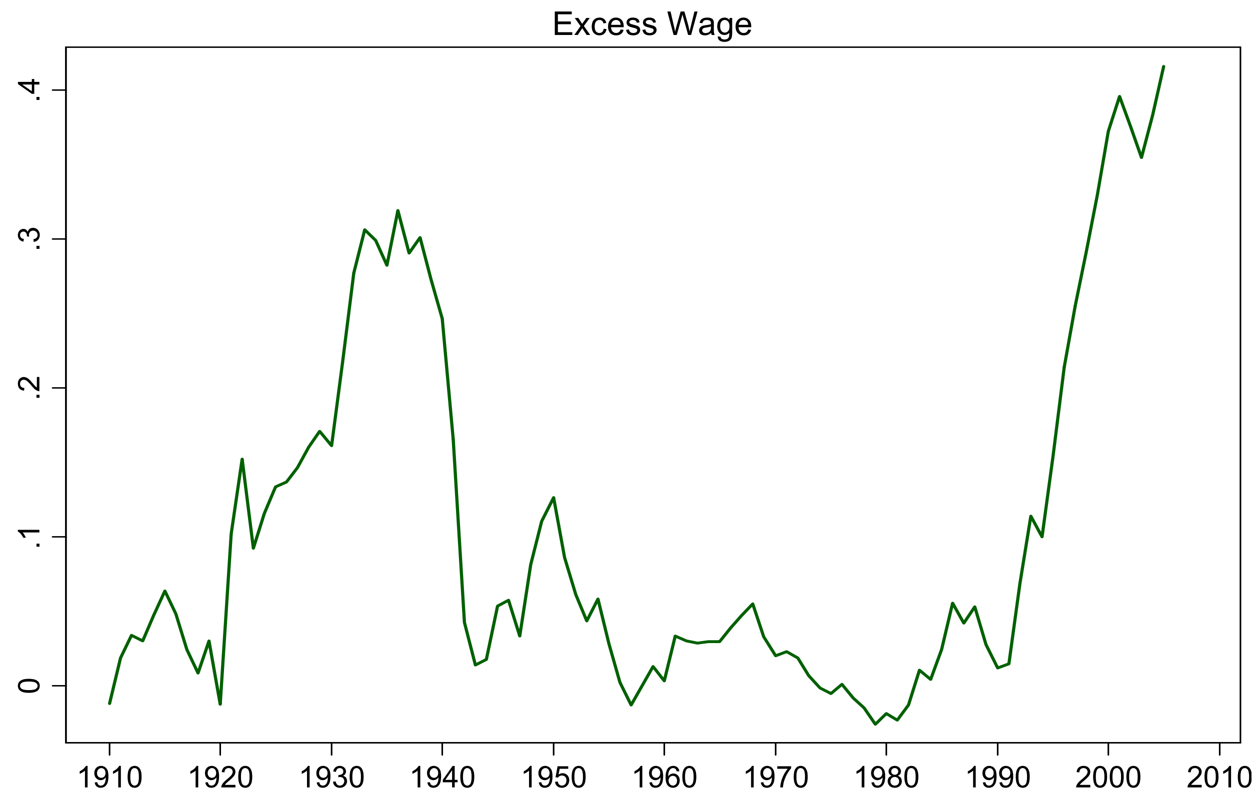
## Is there an easy Fix at hand?: More capital can help but is not enough

- Before going bankrupt Lehman Brothers had quite enough capital;
- Various studies find that more capitalized banking systems didn't escape the 2007-2009 crisis [e.g., Caprio et al., 2014];
- Some papers show that more shareholder friendly banks had worse performance through the crisis [e.g., Beltratti – Stultz, 2012];
- Some authors find that, after Lehman bankruptcy, stock markets placed a premium (discount) on banks doing traditional (financial) intermediation [e.g., Bongini et al., 2010];
- Other scholars show that, after the crisis, even the rating agencies gave a premium to traditional banks [D'Apice et al., 2016; Ferri et al., 2014].

## Is there an easy Fix at hand?: Ethics problems

- Pushing banks to just lift ROE raised the temptation to misbehave:
  - The fines they pay tell us a sad story;
  - The public outrage (e.g., calling "Bangsters" the Bankers) exaggerates but worries;
  - Compensation schemes gave wrong incentives [e.g., Figure from Philippon-Reschef, 2009].

Figure 11: Historical Excess Wage in the Financial Sector



## Shareholder (for profit) Banks vs Stakeholder Banks – 1

- **The main differences *for profit* Bank vs *Stakeholder* Bank:**
- Who are the *for profit*: all the banks, generally shareholder banks, which aims mostly to maximize profit.
- Who are the *Stakeholder*: all the banks that do not aim to profits but are established and exist with social utility aims. They include: public banks, savings banks, cooperative banks (mutual or not) and ethical banks.

- Another key difference has organizational/operational nature: *for profit* banks are generally independent banks, while *Stakeholder* banks are often part of a network.

## Specific mission/governance/business model of Cooperative/Ethical banks – 1

- **The three pillars of Coop banks' difference**
- First, while a Plc bank (SpA) has the sole objective of maximizing profit, the cooperative bank has in whole or in part mutualistic purposes and works for a number of stakeholders, rather than for just one group (shareholders);
- Second, with a cooperative bank customers may have different incentives than with a Plc. In fact, in coop banks customers often are shareholders too and, therefore, appearing both as depositors and as shareholders may have incentives to peer monitoring – the peer control that is at the root of the success of the Grameen Bank of Yunus – that is, to provide information that will enable the bank to avoid lending to unworthy borrowers;
- Third, the different governance. Plc bank shareholders count based on the number of shares held. On the contrary, in the coop bank each shareholder has one vote regardless of the number of shares held (one-head one-vote). This mode of governance raises the bank's democratic accountability and is combined with the mission of the coop bank to the widest audience of stakeholders. In short, diversity of mission, diversity of incentives and greater democratic representation (favored by the one-head one-vote rule) push all along the coop bank to adopt the relationship banking model.

## Relational business model, financial inclusion, and human dignity – 1

- ***Relationship Banking* – typical of Stakeholder banks – to safeguard financial inclusion and human dignity:**
- Safeguarding those bank models based on personal interaction is, so, a key challenge to avoid processes of de-humanization & of social marginalization.
- We should say it loudly to those who pretend to adopt everywhere a reductionist approach that, focusing only on banks' ability to make profit and hold capital, tends to build disadvantage for those banks, such as the stakeholder banks, which produce values for the common good beside remunerating shareholders.

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