ISSN 1429-2939

Nr 2(55) 2014

BEZPIECZNY BANK

SAFE BANK

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BANK GUARANTEE FUND

SAFE BANK is a journal published by the Bank Guarantee Fund since 1997. It is devoted to issues of financial stability, with a particular emphasis on the banking system.

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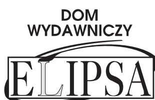

Typesetting and printing by:
Dom Wydawniczy ELIPSA
ul. Inflancka 15/198, 00-189 Warszawa
tel./fax 22 635 03 01, 22 635 17 85
e-mail: elipsa@elipsa.pl, www.elipsa.pl

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FROM THE EDITOR

This issue of "Safe Bank" consists of a selection of articles based on the papers presented at the international conference "Ethics in Banking," which took place at the Cracow University of Economics (CUE) on December 5–6, 2013. The Conference was organized by the Banking Section of the Faculty of Finance of CUE and co-organized by Narodowy Bank Polski, with key speakers such as Prof. Eugeniusz Gatnar from the NBP Management Board and Prof. Jakob de Haan, Head of Research of De Nederlandsche Bank and Professor at the University of Groningen.

Post-crisis restructuring of banks in the global market is a multidimensional process; considerable success has been achieved especially in the areas of bank soundness and safety. Other areas – particularly the reform of corporate governance and the promotion of ethical behavior in the banking market, are lagging behind. Thus, the aim of the conference was to analyze the role of ethical behavior in banking in post-2008 crisis bank restructuring in a broad context, and with a distinction between commercial and cooperative banks' perspective. The aim was to compare different views on the crisis, with a particular emphasis on the safety net, corporate governance, corporate culture, and the role of ethics for bank stability and efficiency. Another goal was to compare experiences in promoting ethical values and market efficiency in different countries, hence the Authors of the selected papers presented the Finnish, French, German, Italian and Polish perspective.

Taking into account the experience from the near past, it is instructive to start the Issue with a short introductory text sent by another key-speaker, Prof. Ingo Walter from the New York University Stern School of Business, on the role of reputation and adverse selection in banking.

We are particularly indebted to Prof. Ewa Miklaszewska for her dedicated efforts to organize the papers presented in this Issue.

Jan Szambelańczyk
Chief Editor

Warsaw, May 2014

Introductory Statement

Ingo Walter*

THOUGHTS ON REPUTATIONAL RISK AND ADVERSE SELECTION IN BANKING

The epic financial crisis of a few years ago left behind massive damage to the process of financial intermediation, the fabric of the real economy, and the reputation of banks and bankers. Even today, some five years later, little has happened to restore financial firms to their former glory near the top of the reputational food-chain in most countries. For reasons of their own, many boards and managers in the banking industry have little good to say about the taxpayer bailouts and inevitable regulatory tightening. In the words for former Barclays CEO Bob Diamond, "There was a period of remorse and apology for banks. I think that period is over. Frankly, the biggest issue is how do we put some of the blame game behind us? There's been apologies and remorse, now we need to build some confidence."[1]

There have been some notable exceptions. In the middle of the crisis Josef Ackermann, former CEO of Deutsche Bank and Chairman of the International Institute of Finance (the preeminent lobbying organization for the world's largest banks), noted in 2008 that the industry as a whole was guilty of poor risk management, with serious overreliance on flawed models, inadequate stress-testing of portfolios, recurring conflicts of interest, and lack of common sense, as well as irrational compensation practices not linked to long-term profitability. Whether at the industry, firm or personal level, the reputational cost of the financial crisis five years ago was enormous.

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* Ingo Walter is a Professor at New York University, Stern School of Business, USA.

1 Appearing before the Treasury Select Committee, UK Parliament, 11 January 2011. www.cbsnews.com/2100-500395_162-7234896.html

Still, memories are short. Redirection of financial flows through the shadow banking system, creation of new products, persistent regulatory fault-lines, and renewed erosion of due diligence in some markets show the persistent need for vigilance. Meantime, banks have been called on the carpet for an amazing variety of transgressions that encompass fixing Libor and foreign exchange benchmarks, aiding and abetting money laundering and tax evasion, rigging metals and energy markets, and an assortment of fiduciary and consumer protection abuses. Most of these allegations are independent of the crisis legacy, and have surfaced despite what were thought to be adequate legal and regulatory safeguards. All of them first came to light at individual banks. But most of them later turned out to be "industry practice."

Andrew Haldane of the Bank of England, among others, has suggested we look to "cultural" factors in modern banking for at least part of the answer. Banking culture is a product of individuals who act collectively in a firm that operates under a combination of market discipline and regulatory constraints. In turn, banks comprise multiple subcultures that range from transactions processing and retail banking to corporate finance and interprofessional trading – subcultures that are distinctive in terms of the professionals they attract and the performance pressure to which they are exposed. Financial markets can sometimes be so efficient that overstepping the rules offers one of the few routes to serious profit – as they say, "no conflict, no interest". Banks and bankers, some would argue, have somehow lost their way in carrying out their key role as efficient allocators of capital and creators of better social welfare. They seem more like wealth-redistributors, from their clients to bank employees and shareholders, all the while privatizing returns and socializing risks on the back of taxpayers when things go badly wrong. Fair assessment or not, it's no wonder the industry as a whole and individual banks have seen their reputational capital erode. What might explain this?

It could be the changed competitive market structure in global banking, in which more intense competitive pressure and heavily commoditized markets have made it increasingly difficult to deliver ambitious promised returns to shareholders and attractive bonus pools to employees. This creates incentives to migrate banking activities to less open and less transparent markets, where transaction costs and profit margins are higher. These are markets that have become increasingly problematic as a result of greater product complexity and erosion of transparency, with efforts to reform them often resisted furiously by banks and their advocates. It could also be that, in such an environment, the definition of "fiduciary obligation" – the duty of care and loyalty that has traditionally been the benchmark of trust between banker and client – has morphed into redefining the client as a "trading counterparty," to whom the bank owes nothing more than acceptable disclosure of price, quantity and product. A deal is a deal, and what happens later is only of limited concern in a world where the "long term" is after lunch.

Compounding the effects of market dynamics is the changing nature of the banks themselves, which might be considered both a cause and a consequence of crisis-related and subsequent reputational issues. If bank size, complexity, imbedded conflicts of interest, and the ability to manage and govern themselves were contributory factors leading to the recent crisis, then these issues are even more problematic today – if only as a result of still bigger and broader financial conglomerates emerging from governments' efforts to stabilize the system. In the restructuring process some important things can easily get lost, with thousands of people from competing institutions newly hired and others dropped from the team. Whatever affirmative culture once existed can get washed-away in the merger integration. Such factors are sometimes complemented by banks' underinvestment in risk management and compliance (the "defense") and its perennial disadvantage in questions of judgment and engagement against revenue- and earnings-generation (the "offense"). Usually this "tilt" is compounded by levels and systems of compensation designed to emphasize bonus against malus. Reputational capital is lost by people, acting individually and collectively. So what drives them is of critical importance.

Nor can boards of directors be let off the hook. They are supposed to set the tone that dominates everything a bank does, and how that is projected into the marketplace. In some cases factors like poor industry knowledge of directors, lack of technical background, dominant or "imperial" chairmen, and a boardroom sociology that puts a premium on "teamwork" can be at fault. And who is supposed to control boards? Presumably it's individual investors and fiduciaries, which control shareholder voting rights. Perhaps most important are institutional investors who fail to use the power of the proxy to challenge errant boardroom behavior – possibly because they themselves face conflicts of interest and do business with the same banks in which they hold voting shares. And not least, banking regulators have plenty of problems understanding and approving conventional risk indicators and management in large, complex banks and other financial firms. Understanding the specific reputation-sensitivity of practices in the banks they regulate at the business-line level just may be too much to ask.

One would like to believe that market discipline – triggered by stock price erosion that reflects the impact of reputation-effects on the franchise value of banks – can be a powerful deterrent. But this depends critically on the efficiency and effectiveness of corporate governance. Banks continue to encounter serious instances of reputation loss due to misconduct despite the effects on the value of their business. Alternatives include civil litigation and external regulation aimed at avoiding or remedying damage created by unacceptable financial practices. Yet civil litigation seems ineffective in changing bank behavior despite "deferred prosecution" agreements not to repeat offenses. This again suggests continued material lapses in the governance and management process. Even criminal fraud

convictions of banks seem to be relatively meaningless. In announcing Credit Suisse "guilty" plea to a criminal charge of aiding and abetting US tax evasion in May 2014, CEO Brady Dougan told a press conference he didn't think there would be any effects on the bank. There was the matter of $2.6 billion in fines and penalties, but he said that could be earned back by the end of the year and wouldn't affect the bank's regulatory capital. No serious changes in strategy. No senior management changes. No client defections. No investor flight. Just business as usual.

Dealing properly with reputational risk can be an expensive business, with compliance systems that are costly to set up and maintain, and various types of walls between business units and functions that impose opportunity costs on banks due to inefficient use of information and capital within the organization. And some kinds of reputational risk exposure in banks subject to conflicts of interest may defy sustainable control and possibly require structural remediation involving withdrawal from certain activities. These are not popular topics among bankers. Nonetheless, it can be argued that operational, compliance and reputational issues contribute to market valuations among the world's major financial conglomerates that fall well below valuations of simpler, more specialized financial services businesses.

In the end, it is probably leadership more than anything else that separates winners from losers over the long term – the notion that appropriate professional behavior reinforced by a sense of belonging to a quality franchise constitutes a decisive competitive advantage. Supply and demand for financial "talent" seem to meet in tight-knit banking subcultures that populate hypercompetitive markets, in which the temptation to trespass on off-limits regulatory or behavioral territory is palpable and self-reinforcing, both within banks and through chat-rooms and high job mobility between them. Adverse selection suggests that banking may be attracting more than its fair share of people who end up in the wrong business for the wrong reasons and create the wrong cultures. There is plenty of scope for problematic professional conduct that turns out to be "industry practice," but there also seems to be scope for firms that get in trouble and those that don't. What next? Here are some options: Tougher due diligence on who gets to do what in banking businesses that are prone to conflicts of interest and compliance issues. Zero-tolerance telegraphed by senior management and boards. Targeting civil and criminal enforcement actions on the specific individuals involved (those closest to the action) instead of those farthest away (shareholders). Compensation schemes that handcuff bankers to the future financial performance of their firm (already well advanced at most banks). Boards' willingness to leave on the table some incremental financial performance to achieve reduced regulatory and reputational risk, admittedly a tough balance to execute. None of this is easy, and there are no free lunches. Hard to prove, but the payoff could be handsome indeed.

Problems and Opinions

Giovanni Ferri[*]

FROM SHAREHOLDERS TO STAKEHOLDERS FINANCE. RECOVERING SUSTAINABLE FINANCE[1]

1. THE EFFECTS OF THE FINANCIAL CRISIS AND THE WAYS OUT

In this paper I will argue that re-regulating finance while preserving and augmenting its stakeholder-oriented component – as opposed to the shareholder/profit maximizing component – is needed not only to restore the stability of finance but also to mend the market economy, saving it from the distortions and the excesses of financial capitalism. The Great Crisis, started in 2007–2008 with the debacle of the subprime mortgage segment in the US and having a second wave centred on the Eurozone sovereign debt crisis in 2010–2012, has deployed wide ranging effects, especially on the rich countries. The unsustainable debt overhang was the result of several causes: global imbalances, excessively lenient monetary policy by the Federal Reserve and the downside of deregulation/liberalisation of finance. I will leave aside the first two and concentrate on the third. Slower growth, global imbalances and financial liberalization brought about unsustainable debt/GDP levels in various advanced countries (fig. 1), while the situation was much better in emerging economies (e.g. the BRICS). Since excessive private debt with

* Giovanni Ferri is a Professor at LUMSA University & Center for Relationship Banking and Economics, Rome, Italy.

1 This paper draws partly on Ferri (2013) and on D'Apice and Ferri (2010).

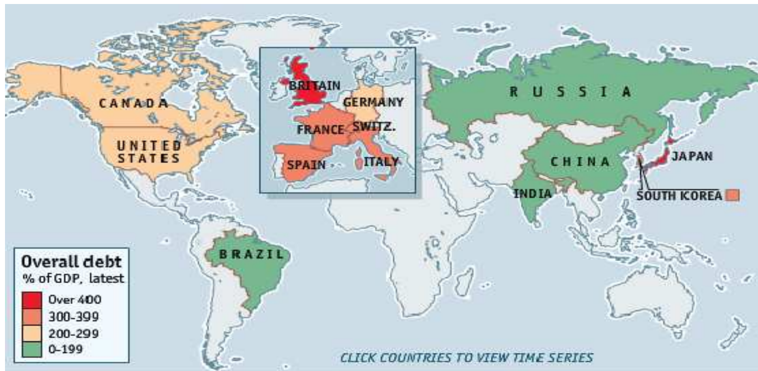
the crisis translates into higher public debt, it is appropriate to consider the sum of private and public debt as a ratio to GDP. Figure 2 shows the long-run trend for the US. Indeed, it is impressive how the trend accelerated since the 1980s concurrently with financial deregulation and liberalization.

When the great leaders of the world gathered in London for the 2 April 2009 meeting of the G20, what they had in mind was the most acute phase of the first – US originated – wave of the crisis. The financial markets had been in a tailspin since the Lehman Brothers bankruptcy in September 2008 and the first signs of recovery were extremely uncertain. Therefore, they took a strong stance announcing stiff measures to re-regulate finance. Among the proposed measures the ones key to our discussion were:

- scaling up IMF resources for crisis prevention and assistance;
- establishing the Financial Stability Board to provide early warning of and address macroeconomic/financial risks;
- reshaping regulatory systems to identify and take account of macro-prudential risks;
- extending regulation and oversight to all systemically important financial institutions, instruments and markets, for the first time including systemically important hedge funds;
- endorsing and implementing tough new principles on pay and compensation and supporting sustainable compensation schemes and the corporate social responsibility of all firms;
- taking action, once recovery is assured, to improve the quality, quantity, and international consistency of banks' capital. In future, regulation should prevent excessive leverage and require buffers of resources to be built up in good times;
- taking action against non-cooperative jurisdictions, including tax havens, standing ready to deploy sanctions to protect members' public finances and financial systems;
- calling on the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards;
- extending regulatory oversight and registration to Credit Rating Agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest.

However, unfortunately, finance seems to be heading exactly to business as usual and most of what was promised at the London meeting has not been delivered. And even the rules that are introduced (e.g. the Dodd-Frank Act) appear to be lagging and could prove largely ineffective.

Figure 1. Public Plus Private Debt to GDP in Selected Countries



Source: The Economist (2010).

Figure 2. Public Plus Private Debt to GDP in the US: Long-run Trend

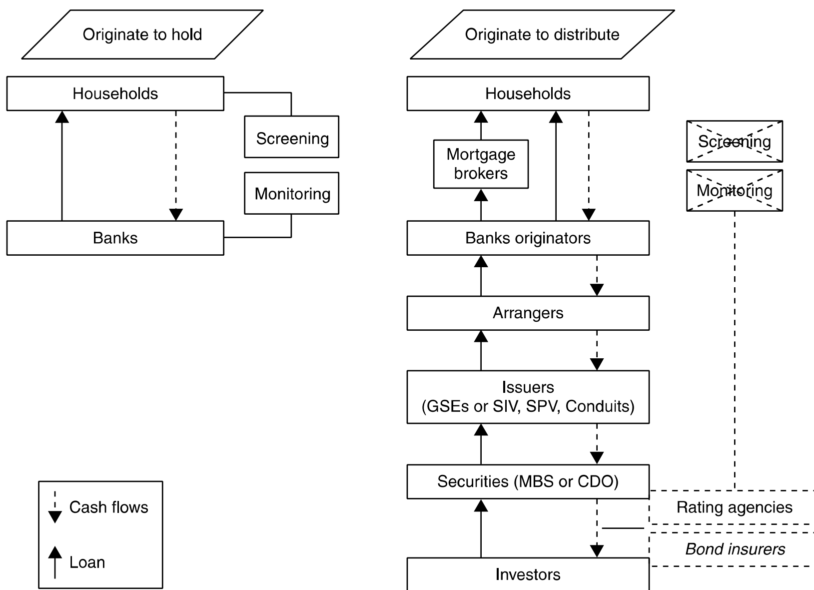
Source: Martenson (2009).

2. THE DEEP MISTAKES OF THE 'LIGHT TOUCH' REGULATION OF FINANCE

Bank lending standards became lower – i.e. more loans go to less worthy customers – because many banks move away from their traditional business model. Indeed, securitisations drastically changed the banking model: from the 'originate to hold' (OTH) to the 'originate to distribute' (OTD) model (fig. 3). In the OTH model the loan is a simple operation between the bank and the borrower. On the contrary, in the OTD model the loan origination is a complex operation (like a multistage

production process) involving various subjects and hinging on financial markets. While OTD promotes risk diversification, it jeopardises the two fundamental activities – screening and monitoring – performed by the banks to reduce the risk of granting loans to unworthy borrowers. Beside that unfavourable transformation from OTH to OTD, a further contribution to the worsening of lending standards in the US is given by the flourishing of a parallel, unregulated banking system, the so called shadow banking system. The importance of the shadow banking system, which was virtually nil until the late 1970s, starts increasing thereafter, thanks to financial deregulation and liberalisation. By the mid 1990s the total liabilities of the shadow banking system outrun those of the regulated banking system. Ten years later, before the start of the crisis, the total liabilities of the shadow banking system approach 20 trillion USD, dwarfing the 13 trillion USD of the regulated banking system.

Figure 3. The bank business model: from OTH to OTD



Source: D'Apice and Ferri (2010).

Those transformations – reducing the risk-control efficacy of the regulated banks and letting the new breed of shadow banks take the lead – heightening systemic risk, i.e. the risk of collapse of the entire financial system, emerged to a large extent because of a misconceived approach to regulating finance. In this regard, the dominant approach followed the 'evolutionary view' of finance.

Following the early promotion of Goldsmith (1966, 1969), the evolutionary view postulated that financial markets be more efficient than banks at managing risks. Thus, as suggested forcefully by Bryan (1988), banks should move from the old model (lend and keep the loans, OTH) to the new model (lend and sell the loans, via securitisation, OTD).

Regrettably, banks' role as certifiers of loan quality was neglected but that role was there only with the OTH model and not with the OTD model. As we already noticed, granting loans to sell them rather then to keep them endangered banks' incentives to perform in depth screening and monitoring of the borrowers, so that lending standards rapidly deteriorated. And the evaluation of the creditworthiness of the loans underlying securitisations fell back on the rating agencies who founded such evaluation on past historical default rates, but these rates were based on the OTH model and, thus, the agencies systematically gave overly optimistic ratings.

On more general terms, for too long we had a 'crossed-eyed' theory of finance. In fact, on the one hand, the theory of financial markets is based on the assumption of complete markets and of investors holding perfect information. But, on the other hand, the theory behind the existence of financial intermediaries assumes the fundamental role of asymmetric information – the lender knows less than the borrower about the true quality of the latter – and of delegated monitoring – whereby depositors entrust banks to screen out and monitor those who will be granted credit. When, with liberalisation, financial markets became dominant, banks' practice and even regulatory principles (e.g. IAS, Basel 2) moved toward financial market type activities while weakening banks' credit function. In a sense, we applied to banks the theory, which, if adequate to financial markets, is certainly inappropriate to banks. There is a clear lesson here: it's wrong subordinating banks to financial markets (and also the opposite would be a mistake). Rather, we need to build on the banks-markets complementarity, as suggested by Allen and Gale (2000).

3. THE CURRENT RE-REGULATION PROVIDES MORE OF THE SAME

The current re-regulation (e.g. Basel 3) just requires more capital for banks, following the past approach of 'mechanical quantification' of risks. Alas, we know that current measures of risk (e.g. the Capital Asset Pricing Model – CAPM or the Value at Risk – VaR) are probably misleading as they are based on untenable assumptions such as the often posited hypothesis of normality in the distribution of risks.

Let's consider the case of the CAPM, which assumes orthogonality between sovereign risk and private risk, i.e. lack of correlation between the former and

the latter. This assumption is deeply questioned by the EU sovereign debt crises. Orthogonality would require that sovereign risk (typically hypothesized to be zero) be uncorrelated with private risk. This is the way we can derive the CAPM fundamental formula:

$$ER_i = r + \beta_i (ER^m - r)$$

where ER_i is the equilibrium expected return on risky asset i, r is the risk free rate (proxied by treasury bond returns), ER^m is the equilibrium expected return on the diversified portfolio and the coefficient

$$\beta_i = \mathrm{cov}(R_i , R^m) / \mathrm{var}(R^m).$$

The fallacy of the orthogonality of risks assumption is evident when governments save distressed banks: then the Credit Default Swap (CDS)[2] spreads drop for banks and rise for sovereigns.

It seems that the right way to go about that would be to acknowledge that we need to revise risk pricing models. Instead, the authorities use stress testing. In the aftermath of the crisis, various authorities such as the Financial Services Authority for the UK, the European Banking Authority for the EU and the International Monetary Fund at the global level calculated stress tests. In a stress test the authority looks at how robust a financial institution is in certain crashes, a form of scenario analysis. However, this scenario analysis is calculated around the risk measures provided by the traditional instruments. As such, though potentially useful, stress tests make neither a sufficient nor a necessary condition. If the risk is overestimated (underestimated) by the traditional measures, stress testing is not a sufficient (necessary) condition.

4. THE NEED TO CATER FOR DIVERSITY

More generally, we should acknowledge the difference between financial risks vs. bank credit risks. Following the recalled assumptions of the theory of financial markets, financial risk management may well exhibit the benefits of diversification, i.e. since the underlying risks are ‘objective’ and observable, the suggestion “don’t put all your eggs in just one basket” seems cogent. On the contrary, given the assumptions of the theory of financial intermediaries, bank credit risk management could feature the benefits of specialisation, i.e. as the

[2] The CDS price can be considered as a proxy of the risk premium because these derivatives protect against the risk of default of a company or sovereign issue.

underlying risks are 'subjective' and hard to observe, this seems to imply that it would be efficient for each intermediary to specialise in overcoming asymmetric information about specific customers rather than diversify their lending across borrowers they know less about.

If we accept the reasoning we just proposed of the benefits of specialisation in lending, then we could also contemplate the possibility that different bank business models will deliver different abilities to manage bank credit risks. Thus, it would appear crucial to distinguish investment banks and wholesale commercial banks – likely better equipped to manage financial risks – from retail commercial banks and cooperative banks – probably more prepared to deal with true bank credit risks.

The reasoning just outlined would have obvious consequences in terms of separating financial market risks – and the intermediaries specialised in dealing with these risks – and bank credit risks – together with the intermediaries having a vocation to deal with these risks. Not surprisingly, this issue was key both in the Volker rule – a ban on the speculative 'proprietary' trading for commercial banks – embodied in the Dodd-Frank Act and in the Vickers' Report, introducing the principle of ring-fencing between commercial banking and investment banking.

5. WHAT CAUSED THE "LENTO PEDE" OF FINANCIAL RE-REGULATION?

The obvious question is: why is financial re-regulation advancing so slowly? Otherwise said, why, using Latin, is it walking with such a 'lento pede'? To answer this question we can gain important insights looking at what supported the re-regulation of the 1930s. Many observers give credit to the 'Pecora Commission' as being the key driver of that re-regulation. Thus, since the working of that Commission had been long neglected, it is worthwhile to recall the basics of it.

The Pecora Investigation was an inquiry begun on March 4, 1932 by the United States Senate Committee on Banking and Currency to investigate the causes of the Wall Street Crash of 1929. The name refers to the fourth and final chief counsel for the investigation, Ferdinand Pecora. Born in Sicily and having migrated to the US in his early childhood, Ferdinand Pecora (January 6, 1882 – December 7, 1971) was a lawyer and judge who became famous in the 1930s as Chief Counsel to the United States Senate Committee on Banking and Currency during its investigation of Wall Street banking and stock brokerage practices. A member of the New York bar since 1911, Pecora was assistant district attorney in New York City (1918–1929) earning a reputation as an honest and talented prosecutor who helped shut down more than 100 bucket shops. Because of his tough reputation, Pecora was not appointed District Attorney. He left the district attorney's office for private practice, where he remained until 1933. Ferdinand Pecora was appointed Chief Counsel to the U.S.

Senate's Committee on Banking and Currency in January 1933, the last months of the Herbert Hoover presidency by its outgoing Republican chairman, Peter Norbeck, and continued under Democratic chairman Duncan Fletcher, following the 1932 election that swept Franklin D. Roosevelt into the U.S. presidency and gave the Democratic Party control of the Senate.

Pecora's investigation unearthed evidence of irregular practices in the financial markets that benefited the rich at the expense of ordinary investors, including exposure of Morgan's "preferred list" by which the bank's influential friends (including Calvin Coolidge, the former president, and Owen J. Roberts, a judge of the Supreme Court of the United States) participated in stock offerings at steeply discounted rates. Spurred by these revelations, the United States Congress enacted the Glass–Steagall Act, the Securities Act of 1933 and the Securities Exchange Act of 1934.

Why, again, was there no substantive action after the London G20 meeting of early April 2009? How do we explain the differences with respect to the 1930s? Indeed, this time we lacked a Ferdinand Pecora to disclose the – often difficult to confess – sins of the late phase of financial capitalism. However, the Pecora Commissions don't come out of the blue. And, perhaps, this time the conditions on the ground were not favourable. First of all, there was a fundamental weakness of the Obama administration, which placed a high bet on health insurance reform and could not deal with many fronts at the same time. Perhaps even more important, expansionary economic policies – suddenly contradicting the deep credo of the free market ideology – avoided that recession turn into depression. So, the lessons of John Maynard Keynes made it more difficult to build the momentum for reform.

6. THE CONCEPT OF THE POLITICAL-ECONOMY CYCLE OF FINANCE

In my view, capitalism alternates phases in which free markets expand (e.g. globalisation) and deepen (e.g. the emergence of new sectors as a result of innovation) with phases characterised by more regulated markets when rules and/or state intervention in the economy tend to be more pervasive. Over the decades, this alternation may be represented as a political-economy cycle of finance. This allegory helps read the events of finance between the 1930s and the present day.

Indeed, financial instability tends to intensify with the extent of the unfettered free market economy. By and large, freer markets sooner or later build imbalances and inefficiencies in price setting mechanisms and, consequently, in the allocation of resources. This occurs when excessively optimistic expectations about future developments evolve and the financial system fuels such misplaced assumptions, leading to excessive indebtedness in the economy. As a result, a speculative

bubble − that is usually identified as such in retrospect − is formed. Eventually, this triggers an epochal systemic crisis, which marks a turning point to change direction towards stricter regulation of the marketplace. In our interpretation, this represents the end of one cycle and the start of a new one.

In fact, solving the crisis requires, in general, two types of actions. The first one consists in the intervention by the state that – fully or partly – takes on itself the losses suffered by the financial institutions in a way to rebuild trust in them by individual investors and savers and to restore the functionality of the financial system. This action may even require (some) nationalisation of banks. The second action entails stiffening regulation and supervision of finance, assembling a framework consistent with pursuing the stability of the financial system. At the international level, the new set-up for financial stability may be crowned by the emergence of a new monetary order centred on the economic power that has come out in hegemonic position from the crisis, whose currency will become thereafter the reference for international exchanges. More generally, solving the crisis implies imposing limits on the free market, beyond the financial system, thereby often swinging the balance from the global to the national dimension of economic processes. This scenario is similar to what is usually known as de-globalisation.

However, over the long run (it may take decades), the regulatory framework tends to lose its consistency and the economic system begins to operate again in an uncontrolled financial environment. Three main factors push in this direction. First, the financial system on its own tends to breed innovations. Alas, financial innovations – though generally beneficial – short-circuit the logic and the substance of the stability controls set up with re-regulation and may undermine the functioning of the international monetary order. Second, the process of market extension – to exploit the international opportunities – and of market deepening – with the start of new business segments, often linked to innovations – needs the support of finance in new forms, different with respect to those consistent with the extant regulatory/supervisory framework securing stability. This further promotes the spread of financial innovations. Third, there is a swing in ideology, whereby free market visions tend to dominate and become increasingly entrenched. Then, economic theory and the policy debate excessively lean towards stressing the negative consequences of the failure by public intervention in the economy while advocating the benefits of letting the markets free (Leijonhufvud, 2009). This calls for deregulation and liberalisation of the financial system.

The mix of these three factors leads once more to the formation of overly optimistic expectations – as Hyman Minsky (1975) reminded us[3] – and this triggers

[3] Hyman Minsky's (e.g. Minsky, 1993) distinguishes three borrower types: hedge units (little leveraged and able to repay both their loan interest and principal); speculative units (able to pay interest on their loans but needing highly liquid markets to renew their debt); Ponzi units

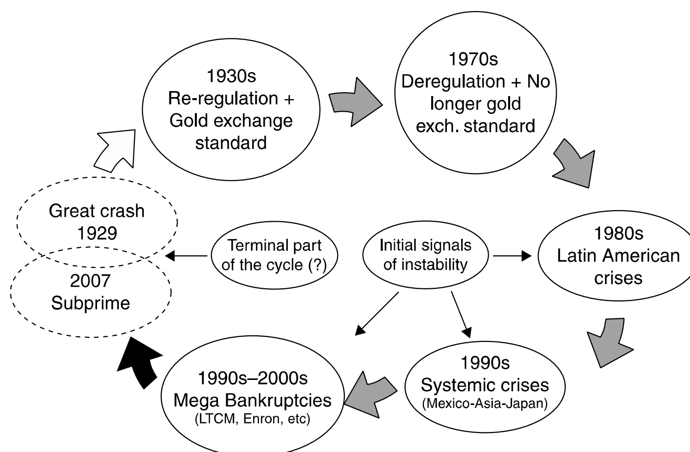
excess indebtedness, misallocation of resources and the build-up of a new speculative bubble. At this point, it is only a matter of time and a new major systemic crisis will arrive thus completing this political-economy cycle of finance that, as we described, embraces the path from one structural-breaking systemic financial crisis to the next one. To be sure, such a systemic crisis drawing the political-economy cycle of finance to a close is not a single, stand-alone episode, but rather it is the epilogue of a series of specific crises whose frequency and gravity tend to aggravate as we move on along the sequence. In fact, when the economic system is already operating within a generalised speculative bubble, even the well-meant interventions to stabilise the financial system after the initial instability events are likely, quite paradoxically, to have destabilising effects. This happens because, in some way, the interventions to salvage the imperilled financial intermediaries cover their speculative losses and – unless a new consistent regulatory framework is quickly put in place – this strengthens speculation as the expectation becomes more widespread that also in the future new interventions to cover speculative losses will be offered. Accordingly, stabilisations turn out to be destabilising because, in solving the instability of individual financial intermediaries, it amplifies systemic risk. Otherwise stated, in line with Charles P. Kindleberger (1978), if the Lending of Last Resort (LOLR) is heavily used to bail out financial institutions in a systemic crisis, this will backfire in terms of augmenting exponentially the moral hazard of the financial intermediaries and building the foundations of a new bigger crisis down the line.

In a sense, financial liberalisation is a driver for economic growth but over time the perils of instability may outweigh those benefits. The history of financial capitalism takes the form of various repeated political-economy cycles. The financial crises of the recent decades will possibly conclude this political-economy cycle of finance originated by the return to stricter regulation of the marketplace as a remedy to the major instability of the 1930s (see fig. 4 and D'Apice and Ferri, 2010). Already in the mid-1930s, countries had developed a consistent regulatory framework to achieve domestic financial stability. Only after World War II was the framework finalised at the international level, with the definition of a new monetary order centred on the US dollar. However, after the abandonment of the gold exchange standard (in August 1971), financial innovation, deregulation and globalisation have progressively generated inconsistencies in the original regulatory framework, providing the background factor of previous crises as well as of the most recent one. By and large, as already stressed, the stabilisation interventions to cope with the crises may themselves turn destabilising when

(extremely highly leveraged unable to even pay interest on their loans unless the constant increase in the value of their collateral assets allows them to refinance their loans). In Minsky's terms, the subprime borrowers are Ponzi units.

the financial system is operating under an inconsistent regulatory/supervisory framework. A case in point was the rescue in 1998 of the speculative hedge fund Long-Term Capital Management (and also the abrupt drop of the Fed funds rate after the dotcom bubble burst in 2000–01) that, in the absence of re-regulation, was a keystone laid for the Great Crisis that started ten years later in 2007.

Figure 4. The political-economy cycle of finance



Source: D'Apice and Ferri (2010).

The triumph of excessively one-sided ideology-driven free market views contributed to building exaggerated trust in the markets and in their ability to self-regulate, motivating policy choices. On the contrary, the progress made by other economics schools – such as Joseph E. Stiglitz and several other scientists moving on that track – in terms of the analysis of the failures of the market was largely disregarded.

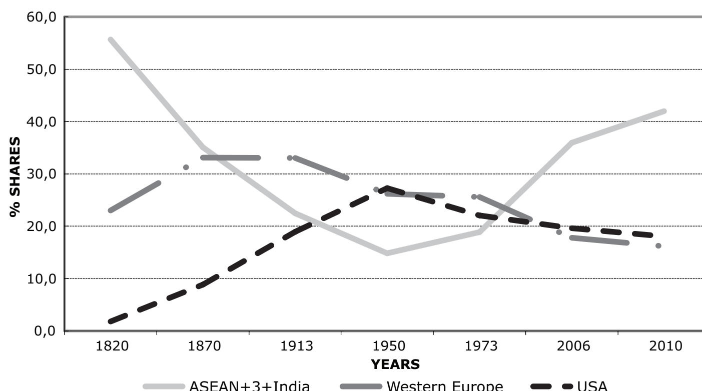
The epochal crisis ignited in 2007 by the turmoil in the subprime mortgage market could suggest this political-economy cycle of finance is ready to come to a close. Indeed, this crisis implies an escalation in terms of its depth and geographical extension and also of the fact that it started at the centre of the financial system and not at its peripheries, as had happened with the previous systemic financial crises of the 1990s and the beginning of the new millennium. The authorities' call for stricter regulation might mark the start of a new cycle. However, re-regulation appears to have lost momentum. In fact, if the pronouncements by the leaders of the G20 in their London meeting of spring 2009 were bold about re-regulation, their statements at the following Pittsburgh meeting in the autumn

of the same year had become much more timid. At the same time, parliamentary actions on both sides of the Atlantic did not seem to move ahead as fast as earlier announced.

Will this mean an even bigger crisis is waiting for us in the future, as the European sovereign debt crisis could suggest? This would be a terrible event also in view of the fact that the public finances of many advanced countries have been exhausted by the interventions to salvage finance from its instability.

There is a further problem. Nowadays, what was once the debate on the decline of Europe has transmuted into one in which, due to the difficulties encountered by the US, the danger of decline refers to the entire Western model. Various considerations ignite this debate but, perhaps, the most striking of all descends from observing that the on-going global crisis distressing the world economy and society originated from global imbalances and excessive indebtedness having the focus in the US (the 2007–09 bout of the crisis) and later on found a second epicentre in the imbalances of Europe (since 2010). Though against that possible sunset of the Western leadership no practical alternative is yet in sight, undoubtedly the world's gravity seems to be moving from West to East, where two countries counting approximately 2.5 billion (plus an additional 0.8 billion in the ASEAN) of the world's 7 billion total have come back to play a strong role.

Figure 5. Distribution of world GDP shares between 1820 and 2010: Western model vs. Asia



Source: our calculations on data from Maddison (2007) and updates from IMF data.

Based on Maddison (2007) reconstruction, it is evident from Figure 5 that the Western Model – as represented by Western Europe and the US – gained its world economic leadership only after the Industrial Revolution. Before that, in 1820, the

West approached 25% of world GDP while the sum of the ASEAN + 3 + India[4] accounted for 56%. The ranking was already reversed by 1870 – 42% the West vs. 35 the East and South Asia aggregation – and in 1950 the disparity reached its maximum (close to 54 vs. 15%). However, since then the ASEAN + 3 + India has vividly rebounded. By 1973, at the time of the first oil shock, it approached 19% – with the West at 48% – owing mostly to the economic miracle of Japan and of the Asian Tigers. But the rebound intensified later on, with the inclusion of China and India, bringing the East and South Asia aggregation to 36% (vs. 37% for the sum of Western Europe and the US) in 2006. By 2010, four years into the crisis, the shift had further accelerated putting the two areas, respectively at 42 and 34%. If we were to take at face value the GDP shares projected by Mold (2010), by 2030 the balance between the two areas could go back to a situation more similar to the pre-Industrial Revolution set up than to anything we have seen there since. Indeed, those projections forecast above 55% for the ASEAN + 3 + India – with most of the gain for China – and just about 25% for the sum of Western Europe and the US.

Obviously, Mold's projections could be exaggerated because they are not adjusted for purchasing power parity. Besides, Mold simply projects the past trends to the future neglecting that all economic miracles have ended sooner or later. Furthermore, given the challenges posed by the current organisation of production along the Global Value Chains, the national accounts might overstate the extent of the Western decline as a large fraction of the value added created in the emerging economies still flows back to rich countries' investors. And, even accepting Mold's figures, that would imply a much milder decline of the West in terms of per capita GDP, due to divergent trends in population between the two areas. In spite of these and other possible corrections to its magnitude, the shift from the Western Model to the East and South Asia aggregation is a reality. Shadows of possible decline of the West materialise also if one considers the conditions of public finances through Europe and the US.[5] There would be several other aspects to be pondered, but this West to East shift in the balance of economic power is most likely going to be the single most important determinant around which to reshape the global economic governance.

Specific issues might arise with the above scenario. We will mention just two. The first issue is that of a possibly multipolar global set up, where evidently the East and South Asia aggregation is not a single entity. Still using Mold's 2030

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[4] As it is well known, the ASEAN includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam) while the +3 means China, Japan and Korea.

[5] In his long-run historical perspective Kennedy (1987) argues that the great powers almost invariably decline after fiscal imbalances emerge.

projections, the largest economy would be China (accounting for 28% of the world GDP), followed by the US (14%), and by virtually coupled India and Western Europe (both at about 11%). The other economies would follow at a considerable distance. The apparent implication seems that a complex world economic architecture would be required to ensure smooth global governance. The second issue stems from the fact that some of the countries – most notably China – performing as the main drivers in the West to East shift are structured as hybrid economic systems, with the State playing a pervasive role. Thus, it is not entirely clear how to interpret the functioning of the apparently vibrant market economy in those countries. And, even disregarding that, some of the emerging economic powers do not function as Western democracy, so raising questions about the respect of individual freedom.

7. WHY WE NEED STAKEHOLDER FINANCE

We argued that the Great Crisis had three main causes: i) the global imbalances, particularly between the US and China; ii) the excessively lenient monetary policy by the Federal Reserve; iii) the downside of deregulation/liberalisation of finance. The joint effect of the three factors was that of generating a debt overhang in the US.

When the financial round of the crisis broke out at the beginning of August 2007, and particularly after its escalation with the bankruptcy of Lehman Brothers in September 2008, the global scale contagion caused pervasive government intervention to salvage the endangered banks. Against this background, at the early April 2009 meeting of the G-20, the chief leaders of the world made bold announcements to stiffen regulation in a way to bring back financial stability. However, those promises were largely not fulfilled.

Next we discussed the deep mistakes of the ‘light touch’ regulation of finance through which commercial banks were subjugated to financial market friendly rules. In addition, we claimed that the current re-regulation provides more of the same and does not cater enough for diversity within the banking system.

As regards the slow advancement of the financial re-regulation, we argued that the lack this time of a strong prosecutor such as Ferdinand Pecora in 1933 made the progress of the reform more difficult. In any case, we asserted that a serious re-regulation is the only way out to restore financial stability, as the allegory of the political-economy cycle of finance helped us outline. Appropriate leadership will be needed to secure a reasonably rapid and smooth transition. Lacking that, the sustainability of finance risks being permanently endangered and the stability of the world could also be at stake.

The key role of stakeholder finance emerges at this juncture. Stakeholder finance is a type of finance that doesn’t focus on short-term profit maximisation, as

shareholder finance does. As I argued, shareholder finance brought about a major transformation of the bank business model that implied transforming ‘informed’ credit into ‘commodity’ credit. When credit is treated as a commodity it becomes unsustainable, it loses its function. Indeed, credit cannot be a commodity, because it needs a human relationship to guide it. It is only through that human relationship that appropriate screening and monitoring will be deployed. Stakeholder finance means adopting the traditional bank business model of relationship banking, which implies performing the appropriate screening and monitoring. If banking regulation persists with a mechanic approach to capital and the Risk Weighted Asset (RWA) approach it is impossible to recognize the difference between informed credit and commodity credit and we are in trouble. Thus, stakeholder finance is the way out of this phase of financial capitalism which, as it happened in the 1920s, is a major source of world instability.

Abstract

The paper argues that re-regulating finance while preserving and augmenting its stakeholder-oriented component – as opposed to the shareholder/profit maximizing component – is needed not only to restore the stability of finance, but also to mend the market economy, saving it

Answering the question why financial re-regulation is advancing so slowly, this paper addresses the historical example of re-regulation of the 1930s. It argues that the lack of a strong prosecutor, such as Ferdinand Pecora in 1933, made the progress of the reform more difficult. It asserts that a serious re-regulation is the only way out to restore financial stability. Appropriate leadership will be needed to secure a reasonably rapid and smooth transition. Finally, the paper analyses why we need Stakeholder Finance.

Key words: Stakeholder Finance, Sustainable Finance

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Panu Kalmi[*]

ETHICS, BANKING AND OWNERSHIP

1. WHAT MAKES BANKS ETHICAL?

At the very least, one could think that ethics in banking implies that the bank will not cheat its customers, banking authorities, or other market participants. Further, an elementary notion of banking ethics would recognize that banks would not engage in illegal activities, such as money-laundering, or would not accept deposits based on criminal activities or finance terrorist actions. A broader definition of ethical conduct in banking would perhaps include such items as good customer service, proximity to customers, financial inclusion, (non-predatory) lending to marginalized borrowers, transparency of operations, support of the communities where the bank is embedded, and avoidance of excessive risk. The list could go on, and some elements may be even somewhat contradictory: for instance, lending to marginalized borrowers is inherently risky.

In the next section, I present a simple model of risk shifting that illuminates the conflict between depositors and shareholders and presents shareholder incentives to gamble "with other peoples' money". Customer ownership through cooperative or savings bank structure solves this problem neatly. However, I point out that these structures have problems of their own. Then I move on to look at some empirical analysis on these issues, both systematic and anecdotal. Towards the end of the paper, I shift the focus to the benefits of organizational diversity in banking, on how banks in different ownership structures may foster that diversity, and also why ownership may not be a sufficient condition for diversity.

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2. THE PROBLEM OF RISK SHIFTING

In the absence of a generally accepted measure of ethical conduct in banking, it is difficult to rank banks according to their ethical behavior, or to explore the trade-offs in behaving ethically. One possible and quite general starting point for the analysis of banking ethics would be the problem of risk shifting (John et al., 1991). The essence of risk shifting is that shareholders have a preference for excessively risky investments, and due to limited liability, they do not take into account the potential profits and losses symmetrically. Imagine the following situation. There are two projects, both of which require an initial investment of 110 euros at time T1. This is received from debt-holders, who invest 100 euros, and shareholders, who invest 10 euros. The investment is done at time T1, and the value of the project (V) will be realized at time T2. The debt-holders are promised a 5% interest (i.e. 5 euros) on their deposits at time T2. All the revenues in excess of what is promised to debt-holders accrue to the shareholders. However, it is also possible that V turns out to be less than 105. In this case, shareholders get nothing, and the value of the project is distributed to the debt-holders, who may either receive a positive interest (if V>100) or suffer a loss on their principal. In sum, the payoffs are

i) If V<=105, debt-holders' pay-off will be V-100 and shareholders' pay-off will be -10.
ii) If V>105, debt-holders' pay-off will be 5 and shareholder's pay-off will be V-10.

Now assume that the pay-off structures of the two projects are as follows. Project A has V=116 at time T2 for certainty. Project B has two possible outcomes: Either V=130 with a probability of 50%, or V=90 also with a probability of 50%. Thus, the expected value from project B is 110, and it is easy to see that from the social point of view project A is better. However, things look different from the point of view of shareholders. (Assume that both debt-holders and shareholders are risk neutral). When we calculate the returns from project A and B for debt-holders and shareholders, we find that

i) The return of project A to debt-holders is 5 (5%) and its return to shareholders is 1 (10%).
ii) The expected return of project A to debt-holders is -2.5 (-2.5%) and its expected return to shareholders is 2.5 (25%).

Thus, because of the asymmetric effect of profits and losses to shareholders (due to limited liability) shareholders would prefer the project with lower expected value at time T2. Assuming that equity investors can decide on which project to invest, this leads to suboptimal project choice.

So far this example has not been specific to banking, but it represents any investment partially based on debt, partially on equity. Another general result from

the model is that when the proportion of equity of total investment is increased, shareholders' interests become more aligned with the highest-value project A. Further, we have not asked why any debt-holders in their right mind would agree to invest in a project that has a negative expected value for them. Either they would increase their required interest rate in response of higher riskiness of project B, or require shareholders to put more equity (or both). All this would make project B relatively more costly from the point of view of shareholders, and make them more likely to choose project A.

However, once we substitute "depositors" for debt-holders, the issue becomes more relevant. In modern banking, due to deposit insurance (currently at the level of 100.000 euros in the euro area), depositors have little reason to worry about the riskiness of their deposit investment, at least as long as they think the deposit insurance is credible. Leaving deposit insurance aside for a moment, let me point a solution to the problem, which may appear somewhat trivial. What if depositors and shareholders are not two groups, but actually the same people? Clearly, in this case, the depositor-shareholders will choose project A, that has a combined pay-off of 6, rather than B, which is a break-even for the investors. In other words, the agency conflict between depositors and owners disappears in the situation where the parties are the same, and no-one has an incentive to gamble with "other peoples' money".

The main examples of customer-owned banks in the real world are cooperative and savings banks.[1] They have significant market shares in many European countries. Taken all cooperative and savings banks groups together, they have around or above 50% in deposits or loans in countries such as France, Germany and Austria and, until recently, in Spain.[2] Cooperative banks are genuine customer-owned banks in the sense that control and residual returns belong to the same party. In cooperatives, customer-members provide equity capital to the cooperative. Even though the ownership of shares may vary across members, each member has one vote only. The criteria for dividing the surplus may differ: in some cooperatives, it depends on profitability, in others, on patronage (use of services). Savings banks, in turn, are non-profits that have no formal owners; in some cases though (as in Germany), public authorities (often municipalities) have control rights. Savings banks are operated to the benefit of their customers, but not by their customers. The boards of savings banks are typically self-perpetuating (each board appoints it successor). Continental European cooperative banks especially, but to some

1 In the UK, the preferred term is mutuals (instead of cooperatives), and the real-life examples are building societies and (the much smaller) credit unions. The UK is considered to be birth-place of Trustee Savings Banks, but these have virtually disappeared.

2 Due to the massive failure of some large Spanish savings banks, the whole sector has now been transformed into joint-stock companies.

extent also savings banks, are organized in networks, where local level banks own regional or national banks, which, either directly or through subsidiaries, may conduct operations such as corporate banking, wholesale banking, investment banking etc.

Even though the ownership structure of cooperative and savings banks solves the agency conflict between depositors and shareholders, some other problems remain pertinent. In the literature of cooperative financial institutions, two further agency problems identified in the literature are those between borrowers and depositors, and the one between members and managers (Cuevas and Fischer, 2006).[3] To start with the first problem, the preferences of the members may differ by the type of their relationship to the bank, whether they are net depositors or net borrowers. Apart from differences in the preferences regarding the pricing of deposits and loans, depositors may also favor a more conservative lending policy.

However, in real life, the agency conflict between members and management is likely to be much more serious. Managerial agency problems arise when there is asymmetric information and managers can take actions that benefit them personally at the expense of owners (members). This may range from "quiet life" to excessive consumption of perks or outright looting of assets. In financial cooperatives, the monitoring of managers is made difficult by the fact that all members have only a small ownership interest and a very small fraction of voting rights, and often little or no experience of banking sector. However, the ownership structure also guards against transfer of assets from the cooperative to other entities, and prevents self-dealing by the managers. Most local-level cooperatives in Europe have a relatively conservative and modest ethos, which constrains the consumption of perks. Usually the cooperative centrals also monitor the local level managers. Thus, perhaps the most common form of managerial misbehavior is then a suboptimal level of effort.

When it comes to the savings banks, they could suffer from even more pronounced agency problems than cooperative banks. Where cooperative banks have weak owners, savings banks are characterized by a complete absence of owners. However, as Hansmann (1996) has pointed out, the absence of strong owner interest also protects from expropriation of other shareholders, of which the previously mentioned risk-shifting is an example.

[3] In continental European – style cooperative banks there could also be a third source of agency conflict, seldom discussed in the literature: between members and non-members. However, the scope of this problem is limited by the fact that non-members can typically easily acquire membership and membership is typically not closed.

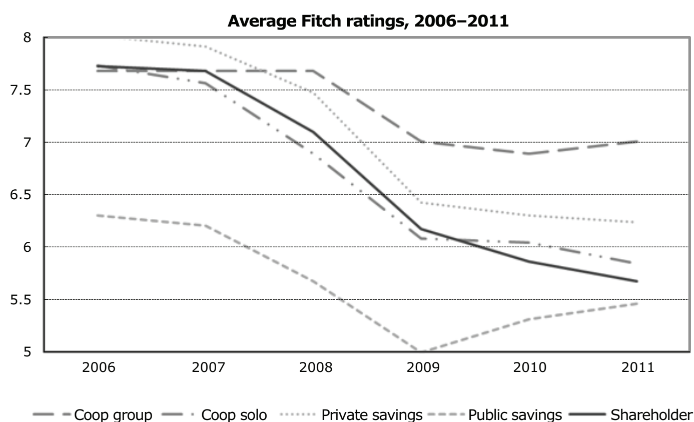
3. WHAT DOES THE EVIDENCE SAY?

There may be case study evidence both supporting the relative stability or instability of stakeholder banks. The fate of Spanish savings banks is certainly evidence against stakeholder banks, although compared to the failures of some core capitalist banking sectors (e.g. US investment banks), the shortcomings of European stakeholder banks may appear small. As the banking sector has become much more fragile, we need statistical data to perform comparisons across types of ownership. This is made difficult by the fact that because of the interventions by fiscal authorities and central banks, very few banks in Europe were actually allowed to fail. However, there is some evidence on which to build. Already before the crisis, Hesse and Cihak (2007) argued – on the basis of distance-to-default z-scores – that stakeholder banks, and especially cooperative banks, were more stable than shareholder banks. From the crisis period, a series of papers by Ferri, Kalmi and Kerola explores the performance of stakeholder banks vis-à-vis shareholder banks, using several levels of disaggregation of ownership. Ferri, Kalmi and Kerola (2014a) investigate the performance of banks under different ownership structure in three dimensions of performance – profitability, loan quality and cost efficiency. For the pre-crisis period, they find that the profitability of shareholder banks was superior to stakeholder banks, but the latter had better loan quality. In cost efficiency, there were no notable differences between shareholder and stakeholder banks in general. However, in the crisis period, the profitability of stakeholder banks improved vis-à-vis shareholder banks, so that there were no significant differences in the levels of profitability during the crisis period. The situation regarding loan quality and cost efficiency remained similar to the pre-crisis situation. There was also some heterogeneity concerning different types of stakeholder banks: for instance, even though stakeholder banks in general did not have higher levels of cost efficiency than shareholder banks, tightly integrated cooperative banks actually did have better cost efficiency than shareholder banks. Private savings banks were in the pre-crisis period very similar to shareholder banks, but their performance deteriorated in the post-crisis period, reflecting the problems of Spanish savings banks.

In another paper, Ferri, Kalmi and Kerola (2014b) study the development of bank ratings using data from two major rating agencies – Fitch and Moody's. Figure 1 reproduces the changes in the Fitch Individual Rating. This particular rating measures the ability of banks to survive without any outside support (notably, from the government). Banks are divided into five groups according to their ownership: cooperative groups, individual cooperatives, private savings banks, public savings banks, and shareholder banks. The ratings are translated into a numerical scale so that higher numerical values indicate better ratings (smaller likelihood of default). As can be seen from the figure, all banks except public savings banks (that have lower individual ratings) start from rather similar levels of ratings, but cooperative

groups are much more stable than other banks. Ferri, Kalmi and Kerola further investigate this in a regression analysis framework, which have the change in ratings between the end of 2006 and the end of 2011 as the dependent variable, and as explanatory variables they use ownership and add controls for country-specific and time effects, initial rating, changes in sovereign ratings, and various bank-specific control variables. They find that the ratings of cooperative groups deteriorate less, and this result is statistically significant. When they repeat their analysis for Moody's, they find that even though the results are not inconsistent, they are not statistically significant. In further analysis they find that Fitch and Moody's give to rate banks in different ownership structures systematically different ratings.

Figure 1. The performance of shareholder banks and various types of stakeholder banks



Source: Ferri, Kalmi and Kerola (2014b).

In a third paper on this topic, Ferri, Kalmi and Kerola (2014c) analyze the sensitivity of banks in different ownership structures to monetary policy changes. First of all, they find that stakeholder banks have much lower volatility of lending than shareholder banks. They also find that stakeholder banks are less sensitive in their credit supply to changes in interest rates than shareholder banks – in fact, the results indicate that the elasticity of credit supply of stakeholder banks to interest rate is around zero. This is consistent with the relationship banking story, where stakeholder banks build long-term commitments with their customers.

These results mentioned above are consistent with arguments that stakeholder banks build long-term relationships with their clients and they take less risk than

shareholder banks. They also seem to suggest that ownership matters and there are many differences across the balance sheets of these banks. More recently, there have been developed arguments that for the functioning of banking markets as a whole and systemic stability, it is important to have banks with different ownership structures (Bülbül et al., 2013; Michie and Oughton, 2013). However, the benefits from diversity also depend on banks having different objectives, not only different ownership structures. Drawing on evidence especially from France (the country with the highest share of cooperative banks), De Serres et al. (2011) argue that cooperative banks suffer from isomorphic pressures: regulations, rating agencies and perhaps managerial preferences move them closer to shareholder banks in their behavior. If stakeholder banks start to behave more and more like shareholder banks, important benefits from diversity will be lost.

The year 2013 was a rather black year for financial cooperatives. Despite the relatively good performance discussed earlier, cooperatives had not been invincible during the crisis: for various reasons, including bad investments abroad, the Austrian Volksbank group had become nearly bankrupt and had to be rescued by the Austrian state already in 2011. However, in 2013 there were several adverse developments for cooperative banks. Credit Agricole, the largest bank in the euro area, had to withdraw from its Greece subsidiary Emporiki, accruing losses in hundreds of millions of Euros. The sale to the Greek Alpha Bank, with a price of €1, was announced in the Fall of 2012 but completed in 2013. Moreover, Credit Agricole, which in the early period of the crisis experienced huge losses from subprime-related securities, is under suspicion of manipulating the Libor rate. Unlike some other large banks, Credit Agricole has not admitted any wrongdoing. If it is found guilty, it is likely to receive a larger fine than those parties (e.g. Deutsche Bank, RBS) that pleaded guilty. For them, the fine was €1.7 Bn.

Later in the fall, the British Co-operative Bank, which is not a traditional cooperative bank owned by its customers but instead owned by the British Cooperative Wholesale Society (CWS), needed to access a £1.5 Bn recapitalization, due to the losses it had encountered after the merger with another cooperative financial institution, the Britannia Building Society, in 2009. Further developments revealed gross incompetence of some leading board members, and did not lack farcical elements. This was embarrassing for a bank that at one point had strongly branded itself as an ethical alternative to mainstream banks. Finally, in late fall 2013 the Dutch Rabobank, which had been seen in many ways as an exemplary cooperative bank, was fined €1 Bn for rigging the Libor rates.

All of the three banks – Credit Agricole, Rabobank and the Co-operative Bank – have had to access external equity to improve their capital ratios. In the Co-operative Bank, the original shareholder (CWS) no longer holds majority control. Having to access external funding further erodes the cooperative character of these banks and reduces their distinctiveness compared to shareholder banks.

Cooperative banks may have more to lose from engaging in dubious practices than many large conventional banks, because cooperatives are perceived as more trustworthy and the loss of trust is difficult to make up. The alleged excuse of Rabobank traders manipulating the interest rates – "there are bigger crooks in the market than us" – may be right, but if one is perceived not to be a crook and benefits from it, the cost of the reputational loss may be large for these "saints".

4. ARE COOPERATIVES DOOMED TO DEGENERATE?

Cooperative degeneration is a term originally attributed to the late 19th century British Fabian Socialist Beatrice Potter (later Webb; see Jones, 1976). Originally the term was applied to worker cooperatives that transformed into capitalist enterprises and there is now rather large literature discussing and disputing the phenomenon (see e.g. Estrin and Jones, 1992). As far as I know, it has not been used in connection with financial cooperatives before. However, one could speculate that the current level of hybridization (i.e. combination of listed subsidiaries with cooperative ownership) of cooperatives is just one step away from a transformation to full investor ownership.[4] In fact, there have not been full demutualizations (conversions into investor ownership) of continental European-type cooperative banks. The US savings & loans sector and the UK building societies remain examples where a large part of the sector (though not the entire sector) was demutualized.

It is clear that there are many different kinds of cooperative banks. A large majority of these banks have been completely exemplary in their conduct. The large risks lay in the fact that the central units, living in rather separate worlds compared to the local banks, start to take huge risks. This has been apparent in the internationalization experiences of cooperative banks and in derivatives trading, all areas where cooperative banks have experienced huge losses. The problem is that the managers of the cooperative groups tend to regard the investment and international banking operations of these banks as indispensable. In this regard, the cooperative banks may in the long term benefit from the recommendations of the Liikanen Committee (2012) regarding the separation of "retail banking" and "investment banking" activities. These safeguards might actually prevent the core banking business of cooperative banks, the local levels, from failing due to crisis arising from riskier activities. However, the practice of cooperative banks has

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[4] Finnish cooperative banking group OP-Pohjola forms a rather interesting exception in this regard. In February 2014, they announced that the group would buy out outside investors from its listed subsidiary Pohjola Bank. At the time of the writing (March 2014) it is yet unclear whether this plan will materialize. In any case, it represents a move against the current.

moved into another direction, with the introduction of joint liability of operations. Therefore, perhaps not surprisingly, the European Association of Co-operative Banks has opposed the proposed measures of the Liikanen report (EACB, 2012).

The cooperative banking sector is also influenced by the "too big to fail" (TBTF) syndrome. While local cooperatives are practically always small enough to be allowed to fail (and usually are taken care of by the group), entire groups are so large that they must be saved, as has been seen in the Austrian Volksbank case. In fact, the TBTF syndrome might mean that it is ultimately more advantageous for cooperative banks to organize in tighter federations, which also enables faster growth than retaining the local orientation. From the point of view of the regulators, it is also easier to regulate one large single entity rather than a multitude of small organizations.

Whatever the development of existing cooperative banks, in the long-term the financial cooperative sector cannot remain viable without the entry of new cooperative banks. In the traditional cooperative banking sector, there typically is a process of consolidation via mergers, and new entry is non-existent. However, in the past few decades new types of banking organizations have emerged, namely the social banks (alternatively called ethical banks).[5] Many, though not all, banks in this sector have been organized as cooperatives. Prominent examples of such banks include Banca Populare Etica in Italy or Credit Coopératif in France (the latter is an older bank, dating from the late 19th century). The social banks differ from the traditional cooperative sector in several ways: for instance, they lend to marginalized borrowers (financially excluded, immigrants, social enterprises etc.) and they are less based in specific localities than traditional cooperatives. After October 2008, when in general very few banks have been established, there have emerged new cooperative banks in countries where they have been largely absent, namely in Belgium (NewB) and in Israel (Ofek). Both of these cooperatives are still at a budding stage.

5. CONCLUSIONS

The great crisis that started in 2007–2008 has taught an important lesson related to the importance of banking diversity. In order to maintain systemic stability, it is not enough to have well-diversified banks doing more or less the same thing – what is needed is banks with different business models doing different things (Haldane, 2010). Stakeholder banks – cooperative and savings banks – have a valuable role in maintaining that diversity. However, if there is homogenization of banking practices – caused by "one size fits all" regulations or managerial

5 See Cornée and Szafarz (2014).

emulation of "best practices" – the diversity does not increase. In a time when customer trust towards banks is at an all time low, customers are moving from shareholder banks to cooperative financial institution en masse (witness the success of Bank Transfer Day in the U.S. in November 2011). In other words, there is a social need and customer demand for banks that are different, but there are many pressures towards undesirable homogenization, many of them originating from bank regulations. These include the capitalization rules originating from Basel accords and the role of rating agencies in calculating capitalization, and the large disproportionalities in regulatory burden (Ferri and Kalmi, 2014), all of which favor large banks at the expense of smaller banks.

It is not always clear that smaller means more ethical, and in the absence of generally accepted measurement of ethical characteristics in banking, it is hard to enforce regulation favoring "more ethical" organizations. However, a regulation fully recognizing the value of diversity of banking organizations would go a long way to ensuring also a more stable and perhaps a more ethical banking sector.

Abstract

The paper analyses the notion of banking ethics and presents a simple model of risk shifting that illuminates the conflict between depositors and shareholders and presents shareholder incentives to gamble "with other peoples' money". Customer ownership through cooperative or savings bank structure solves this problem, however, these structures have problems of their own. Finally, it stresses the benefits of organizational diversity in banking, on how banks in different ownership structures may foster that diversity, and also why ownership may not be a sufficient condition for diversity.

Key words: Bank ownership, bank diversity

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SAVINGS BANKS AND COOPERATIVE BANKS IN EUROPEAN BANKING SYSTEMS[1]

Until about 25 years ago, almost all European countries had a so-called "three pillar" banking system comprising private banks, public savings banks and (mutual) cooperative banks. Since that time, several European countries have implemented far-reaching changes in their banking systems, which have more than anything else affected the two "pillars" of the savings and cooperative banks. The paper first describes these changes and points out the specific situation in Germany, as this country is almost unique in so far as the German savings banks and cooperative banks have maintained most of their traditional features. The article then describes the structure of the German "Three-Pillar" banking system and the place and role of savings and cooperative banks in it and concludes with

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1 This paper is a brief summary of two recently published papers by the same authors. One of them, *Caisses d'Épargne et Banques Cooperatives en Europe,* has been published in French in the *Revue d'Économie Financière*; and the other one, entitled *The Persistence of the Three-Pillar Banking System in Germany* appeared in O. Butzbach and K. von Mettenheim, eds., *Alternative Banking and Financial Crisis.* For details, see the list of references.

a plea for diversity of institutional forms of banks by arguing why it is important to safeguard the strengths of those types of banks that do not conform to the model of a large shareholder-oriented commercial bank.

1. SAVINGS BANKS AND COOPERATIVE BANKS ACROSS EUROPE

Historically, savings banks and cooperative (or mutual, customer-owned) banks have played an important role in the financial systems of almost all European countries. However, the wave of financial deregulation, liberalization and privatization in the late 20th century has changed the role and the institutional forms of these banks in most European countries. The general tendency of the past years was to regard these types of banks as somehow old-fashioned, outdated and inefficient, and to advocate and even implement policies that correspond to this view. In some European countries, savings and cooperative banks have completely disappeared as specific groups of financial institutions, and in some others, they have changed so much that it suggests asking whether there is still today any substantial difference between these banks and conventional commercial banks in the legal form of a corporation and with the set of objectives that private banks can be assumed to have.

Until about 25 years ago, almost all European countries had a so-called "three pillar" banking system comprising private banks, (public) savings banks and cooperative (mutual) banks. Historically, the German savings banks and in particular the German cooperative banks had served as a model for creating similar banks in other European countries and even around the entire world. However, while those in other European countries have greatly changed in recent years, the German savings and cooperative banks have maintained most of their traditional features over the last decades. As far as their legal and institutional features are concerned, the German savings and cooperative banks are today almost exactly as they had been 50 and even 80 years ago.[2] Therefore, they arguably still correspond best to what one might call their prototypes.

Several European countries have implemented far-reaching changes in their banking systems, which have more than anything else affected the two "pillars" of the savings and cooperative banks. There have been several factors that drove the changes in Europe. Certainly, the political climate of the time and EU-wide harmonization were important. However, there was also the presumption that in their former set-up the regional banks were not competitive.

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2 For a description of these features see the references in note 2 above and the respective country sections on Germany in Ayadi et al. (2009) and Ayadi et al. (2010).

The most important changes occurred in Austria, France, Italy and Spain. In a nutshell the changes are as follows:[3]

- ❖ In Austria the three networks of formerly independent local savings and cooperative banks have been transformed in such a way that their respective central institutions have gained far reaching power over the now *de facto* "subordinated" local and regional institutions. The reform in 1979 abolished the regional principle, which encouraged several savings banks to start operating at the national level. In 1986, a revision of the Savings Banks Law permitted splitting up a savings bank into two entities with different legal forms. This reform led to a complex structure of cross-ownerships with some savings banks holding shares in other savings banks, allowing for the creation of central institutions.
- ❖ In France, savings banks have been converted into yet another group of cooperative banks – of which there had been three for a long time – and have been phased out as a special type of financial institution in 1999. In 2009, the newly created group of cooperative savings banks merged with the cooperative group *Banque Populaires*. Today, French savings banks still exist merely as a brand under the group *Banque Populaire Caisse d'Epargne* (BPCE), but they are no longer comparable to publicly owned savings banks in the traditional sense.[4] In contrast to the former public savings banks, the cooperative banks continue to be an important element of the French banking system.
- ❖ In Italy, savings banks were partially privatized and several of them were integrated into large commercial banks like UniCredit and INTESA. Cooperative banks consolidated in a big way, and for both groups of banks, as much as for other Italian banks, the regional principle was abolished. Legislative changes in the 1990s further pushed the privatization of the numerous Italian state-owned banks, abolished geographical restrictions, limited the fraction of the shares that any one foundation could hold in one savings bank and finally led to the merger with banks of various types and the creation of large nationally as well as internationally operating banks.

  For the cooperative banks the relevant laws largely removed the former restrictions and allowed the *Banche Popolari* (BP) to drift away from their former cooperative status and their local roots. A wave of mergers led to the

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3 For more details, see Adyadi et al. (2009 and 2010) and, for the more recent developments Bülbül et al. (2013) and Schmidt et al. (2014. On cooperative banks in Europe, see also Fonetyne (2007).

4 For a discussion of the French savings banks and their reform, see Moreau and Boukhorssa (2002) and Polster (2005).

development of large cooperative banks belonging to the BP banking network, while the *Banche di Credito Cooperativo* (BBC) retained their original model as far as their organization as cooperatives and their local business focus are concerned.

❖ In Spain, the reforms and the economic liberalization that began in the 1970s, reshaped the savings banks with the intention of making them become modern and efficient financial institutions – in spite of the strong role they already played at that time. They were formally and partially privatized, the regional principle was abolished and they were granted the freedom to provide a broad range of financial services in all parts of the country. This transformed them into universal banks and important competitors to other institutions in the banking sector. However, for many of them this new business model proved to be unsustainable, as the recent crisis has shown with surprising clarity.

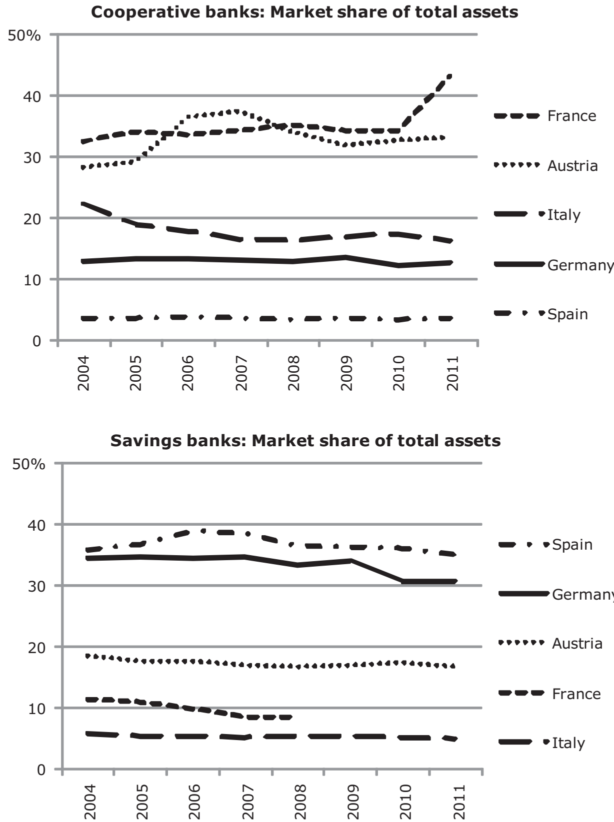
A few brief remarks on other European countries show that in some countries the changes have gone even further:

❖ In Belgium savings and cooperative banks have essentially disappeared.
❖ In Great Britain the large former public savings bank (TSB) was sold to Lloyds Banking Group, and several cooperative banks, especially the larger so-called building societies, were converted into corporations and sold to large private commercial banks. Most of the converted building societies or the private banks that had bought them ran into serious problems during the financial crisis.
❖ In the Netherlands savings banks have disappeared and the formerly independent cooperative banks have been amalgamated into one big national bank (Rabobank).
❖ In Sweden, the former local savings banks have been converted into joint stock corporations in the 1990s, and most of them were consolidated into a single national savings bank (Swedbank).

The role of savings banks and cooperative banks varies significantly between European countries. This is related both to historical reasons and to developments over the last decades as described above.

Figure 1 presents the market share of savings banks and cooperative banks in terms of total assets in selected countries over the last years (including total assets of the respective central institutions). As illustrated in the left panel, until today savings banks continue to play an important role particularly in Spain and Germany, but not so any more in several other countries. The right panel highlights the strong role of cooperative banks in France and Austria and only a very limited role in other countries. In some countries, such as Austria and Germany, both banking groups play an important role.

Figure 1. The role of savings banks and cooperative banks across Europe



Based on the European Savings Banks Group (ESBG, 2013), the European Association of Co-operative Banks (EACB, 2013) and the European Central Bank (ECB, 2013). Note that the figures for savings banks and cooperative banks include the respective central institutions. For savings banks and cooperative banks, we calculate the market share for each country as the total assets of the respective ESBG and EACB member organizations, respectively, divided by the total assets of all financial institutions in that country as reported by the ECB. Missing values for savings banks for the years 2006, 2009 and 2010 were interpolated.

As one of the motives for initiating far reaching reforms was the belief that the efficiency of local savings and cooperative banks is lower than that of other banks with comparably large branch networks, it is instructive to take a closer look at this aspect. As we will demonstrate below, evidence from the German banking market does not support the belief that local savings banks and cooperative banks are less efficient.

2. THE GERMAN "THREE PILLAR" BANKING SYSTEM

Until today, the German banking system is a so-called "three-pillar system". The first pillar is formed by the private banks. It includes the "big banks" which have nationwide branch networks.[5] The savings bank group is the second pillar, and the cooperative banking group is the third pillar.[6] Table 1 shows the numbers of institutions and branches of the three "pillars" for 2000 and 2012.

Table 1. Number of banks and branches by banking groups in 2000 and 2012

	Institutions				Branches			
	2000		2012		2000		2012	
	number	(%)	number	(%)	number	(%)	number	(%)
Private commercial banks	294	(10.7)	390	(19.7)	6,520	(15.1)	9,610	(26.5)
Big banks	4	(0.1)	4	(0.2)	2,873	(6.6)	7,041	(19.4)
Regional banks and others	200	(7.3)	209	(10.6)	3,567	(8.2)	2,444	(6.7)
Branches of foreign banks	90	(3.3)	177	(9.0)	80	(0.2)	125	(0.3)
Savings bank groups	575	(21.0)	432	(21.9)	17,530	(40.5)	13,094	(36.1)
Savings banks	562	(20.5)	423	(21.4)	16,892	(39.0)	12,643	(34.9)
Landesbanken and DekaBank	13	(0.5)	9	(0.5)	638	(1.5)	451	(1.2)
Cooperative bank groups	1,796	(65.5)	1,106	(56.0)	15,357	(35.5)	11,789	(32.5)
Cooperative banks	1,792	(65.4)	1,104	(55.9)	15,332	(35.4)	11,778	(32.5)
Central institutions	4	(0.1)	2	(0.1)	25	(0.1)	11	(0.0)
Other banks	75	(2.7)	48	(2.4)	3,887	(9.0)	1,746	(4.8)
All banks	2,740	(100.0)	1,976	(100.0)	43,294	(100.0)	36,239	(100.0)

Based on Deutsche Bundesbank (2013). Note that as of 2004, big banks include Postbank AG with its many branches.

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[5] "Big banks" (Grossbanken) is a term and a classification employed in the official statistics of the Bundesbank, Germany's central bank. It refers to those banks that have large branch networks. The group currently includes Commerzbank AG, Deutsche Bank AG, Deutsche Postbank AG and UniCredit Bank AG (formerly HypoVereinsbank AG).

[6] For a thorough description and analysis of the German banking sector see Hackethal (2004).

Table 2 contains information on the groups' market shares with respect to total assets, loans to non-banks and deposits and borrowing from non-banks for the years 2000 and 2012.

Table 2. Market share by banking groups in 2000 and 2012

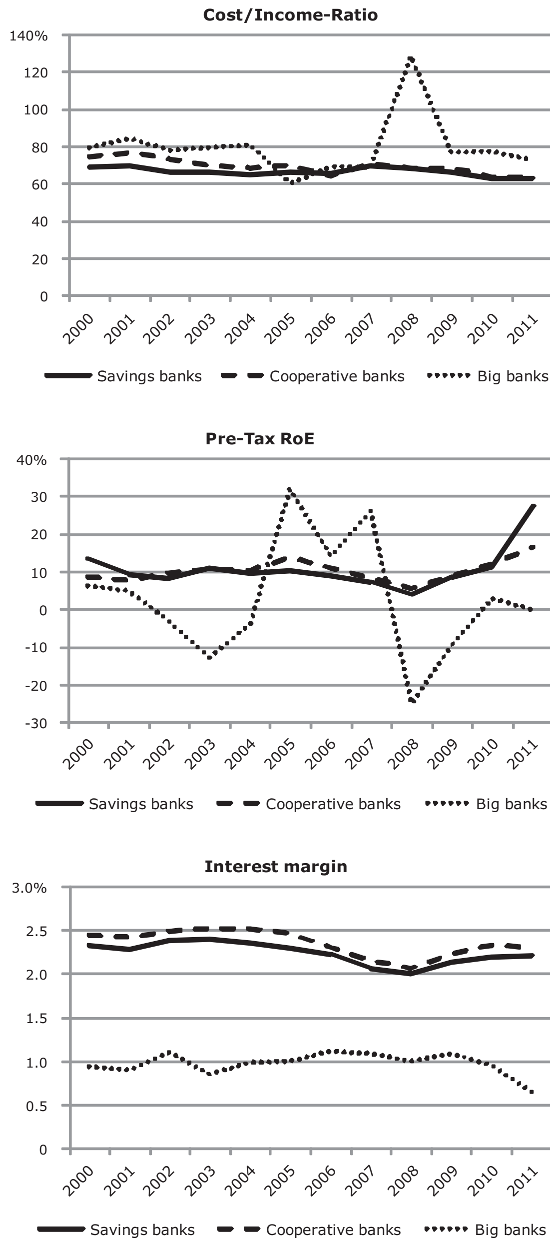
	Total assets		**Loans to non-banks**		**Deposits and borrowing from non-banks**	
	2000	**2012**	**2000**	**2012**	**2000**	**2012**
Private commercial banks	28%	39%	26%	27%	26%	36%
Big banks	16%	25%	15%	13%	14%	17%
Regional banks and others	10%	10%	10%	13%	12%	16%
Branches of foreign banks	2%	4%	1%	1%	0%	3%
Savings bank groups	35%	28%	35%	36%	39%	34%
Savings banks	16%	13%	19%	21%	26%	24%
Landesbanken and DekaBank	20%	15%	16%	15%	13%	11%
Cooperative bank groups	12%	12%	12%	15%	18%	17%
Cooperative banks	9%	9%	11%	13%	17%	16%
Central institutions	4%	3%	2%	2%	1%	1%
Other banks	24%	20%	26%	22%	17%	12%
All banks (in billion Euros)	6,148	8,315	3,479	3,949	2,261	3,328

Based on Deutsche Bundesbank (2013).

Over the years, the local savings and cooperative banks have been able to prosper and at times even outperform the commercial and purely shareholder oriented banks. The following Figure 2 provides performance indicators of German branch banking and allows for an assessment of the financial situation of those banks in the three pillars that have extended branch networks and are therefore to some extent comparable. The left panel of Figure 2 shows that the cost-income ratio is lower for savings banks and cooperative banks than for the large commercial banks. As shown in the middle panel, return on equity is on average higher and clearly more stable for savings banks and cooperative banks. Finally, the right panel shows that the interest margins for all banks have been steadily declining, but throughout the years the interest margins are higher for savings banks and cooperative banks than for big banks.[7]

[7] The performance indicators of the central financial institutions of the savings bank group and the cooperative bank group, which are not shown in Figure 2, are largely similar to those of the big private banks.

Figure 2. Performance indicators of German branch banking



Based on Deutsche Bundesbank, Monthly Reports, September 2001–2012.

Not only standard performance indicators show that the local banks performed about as well and at times even better than the private big banks, but also more elaborate ways of analyzing and comparing performance confirm this result for the years before the financial crisis began in 2007. For example, Altunbas et al. (2001) examined a sample of German banks between 1989 and 1996. They found that public and mutual banks are not less efficient, but rather have slight cost and profit advantages over their private sector competitors. This may appear particularly surprising given that savings and cooperative banks pursue the dual objective of profit and benefit for their customers, an effect that cannot be included in standard performance measurements.[8] Probably less surprising, but equally relevant, is that German savings banks and cooperative banks are on average less risky than private commercial banks (Beck et al., 2009).

Further, using a sample for the period 1995 to 2007, Behr et al. (2013) find that the lending of German savings banks is less cyclical compared to that of the private banks and that German small and medium-sized enterprises that increase their borrowing from savings banks are less credit constrained. Hence, the high financial stability of German savings banks also benefits their clients.

In contrast to the large banks which experienced large losses due to overly risky investments and off-balance sheet activities of a precarious nature in the pre-crisis years, German local savings and cooperative banks weathered the storm largely unharmed. This is foremost due to their traditional business model concentrating on the core-business of banking and corresponding to their mission and tradition. The local banks benefitted from their strong deposit-gathering ability and the established and close relationships with their business clients. Moreover, their conservative business models prevented them from becoming involved in those lines of risky business that hurt most large private banks. Moreover, in contrast to other banks, the savings and cooperative banks have not curtailed lending during the crisis period.

Nevertheless, like almost every financial group, the savings banks group as a whole was also affected by the financial crisis. *Landesbanken* or regional banks also belong to the savings bank group and serve, among other capital market related activites, as clearing banks for the local savings banks operating in their respective regions. Four of them (HSH Nord, BayernLB, SachsenLB and WestLB,) suffered greatly, indirectly also causing large losses to local savings banks in their roles as co-owners, guarantors and business partners. This is one reason why some *Landesbanken* are currently undergoing major reforms (HSH Nordbank and BayernLB), were merged (SachsenLB with LBBW), were largely liquidated (WestLB), or are re-aligning their business models. Other *Landesbanken*, such as

[8] This point is also made very clearly in Fonteyne (2007).

Helaba, did relatively well during the financial crisis and thus even strengthened their positions within the savings banks group.

Being even less involved in structured finance and capital markets products than the savings banks, the cooperative banks have survived the financial crisis better than any other banking group in Germany, even though their central financial institution DZ-Bank also had some problems and needed help, which it got from other institutions belonging to the network. Very soon, these problems were overcome, and DZ-Bank returned to profitability.

In conclusion, one can say that despite some problems with their central financial institutions, savings banks and cooperative banks have proved to be a stabilizing factor for the German financial system and for their clients and thus also for the entire German economy. The financial crisis has strengthened the positions of the two groups of banks and thereby has also stabilized the traditional three-pillar structure of the German banking system.

3. FINANCIAL CRISIS: LESSON LEARNED

While during the years before the financial crisis the general views concerning the merits and the potential of savings banks and, though to a lesser extent, also those concerning cooperative banks in Europe and worldwide had become more and more skeptical over the years, it seems that as a consequence of the crisis this attitude has changed. Banks with public ownership and member or client based financial institutions have regained some recognition, because the vast majority of them had fared better than their larger, purely private competitors and also because they have held up their supply of loans to the economy at a time when big banks cut back lending.

The financial crisis has generated the insight that in the area of banking there can be too much profit orientation, too much profit pressure emanating from the capital market on listed banks and too much financial sophistication. Working together, these factors can lead to banks accepting and even generating too much risk for themselves as institutions, for their respective national financial systems and even for society at large. Local and regional banks are less risky and this contributes to the stability of entire financial systems. After all, many big private banks had incurred so much risk that policy makers and regulators have adopted a skeptical view of their merits and are now trying to find ways of limiting their riskiness. Indeed, many current policy initiatives try to make all banks behave a bit more like the savings banks and cooperative banks of yesteryear.

The formerly “modern” view that all financial systems should resemble as much as possible the model of a financial system in which capital markets are the most important force and in which banks are large, private, purely shareholder-oriented

and exchange-listed corporations has been severely discredited by the experiences from the recent financial crisis. It is a very important lesson of the financial crisis that we simply do not know which type of bank and which structure of a financial system are better under different circumstances.

This agnostic position leads to the argument of diversity. In the life sciences, from where the notion of diversity comes, the value of diversity has been widely recognized in recent years, and there is a crucial underlying argument why biodiversity is so important: Even the best experts do not know, and in fact cannot know, what the future challenges to human life and health and to the environment may be, and this is the main argument put forth for preserving biodiversity. Currently endangered species might some time later serve to cure diseases which are not even known today, and this is why they need to be preserved already now.

Much the same applies to the types of banks and banking groups that are the topic of this article. As we simply do not know which type of bank is best if regarded in isolation and which mix of different types of banks within a financial system is best for the economy and for society at large, we regard it as very important to "preserve" these types of banks and prevent them from being sidelined or even abolished. If policy makers accept this argument and act accordingly, they would not only ensure the good prospects of savings banks and cooperative banks, but also provide for the future development of the banking system in Europe.

Abstract

Until about 25 years ago, almost all European countries had a so-called "three pillar" banking system comprising private banks, public savings banks and (mutual) cooperative banks. Since that time, several European countries have implemented far-reaching changes in their banking systems, which have more than anything else affected the two "pillars" of the savings and cooperative banks. The paper first describes these changes and points out the specific situation in Germany, as this country is almost unique in so far as the German savings banks and cooperative banks have maintained most of their traditional features. The article then describes the structure of the German "Three-Pillar" banking system and the place and role of savings and cooperative banks in it and concludes with a plea for diversity of institutional forms of banks by arguing why it is important to safeguard the strengths of those types of banks that do not conform to the model of a large shareholder-oriented commercial bank.

Key words: German three pillar banking system, cooperative banks, savings banks

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THE ROLE OF DIVERSITY OF BANKING MODELS: POSITION AND PROSPECTS OF POLISH COOPERATIVE BANKS

1. INTRODUCTION

The deregulation of financial markets over the last two decades has dramatically influenced the scale and complexity of banking firms. In the pre-crisis period, universal bank strategies were largely directed towards expansion, while business models centered on operational efficiency accruing from new sources of profits and high leverage. The preferred bank business model was that of universal (conglomerate) banking, where bank expansion was based on non-interest income and non-depository funding (Allen et al., 2011) and the adoption of new models for conducting banking activities, based on product synergies, scale and scope benefits and global coverage (Demirguc-Kunt and Huizinga, 2009). The global financial crisis of 2008 highlighted the riskiness of that model and demonstrated that in many cases benefits from diversification from traditional banking have been overstated. With countless cases of nationalization or forced takeovers of failing banks, questions have been raised as to the proper size and scope of banking activities. Retail banking carried out by locally-based, small institutions, such as credit unions, mutual savings banks, building societies or cooperative banks,

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for years has played an important role in local environments, enhancing bank reputation and trust. However, pre-crisis deregulation and the growing size and complexity of banking firms and post-crisis restructuring, based on massive public assistance aimed at stabilizing large banks, has created a hostile environment for locally based banks.

2. THE BANKING SECTOR IN POLAND: THE POSITION OF COOPERATIVE BANKS

Poland has a relatively low concentrated banking sector, with a traditional bank business model. Foreign capital dominates, but the Treasury is also an important shareholder. Polish private capital dominates in smaller banks and in the cooperative sector. Overall, the Polish banking sector in the post-crisis period is characterized by good performance as well as by solid fundamentals, as indicated in Table 1.

Table 1. Polish bank performance (%)

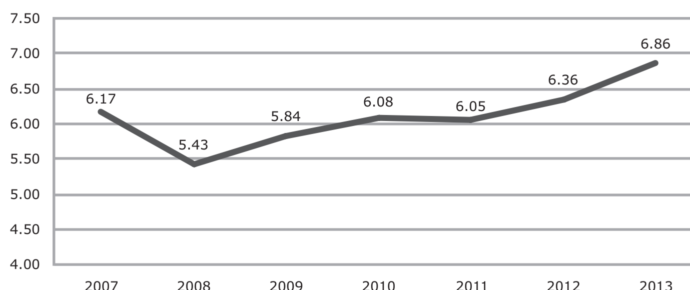
Banks/ year	ROA					ROE					C/I				
	2009	2010	2011	2012	2013*	2009	2010	2011	2012	2013*	2009	2010	2011	2012	2013*
Sector	0.81	1.03	1.26	1.22	1.14	8.37	10.21	12.64	11.19	10.4	54	52	51	51	53
Commercial	0.83	1.10	1.27	1.23	1.17	8.22	10.19	12.71	11.19	10.53	53	51	49	49	51
Cooperative	1.18	1.12	1.21	1.19	0.86	10.46	10.46	11.59	11.23	8.39	72	69	67	66	70

* Data for 30.09.2013.

Source: *Raport o sytuacji banków 2007–2011*, *2012*, UKNF, Warszawa 2012 and 2013; *Informacja o sytuacji banków w okresie I–IX 2013 r.,* UKNF, Warszawa 2013.

Since 1989, Polish cooperative banks have undergone comprehensive restructuring in order to adapt to market economy rules, and later to adjust to EU requirements. This restructuring was painful – their number has plummeted from 1510 in 1995 to just 570 today (Szambelanczyk, 2006). On the whole, however, cooperative banks have benefited from the consolidation process and today serve over 10 million customers through a countrywide network of 4600 branches. Since Poland's accession to the European Union, cooperative banks have become an important channel through which money from the Common Budget is transferred to farmers and local authorities nationally (Siudek, 2010). Today cooperative banks represent 90% of the total number of banks, 25% of bank branches and 20% of employment, but only 6.86% of total banking assets (fig. 1).

Figure 1. Cooperative banks' market share (in total assets)



Source: own calculations based on KNF data.

They are small, locally based institutions: the majority (around 350 banks) have assets below 20 million Euro, and only 66 are relatively large, with assets above 50 million Euro. The cooperative sector follows a two-level model and in 2013 there were two cooperative networks, one headed by BPS SA (Bank Polskiej Spółdzielczości SA) with 363 banks; another by SGB-Bank (Spółdzielcza Grupa Bankowa) with 206 banks, and one cooperative bank which operated independently (Krakowski Bank Spółdzielczy). The mission of cooperative banks is to support their customers as well as members of local communities, as opposed to the profit-maximizing objectives of commercial banks, although their interest margin is higher than that of commercial banks (tab. 2).

Table 2. Net interest margin (net interest revenues /av. assets)

	2007	2008	2009	2010	2011	2012	2013
Sector	3,30	3,26	2,51	2,79	2,85	2,68	2,50
Commercial banks	3,20	3,15	2,32	2,83	2,89	2,64	2,49
Cooperative banks	4,77	5,20	4,08	4,11	4,28	4,31	3,50

Source: own calculations based on KNF data.

Among a number of locally active financial institutions, banking activities are conducted also by unregulated (till 2012) credit unions (SKOKs). Although SKOKs represent only 1.3% of the total assets of the banking sector, they have grown at a remarkable rate since their implementation in 1992. SKOKs operate among low income individuals, especially those who do not have accounts with other banks. In 2010, there were 61 SKOKs with 1800 branches, serving over 2 million customers (15% of Polish households). Their assets in June 2010 were over 4 billion US$ (WB 2012). The Credit Union Act of 1995 defined SKOKs as self-regulatory organizations,

which gave them flexibility and low-cost advantage. The new Credit Union Act of 2009, implemented in October 2012, provided for external supervision and depositor protection, similar to the rest of the regulated banking institutions, both commercial and cooperative. This was a move in the right direction, as many surveys have indicated that many customers did not differentiate between self-regulated SKOKs and fully regulated cooperative and commercial banks (KNF, 2012b).

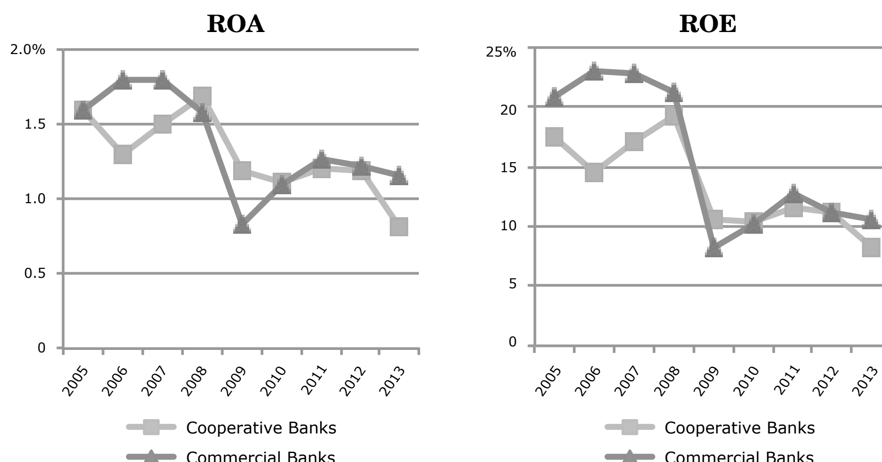
Poland's cooperative banks have a limited scale and scope of operations. At the end of 2011, loans constituted 55% of their assets (40% to households and micro enterprises and 15% to firms, mostly SMEs), followed by interbank loans (30%) placed in the associating banks. They financed 77% of their assets by deposits, mostly from households. The crisis changed their strategies, giving incentives for moving into more risky small enterprise financing (tab. 3), the area less attractive for commercial banks.

Table 3. Changes in loan structure of commercial and cooperative banks (%)

	Commercial banks			Cooperative banks		
	2008	**2010**	**2011**	**2008**	**2010**	**2011**
Households	55.7	62.0	61.8	74.7	70.5	67.1
Firms	40.2	31.3	30.0	19.8	22.1	24.1
Local and central governments	3.8	6.2	7.8	4.9	6.7	8.0
Others	0.3	0.5	0.4	0.6	0.7	0.8

Source: BFG, 2011.

Figure 2. Cooperative and commercial banks profitability



Source: Own calculations based on KNF.

The cooperative model has performed well in the post crisis period in a number of countries. In Poland, the cooperative banks, although less profitable in the pre-crisis booming years, have a similar (till recently) post-crisis performance to that of commercial banks (fig. 2). However, the cooperative sector is not homogenous, there are small banks which struggle to maintain the required capital and large banks, which could easily demutualise. Overall, the Polish cooperative sector in the post-crisis period is characterized by good performance and an important role in local SME financing.

Similar conclusions can be drawn when analyzing the cooperative bank soundness, based on the Z-score index of bank sensitivity to risk (default). The index is based on the volatility of returns and the lack of adequate capital as the main sources of risk (Lown et al., 2000) and is calculated as the sum of equity capital to assets ratio (CAR) and return on assets ratio (ROA), divided by the standard deviation of ROA. Thus the value of the Z-Score is determined by the level of capitalization and by the level and stability of profits, and can be interpreted as the distance from a default, measured by the standard deviation of profits. A high level in the Z-Score denotes bank stability, which means it has enough equity capital to cover potential losses.

$$Z - Score_t = \frac{ROA_t + CAR_t}{\sigma(ROA)}$$

ROA_t, CAR_t – Return on Assets and Capital to Assets Ratio for year t;
$\sigma(ROA)$ – standard deviation.

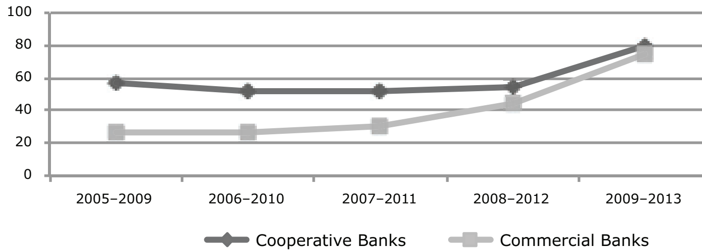
The 2008 crisis resulted in a lowering of the Z-score index for the entire banking sector, but more profoundly for the commercial banks (fig. 3A). Changes in the Z-score index for the cooperative banking sector were less dramatic and the values were higher than for commercial banks, demonstrating their stable position throughout the crisis. However, as fig. 3B demonstrates (for 3-year windows) this was a short term advantage, and in 2011–2013 the situation started to reverse.

When analyzing the subgroups within the cooperative banking sector, divided according to the asset size, we can observe that the smallest banks are the safest (fig. 4).

Among cooperative subgroups, the largest banks have a low ROA, but the highest ROE, and the smallest banks just the opposite, indicating that size matters in business decisions and profitability indicators (fig. 5). For large cooperative banks (assets over 200 m PLN) the crisis years turned out to be the most profitable, thanks to retaking some business and customers from commercial banks. Overall, the Polish cooperative sector in the post-crisis period is characterized by good

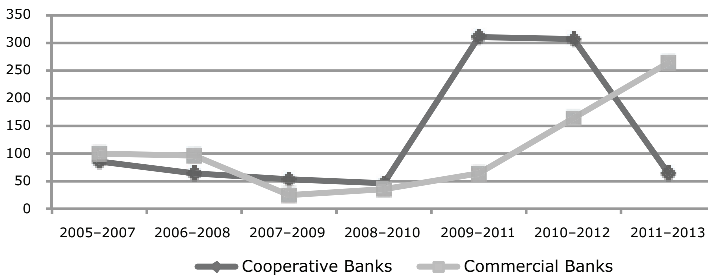
performance and important role in local SME financing, although with some challenges ahead.

Figure 3A. Z-score for commercial and cooperative banks in 5-year rolling windows



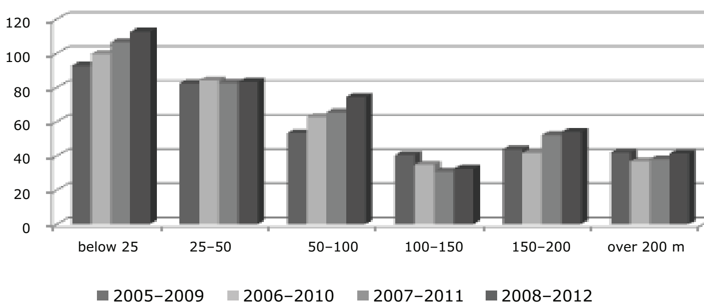
Source: Own calculations based on KNF.

Figure 3B. Z-score for commercial and cooperative banks in 3-year rolling windows



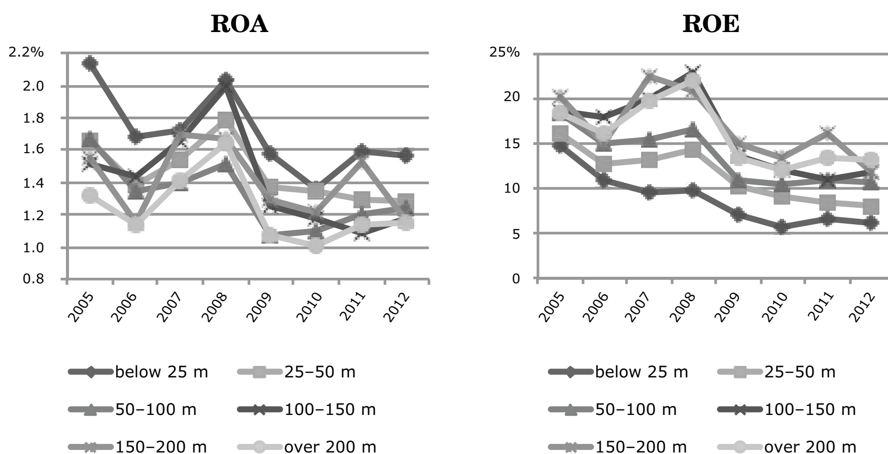
Source: Own calculations based on KNF.

Figure 4. Z-score for subgroups of cooperative banks



Source: Own calculations based on dataset obtained from KNF.

Figure 5. Cooperative banks profitability: comparison within the sector



Source: Own calculations based on dataset obtained from KNF.

3. THE CHALLENGES TO THE COOPERATIVE BANKING MODEL

The European Association of Cooperative Banks has pinpointed the following key cooperative values (Oliver Wyman, 2012): trust, governance, resilience (adapting to changing circumstances), proximity to customers, social commitment (supporting local customers) and solidarity: i.e. reinvesting capital at the local level. The financial crisis of 2007–2009 stressed their importance: throughout the crisis, local banks in many European countries had a superior performance the big banks (Ayadi et al., 2010). Thus another challenge for the cooperative sector is not to lose identity in the form of operational independence and regional focus.

Cooperative banks in Europe form a mix of different business and associating (network) models and governance structure. Despite different organisational and ownership structures, they are well integrated and complementary to the European commercial banking sector. Cooperative bank governance models range from a centralized one, where member banks have delegated significant supervisory and decision taking power to a central entity (such as the Rabobank model) and, on the other extreme, a network model, where a central entity provides support and has an advisory role, but the decision making power rests with the member banks, such as in the Polish cooperative networks (Oliver Wyman, 2012). In the light of the recent liquidity regulation (CRD IV), an important feature is also the level of network cooperation between local, regional and central institutions. In some

countries networks have evolved into large complex conglomerates, with a strong reliance on a central institution In networks with less formal organizational structures, such as the Polish one, there is a potential area of conflict between the bottom-up ownership and top-down authority, as growing centralization may worsen cooperative banks' identity and mission. In general, the Italian and Spanish models are considered less centralized that the Austrian, German, Dutch, Finnish and French ones (Ayadi et al., 2010, p. 20).

In the decentralized cooperative network model, intra-group protection schemes are advocated as a key factor in ensuring the overall resilience of cooperative groups. Protection schemes are administered by a central body which acts as an overseer. The Capital Requirements Directive (EC 2006/48) accepts cooperative networks as "Institutional Protection Schemes" (IPS) if they have a mutual support system. In this case, the network central institution may intermediate liquidity within the network, fulfilling the Directive's liquidity requirements (assigning a zero weight for intra-network exposures). This organisational innovation is intended to ensure the solvency and liquidity of a group of affiliated institutions (BIS, 2010). It entails all participants relinquishing to the central body of the IPS the capacity to determine and implement business strategies and internal risk control. The second pillar comprises the mutual liquidity and solvency pacts between the participating cooperative banks and the third pillar is a commitment to the stability of the agreements. These intra-group protection schemes (IPS) are advocated as a key factor in ensuring the overall resilience of cooperative groups, although they bring a significant degree of centralization and tighter cooperation within a group of affiliating banks. The evolution of the network structure is thus an important challenge for the Polish cooperative banks.

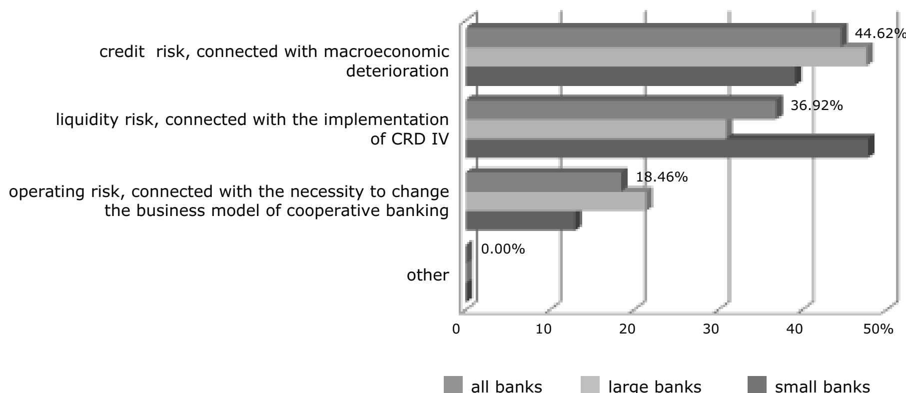
4. THE CHALLENGES FOR POLISH COOPERATIVE BANKS: THE RESULTS OF A 2013 BANK SURVEY

A report by Oliver Wyman, based on a cooperative bank global survey (Oliver Wyman Report, 2012), indicated key success factors for cooperative banks, such as efficiency, customer satisfaction and proper handling of regulations. A similar cooperative bank survey was coaducted by the authors in the early months of 2013, with the aim of analyzing how the Polish cooperative banks understand the challenges ahead. The key answers are analyzed below, for the total group (62 banks) and for subsections of small (assets less than 100 m PLN) and large (assets above 100 m PLN) cooperative banks.

Both for the Polish cooperative banks and globally, the implementation of post-crisis regulations will impose considerable new costs concerning the quality of capital, higher capital requirements, the introduction of a leverage ratio and new

liquidity standards (McKinsey, 2011). In Poland, the biggest problem will be with the implementation of CRD IV liquidity requirements, particularly for the central associating banks (fig. 6).

Figure 6. Major risks for the cooperative banks



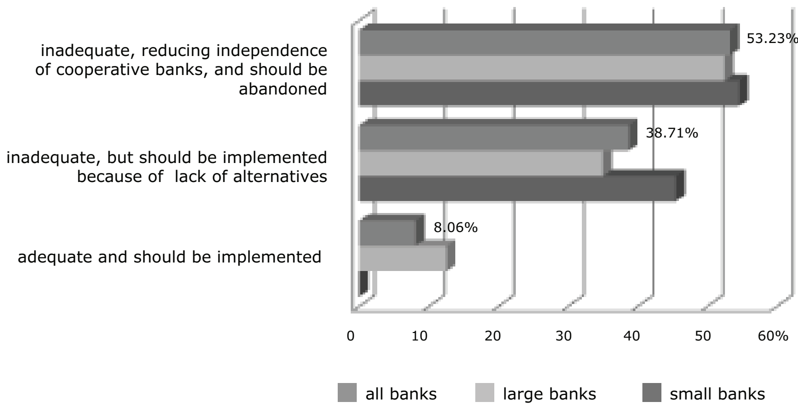
Source: Own research (cooperative bank survey, 2013).

In the Polish two level cooperative sector model, the subordinated cooperative banks have excess liquidity from local deposits, which they place in the associating banks, and 30% of their net interest income comes from interbank activities. However, those transactions are treated as interbank transactions and do not count as required liquidity for associating banks. Moreover, interbank deposits are not accepted in the CRD IV liquidity requirements. If associating banks start to take deposits directly from the market, they will be in direct competition with the subordinated banks, thereby risking problems with their owners. In the Polish model, associating banks coordinate and control subordinated banks, but at the same time are owned by them, which sometimes creates a stalemate.

The regulatory body (KNF) has suggested a compromise by implementing the Individual Protection Scheme (IPS), which is also advocated by the EU. However, there is a considerable resistance among most Polish cooperative banks to giving up their independence and the scheme is immensely unpopular (fig. 7).

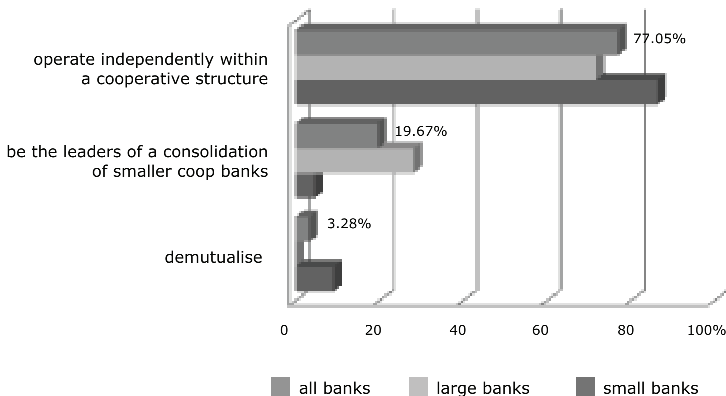
So far, it has not been the intention of the regulatory authorities to interfere directly with the cooperative banking structure, as was done in the 1994 and 2000. However, some actions could be advisable. Regulatory intervention may be aimed either at strengthening the position of "mother banks" for cooperative groups, or at encouraging the strongest cooperative banks to demutualise, or making the IPS obligatory only for small cooperative banks. However, these options have also been immensely unpopular in the bank survey, making any direct intervention difficult (fig. 8).

Figure 7. The attitude of cooperative banks to the IPS scheme



Source: Own research (cooperative bank survey, 2013).

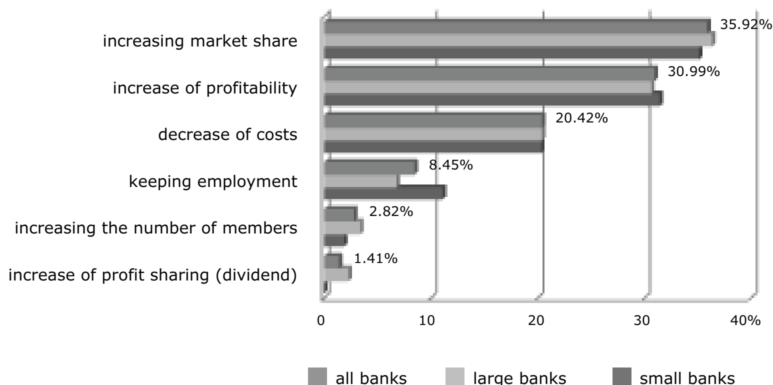
Figure 8. The optimal position of the largest cooperative banks



Source: Own research (cooperative bank survey, 2013).

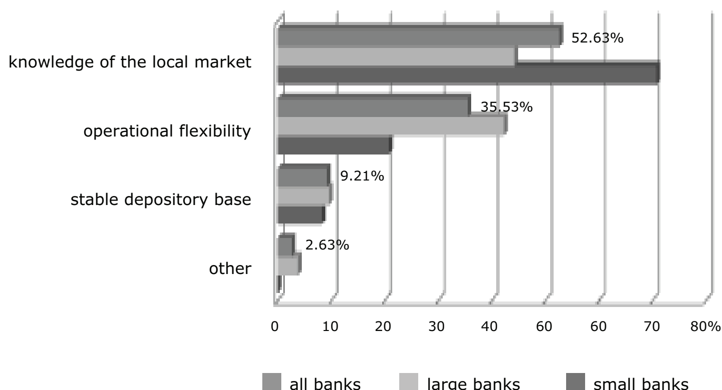
In the strategic part of the survey, cooperative banks seemed to be ready to gain from a favourable post-crisis environment, indicating a need for expansion and an increase in operational efficiency (fig. 9). On the other hand, they did not sense any fundamental change in their market position, as in the survey the majority of banks indicated that the cooperative banking share will increase in the long run only marginally, to 10%. Deep knowledge of the local market and operational flexibility were indicated (fig. 10) as major advantages of the cooperative model.

Figure 9. Cooperative banks' priorities



Source: Own research (cooperative bank survey, 2013).

Figure 10. Main advantages of the cooperative model



Source: Own research (cooperative bank survey, 2013).

5. CONCLUSIONS

The financial crisis has highlighted the advantages of alternative business models of banks, aimed not only at maximizing short-term profits but at the fulfillment of some social objectives. In particular, the crisis has stressed the important role and position of cooperative banking. Consequently, there is a growing recognition that an important factor for the construction of a healthy banking system is the existence of different forms of banks' activities: the coexistence of large global

corporations, imposing standards and technological progress, and a complementary role played by local and specialized banks, based on relationship banking.

The cooperative model has performed well in the post 2008 crisis period in a number of other countries. However, the implementation of post-crisis regulations will impose new considerable costs, concerning the quality of capital, higher capital requirements, the introduction of a leverage ratio and new liquidity standards (McKinsey, 2011). The data presented in the paper supports this assertion. The Polish cooperative banks, with their traditional business model, have come out of the 2008 crisis with a high Z-score and satisfactory profitability. However, these were short-term advantages. Today they face a necessity to restructure their network model and devise new strategies to answer the new challenges ahead.

Abstract

The global financial crisis of 2008 highlighted the riskiness of the pre-crisis bank model and demonstrated that in many cases the benefits of diversification from traditional banking have been overstated. With countless cases of nationalization or forced takeovers of failing banks, questions have been raised as to the proper size and scope of banking activities. Retail banking carried out by locally-based, small institutions, such as credit unions, mutual savings banks, building societies or cooperative banks, has for years played an important role in local environments, enhancing bank reputation and trust. The financial crisis has highlighted the advantages of alternative business models of banks, aimed not only at maximizing short-term profits but also at the fulfillment of some social objectives; thus the aim of the paper is to analyze the position and challenges for the cooperative banking sector, based on the Polish experience.

Key words: Polish cooperative banks, bank business model

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APPENDIX

Cooperative bank survey: selected answers, in %, 2013

	All banks (62)	Smallest banks: assets less than 100 m PLN	Largest banks: assets above 100 m PLN
1. The current model of cooperative banking is:			
stable in the short run	37.10%	40.91%	35.00%
stable in the long run	48.39%	45.45%	50.00%
needs urgent modification	14.52%	13.64%	15.00%
2. Large cooperative banks (capital above 5 m Euro) should ultimately:			
operate independently within the cooperative structure	77.05%	86.36%	71.79%
demutualise	3.28%	9.09%	0.00%
be leaders of consolidation of smaller coop banks	19.67%	4.55%	28.21%
3. The powers of associating banks:			
should be stronger	40.32%	50.00%	35.00%
should remain as today	30.65%	27.27%	32.50%
should be modified	29.03%	22.73%	32.50%
4. In the long run, cooperative banking share will be (as % of total assets)			
as today (5–8%)	33.87%	36.36%	32.50%
increase slightly (to 10%)	61.29%	59.09%	62.50%
increase quite dramatically (to 20%)	4.84%	4.55%	5.00%
5. In the ST, the major risks are:			
credit risk, connected with macroeconomic deterioration	44.62%	39.13%	47.62%
operating risk, connected with necessity to change business model of cooperative banking	18.46%	13.04%	21.43%
liquidity risk, connected with the implementation of CRD IV	36.92%	47.83%	30.95%

	All banks (62)	Smallest banks: assets less than 100 m PLN	Largest banks: assets above 100 m PLN
6. The regulatory proposal to deal with CRD IV implementation is IPS (Institutional Protection Scheme). This proposal is:			
adequate and should be implemented	8.06%	0.00%	12.50%
inadequate, reducing independence of cooperative banks, and should be abandoned	53.23%	54.55%	52.50%
inadequate, but should be implemented because of lack of alternatives	38.71%	45.45%	35.00%
7. The main advantage of cooperative model is:			
stable depository base	9.21%	8.33%	9.62%
knowledge of local market	52.63%	70.83%	44.23%
operational flexibility	35.53%	20.83%	42.31%
other	2.63%	0.00%	3.85%
8. ST bank priorities are:			
keeping employment	9.23%	13.64%	6.98%
increase of profit sharing (dividend)	0.00%	0.00%	0.00%
increase of profitability	67.69%	63.64%	69.77%
decrease of costs	23.08%	22.73%	23.26%
9. LT bank priorities are (indicate 3):			
maintaining employment	8.45%	11.11%	6.82%
increase of profit sharing (dividend)	1.41%	0.00%	2.27%
increase of profitability	30.99%	31.48%	30.68%
decrease of costs	20.42%	20.37%	20.45%
increasing market share	35.92%	35.19%	36.36%
increasing the number of members	2.82%	1.85%	3.41%
Size of assets			
below 100 m zł	35.48%	**100%**	0.00%
101–200 m zł	27.42%	0.00%	42.50%
above 200 m zł	37.10%	0.00%	57.50%

Source: Own research.

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DIFFERENTIATING BETWEEN SINCERE AND INSINCERE CORPORATE SOCIAL RESPONSIBILITY (CSR): EVIDENCE FROM THE GERMAN BANKING INDUSTRY

1. INTRODUCTION

Firms have fully understood the benefits of accommodating their communication strategy to the increasing demands of society as regards business ethics and corporate responsibility. The space they devote to these issues in their annual reports is bigger and bigger, and their discourse is not only about pious intentions but also about implementation. Similarly, scholars try to apprehend this reality with an ever wider range of concepts: social responsibility, social responsiveness, corporate citizenship, etc. The problem is that this mutual sophistication makes it increasingly difficult to differentiate between firms that are sincerely engaged in Corporate Social Responsibility (CSR) and those that use this concept as a mere window-dressing for marketing purposes.

Within this context, this paper will show how to discern the difference between them in the case of the banking industry. Taking the concrete case of Germany,

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four different types of banks will be analyzed: the three traditional groups used by the German Central bank (Commercial, Cooperative and Savings Banks) and a new type of bank which emerged in the 1980s: ethical banks. For each of these four types of financial institution, the main objective is to see if there is a difference between, on the one hand, what the banks *say* they do (through analysis of CSR policies in their annual reports) and, on the other hand, what the banks actually *do* (through analysis of their financial statements).

The results will lead us to conclude that a sincere commitment to CSR involves a substantial change in the business model. Is that necessarily the future of ethical approaches to business? Should it be the same for all types of firms? A debate will be opened. In the meanwhile, an analysis of the banking industry shows that only a few institutions are ready to take a step forward in this direction.

The aftermath of the subprime mortgage crisis has accelerated the pre-existing process of an ethical approach in the banking industry. Today, all banks claim to be socially, environmentally and economically committed to the philosophy of sustainable development and sustainable finance. Nevertheless, the present paper will show that, beyond outward similarities, there are two major types of banking approaches, each reflecting a distinct business model. On the one hand, there is a number of banks whose ethical/social approach is mainly based on *what they say*. This is mainly the case of commercial banks (i.e. shareholder-based banks), which usually demonstrate outstanding CRS reporting but are not ready to change in depth their traditional business model. On the other hand, there are banks whose ethical/social approach is based on *what they do*. This can be illustrated by a new and still fairly unknown type of bank which emerged in the mid-1980s: the so-called ethical bank. They publish modest CRS reports but as an analysis of their financial information shows that, in their banking practice, they go far beyond other banks in the objective of socially responsible finance.

The present paper will thus explore new methods on how to differentiate between sincere and insincere commitment with CSR. It is organized as follows: after these few introductory words, the following section will set up the theoretical framework. Section three will then explain the methodology used. Section four will analyze the main features of mainstream banking. Finally, section five will show the contours of alternative banking and its consequences.

2. THE THEORETICAL FRAMEWORK

Social demand for ethics vis-à-vis corporations is not new. Industrial accidents like those of Chernobyl and Bhopal, or simply the everyday pollution created by manufacturing plants on our doorsteps, have laid the foundations of growing

community awareness as regards environmental issues. Similarly, accounting scandals such as those of Enron or WorldCom, have stirred the demand for corporate responsibility beyond the financial sphere. The resulting pressure of public opinion has forced firms to reconsider their role in society. Today firms cannot be envisaged any more as a passive spectator of what happens around them, but rather as an active social actor. Consequently, we are witnessing major changes not only in the managers' way of thinking but also in the theoretical framework that describes the relationship between firms and society.

The status of corporations in society is shaped by one fundamental question: do they exist only to create wealth for shareholders? Or does good corporate governance demand that a firm's board of directors also consider the interests of other stakeholders (ultimately society at large)? In this regard, it is interesting to note that at the beginning of the modern industrial era scholars did not see any seeming contradiction between individual (firms') wealth and collective (social) welfare. Adam Smith in particular made it utterly clear that, through the "invisible hand", individual profit seeking will invariably lead to the most efficient allocation of resources and, therefore, it will result in the greatest utility for the whole society (Smith, I, 7).

With the passage of time, the fact that the marketplace conditions described by Adam Smith rarely matched reality made this apparent convergence of interests collapse. Accordingly, the role and nature of the corporation as regards society opposed two different views: shareholder primacy theorists on the one hand, and social welfare theorists on the other. Proponents of the first school, best endorsed by Milton Friedman's famous article "The Social Responsibility of Business is to Increase its Profits" (1970), contend that the primary purpose of a company is to maximize shareholder wealth. Any other activity diverting from that focal goal would be considered a waste of resources and would weaken the competitive power of the company. Even if any stockholder can personally use his dividends to support any social cause he may choose, at the corporate level the firm has no competence to handle social problems related to the general public. This latter task is not the responsibility of business organizations, but of governments.

Conversely, supporters of social welfare theory advocate for a broader notion of corporate responsibility. Public opinion, which ultimately makes the law, can view corporations as economic institutions acting not only in a given marketplace, but also in a specified society. Consequently, firms have the right to make profits but also the obligation to provide certain social services. Shareholder wealth maximization might thus be tempered by some kind of moral commitment to social expectations. Howard Bowen's (1953) landmark book was probably the first to abridge these ideas into the specific concept of corporate social responsibility (CSR). Archie Carroll (1979; 1991) systemized further the notion of CSR by suggesting that the corporation's responsibility to maximize financial return to shareholders is just

a “bottom line”. The overall picture of his pyramidal model expanded the firm’s obligations towards the legal, ethical and philanthropic spheres. Finally, Edward Freeman’s (1984) influential book deserves particular mention here because it helped to personalize the so far vague notion of social responsibilities. It was through the new term “stakeholder” that he delineated the specific groups that should be considered by the firm in its CSR orientation.

With the evolving process of globalization and the absence of a supranational governmental body with the authority to monitor the activity of transnational companies, attention was shifted from social responsibility to social responsiveness. This latter concept implied not only the condition of having assumed an obligation, but in compliance with ever growing expectations of the community, it also emphasized an action-oriented dimension of concrete implementation. Firms were thus confronted by the problem of determining to what extent this new focus on corporate social performance (CSP) would affect their financial results. A big debate was then opened around two main questions: Is CSP indeed related to corporate financial performance (CFP)? If so, what is the direction and the underlying mechanism that explain this relationship?

Despite the enormous bulk of surveys on this subject over the last 40 years, the empirical evidence put forward still remains inconclusive. A growing number of studies support the hypothesis of a positive CSP-CFP link (Schreck, 2011; Callan and Thomas, 2009; Peters and Mullen, 2009; Rettab et al., 2008; Orlitzky et al., 2003). They contend that companies firmly committed to being socially responsive are generally rewarded with better financial results. Reputation always being an important mediator in the relationship (Neville et al., 2005), it would seem that CSR and stakeholder satisfaction are “good for business”. On the contrary, other scholars claim that CSP and CFP are negatively related (Garcia-Castro et al., 2009; Makni et al., 2008; Laan et al., 2007; Lopez et al., 2007). Most of them consider that a company engaged in CSP activities necessarily incurs additional costs that dilute its primary purpose, which is to maximize profits. So, according to this view, CSR “distracts” from business. There is even a third hypothesis, endorsed by some other authors (Soana, 2011; Magnolis et al., 2007; Aupperle et al., 1985; Abbott and Monsen, 1979; Alexander and Buchholz, 1978), for whom there is not a significant correlation between CSP and CSF.

There is thus considerable incertitude concerning the CSP-CSF relationship. It should be noted that the whole issue is affected by various methodological problems. For instance, there is little agreement among researchers as regards the definition and measurement of the two main variables at stake (CSP and CFP). This fact, in turn, raises questions of data reliability and comparability across studies (Margolis et al., 2007). And yet, there is a clear tendency in modern literature to consider that engaging in CSR activities can reduce costs and risk to a firm, thus enhancing its reputation and legitimacy and, ultimately, creating new competitive

synergies. One could even say that, after several decades of social activism, CSR has become a strongly institutionalized feature in mature economies (Brammer et al., 2012). The idea that corporations should engage in some form of responsible behavior has become a legitimate social expectation. This fact is illustrated by the diffusion of CSR departments within companies, the spread of stock market indices related to sustainability, the proliferation of social ratings and environmental standards, etc.

Interestingly, this prevalence of a CSR perspective in the current business environment has strongly attenuated the age-old opposition between shareholder primacy advocates and social welfare theorists, initially conveyed by authors such as Adolph Berle (1931) and Merrick Dodd (1932). Time passing, a subtle modification in the notion of what really constitutes shareholder wealth has led many contemporary scholars to believe that one can keep profit seeking as the primary goal of the firm while doing so in a socially responsible manner (Parkinson and Kelly, 2001). Michael Jensen (2001), for example, suggests that the ancient conflict between shareholder value and social responsibility can now be finally reconciled through what he calls “enlightened value maximization”. This concept incorporates the basic tenets of stakeholder theory but specifies that long-term value maximization must be the firm’s sole objective. Therefore, in this new enlightened form, social and environmental responsibilities are considered as legitimate means to the end of shareholder benefits. Somehow, the message is that companies must engage with Dodd’s theory of social welfare in order to truly achieve Berle’s concept of profit maximization. Eventually, this reconciliation of previously opposing perspectives is not without recalling the harmonious vision of society proposed by Adam Smith.

The problem is that this enlightened conception of CSR offers little practical guidance for managers’ decisions where a tradeoff between competing stakeholder interests are to be made, especially in a medium or short-term horizon. From the Principal-Agent theory perspective (Jensen and Meckling, 1976; Eisenhardt, 1989), modern corporations are seen as a set of contracting relationships among individuals who have conflicting objectives. Managers, for example, might potentially seek to maximize their own utility at the expense of shareholders’ interests, all of which does not necessarily enhance the company’s long-term value. Likewise, we shall see in the following sections that even if the culture of “short-term profit at any cost” is now unanimously banished from the business vocabulary, there is still much “green-washing” in the actual business practice. Conceiving CSR in its enlightened form as a way to reconcile firms and society might seem at a glance a good idea, but it does not exclude “window dressing”. Consequently, the traditional (not “enlightened”) shareholder perspective is not as outdated as some would like us to believe. Friedman himself noted, on an interview reported by Joel Bakan, that this insincere CSR can be fully justified:

> "The executive who treats social and environmental values as means to maximize shareholders' wealth – not as ends in themselves – commits no wrong. It's like »putting a good-looking girl in front of an automobile to sell an automobile«, he told me. »That's not in order to sell pulchritude. That's in order to sell cars«." (Bakan, 2004, p. 34)

3. METHODOLOGY

Before going through the analysis, it first seems appropriate to clarify the methodology. In this regard, it has already been said that the main objective of this paper is to study how the banking industry conceives their business activities according to two different approaches. Each of these banking patterns is determined by taking into consideration two different types of variables, which in turn are measured by examining the different nature of their corresponding sources:

- ❖ *What they say.* – The banks' CSR discourse will be apprehended on the basis of their social and environmental reporting. Their promises at that level will then be compared with their practices for implementation. As a guiding tool, we have summarized the banks' CSR policies in Table 1, which is largely based on the method used by Bert Scholtens (2009). Despite its limitations, already pointed out by the author himself, this methodological framework has at least the advantage of being easy to apply to the different banks and hence gives us a common ground for assessing their CSR policy at a glance from a comparative perspective.
- ❖ *What they do.* – Beyond the narrative analysis of CSR policies, the reality of how banks are committed to sustainable finance is ultimately reflected in their financials. Three different types of documents will be analyzed: the balance sheet, the income statement, and the off-balance sheet.

The present study will be focused on the particular case of Germany. Several reasons justify this choice. First of all, Germany is a country with a fairly diversified banking industry. Unlike other European countries, there is one ethical bank in Germany: the GLS Gemeinschaftsbank, founded in 1992 with headquarters in Bochum. It should also be noted that Germany is one of the few countries where a sizeable group of savings banks with a distinct business model have been preserved (Ayadi et al., 2009). In a previous article (Relano and Paulet, 2012), ethical banking had already been compared with commercial and cooperative banks, but savings banks had then been ignored. Particular attention will thus be given here to this group in the comparative analysis with ethical banks. Finally, the present article will explore new methodological devices. Choosing again the same country is thus a way of testing the explanatory power of the methodology itself.

The study of the German banking industry will be conducted at two different levels. On the one hand, the whole sample of German banks displayed in its different categories will initially be considered for comparative analysis. On the other hand, and as a means of putting a concrete "face" on each of the above-mentioned categories, a study of some concrete financial institutions will be proposed. Let it be recalled, for example, that the GSL Bank is the only existent representative of ethical banks in Germany. To carry out some comparisons with specific individual institutions of the other baking categories seemed then the most appropriate in certain cases. Both levels (general and individual) are in fact complementary and mutually reinforcing as regards the main hypothesis and the final conclusions.

4. MAINSTREAM BANKS: CSR AS A MARKETING DEVICE

To say that banks really care about sustainable development has now become commonplace (Jeucken, 2001). They all claim to be the most virtuous institutions as far as the environment and society are concerned (Saeed, 2004). Plenty of initiatives are indeed addressed to these matters. In terms of the environment, for instance, many banks would put forward their commitment to reducing their consumption of electricity by using energy efficient bulbs or their efforts in recycling paper from photocopies. Active employee travel policies with respect to commuting or with fair gender/race representation in the institution are not exceptional any more (Giddings et al., 2002). Nevertheless, all these actions just concern the direct impact of banks on the planet and society. Most of them are fairly easy to implement and are not very expensive, giving moreover an instantaneous "green image". But they are not the most important to take into consideration. Far more critical, though less visible, is the indirect impact of banks through the clients and projects they finance. Notice that, without intermediary financial institutions like banks, the Three Gorges Dam on China's Yangtze River, or the Baku-Tbilisi-Ceyhan oil pipeline, linking the Caspian Sea to the Mediterranean, would never have been possible. When civil society realized this, pressure for recognition of environmental and social responsibility largely shifted from the heavy industry to the banking sector. The so-called Collevecchio Declaration (2003), a global coalition endorsed by more than 200 organizations to promote sustainable finance in the banking sector, is in that sense an outstanding example.

The response of the banking industry to this challenge did not take long to come. In June 2003, ten of the world's largest banks launched the so-called Equator Principles, which is a set of environmental and social benchmarks for managing environmental and social risk related to project financing. Another important tool used by banks for complying with the demand of social and environmental accountability, but which now falls within the investment domain, is Socially

Responsible Investment (SRI). The idea is not new. It had emerged in the US by the end of the 1920s, but its exponential development has coincided with the recent success of concepts such as business ethics and socially responsible finance (Loiselet, 2000). So, in a similar manner as firms have been trying to comply with the goals of sustainable development through the concept of CSR since the 1990s, banks have been attempting to fulfill this very same demand since the 2000s by means of different devices adapted to the financial domain. Some of the most important ones are listed in the first column of Table 1.

Table 1. CSR performance of different types of banks (2011)

	Deutsche Bank	Volksbank Baden Baden	Landesbank Baden-Würtenmberg	GLS Bank
1. Sustainability report	1	1	1	1
2. ICC Business Charter on Sustainable Dev.	0	0	0	0
3. UNEP Finance Initiative	1	0	1	1
4. Equator Principles	0	1	0	0
5. Global Compact	1	0	0	1
6. “Who Cares Wins” report	1	0	0	0
7. Certified environmental management	0	1	1	1
8. Certified environmental management	1	0	1	0
9. Environmental policy	1	1	1	1
10. Supply chain management	1	0	1	0
11. Quantitative environmental targets	1	0	1	0
12. Transparency of environ. performance	1	1	1	1
13. Environ. risk management in loans	1	1	1	1
14. Exclusion of specific sectors	1	1	1	1
15. World Bank guidelines	1	0	1	1
16. OECD guidelines	1	0	1	0

	Deutsche Bank	Volksbank Baden Baden	Landesbank Baden-Würtenmberg	GLS Bank
17. Socially responsible investing (SRI)	1	1	1	1
18. Socially responsible saving	0	1	0	1
19. Sustainable financing	1	1	1	1
20. Microcredit	1	0	0	0
21. Environmental advisory services	1	0	1	1
22. Climate products	0	0	1	1
23. Other sustainability products	1	0	1	1
24. Sponsoring (NGOs, community,…)	1	1	0	0
25. Community involvement	1	1	0	0
26. Training on SD to employees	1	1	1	1
27. Diversity and opportunities	1	1	1	1
28. Feedback from employees	0	1	0	1
29. Business ethics principles	1	1	1	1
Total	**23**	**16**	**21**	**19**

Source: annual reports of banks

If we check to what extent the different types of banks apply these elements, simply by giving them a "digital" score (0 or 1) according to their compliance or not with the issue under consideration, it appears very clearly that Deutsche Bank is the most virtuous institution in terms of responsible finance, with a total of 23 points (see tab. 1). Contrary to popular belief, Table 1 also shows that cooperative banks are not always the champions of CSR. Finally, it is worth noting that Deutsche Bank publishes annually a specific CSR report of more than 100 pages and a separate web site is devoted to their corporate responsibility, whereas the *Nachhaltigkeitsbilanz* of the GSL Bank is just a two-pages-chapter of its corporate report. More generally speaking, commercial banks are normally very good in communicating about CSR. The problem is that this ostentatious proclamation of good intentions on sustainability is often used for "greenwashing" purposes. In many cases there is a gap between what the banks say and what they actually do in their in their day-to-day practice.

It is indeed fairly easy for a bank to announce its commitment to responsible finance as a primary goal of their overall strategy. It suffices to issue a certain number of ethical funds, to devote some money to social patronage, to promote a number of internal environmentally-friendly attitudes, to pronounce adherence to international principles which do not compromise the core of the business, and finally to publish an annual extra-financial report in which all these initiatives are highlighted. But one thing is to "look green" and another quite different to "be really green". A pioneering critical study entitled *Shaping the Future of Sustainable Finance* (Durbin et al., 2006), gives clear evidence that the above-mentioned initiatives are no guarantee of sincere commitment. After reviewing the environmental and social policies adopted by 39 key banks from around the world, their conclusions are not very promising. It seems that banks are adopting an environmental rhetoric with little commitment to changing their performance. With few exceptions, bank practices are lagging significantly behind relevant international standards.

The critical point is implementation. Writing in an isolated office about CSR policies is far easier than putting it into every-day practice. In that sense, a considerable number of commercial banks seem not to realize the contradiction existing between their CSR policies and some of their investing and financing decisions around the world. Three examples will illustrate this point for the case of Deutsche Bank (Van Gelder and Denie, 2007, pp. 116–137). The first concerns the production of cluster munitions. Due to the indiscriminate targeting of this explosive device, civilians account for 98% of the victims and thus represent a direct contravention of international humanitarian law. Despite this, Deutsche Bank has repeatedly given credit facilities to various producers of this weapon, like Textron or Rheinmetall. Likewise, Deutsche Bank has contributed to financing the controversial mining techniques of the American company Freeport McMoran, which are devastating extraordinary diverse ecosystems and unique endemic species in New Guinea. Finally, it is not anodyne to note that Deutsche Bank was the only Western bank to hold the accounts for the Central Bank of Turkmenistan during the period of Saparmurat Niyazov, a notorious dictator and leader of an oppressive regime violating the human rights of its citizens. And yet, the German institution has never clarified how this financial support for Niyazov's Turkmenistan fits with its voluntary human rights commitments under the UN Global Compact.

There is thus an obvious gap between the theoretical intentions on sustainability, as expressed in the CSR reports, and the practical consequences of certain financial activities. The main reason explaining this inadequacy is that commercial banks have tried to satisfy the customer's simultaneous demand for profitability and ethics. Unfortunately, this is just not possible, at least in the short term. So those banks which are not ready to renounce the dogma of maximization of profits can only be engaged in the idea of sustainable finance in a rather superficial

manner. This is so far the most common attitude amongst commercial banks. Obviously, most of them offer their clients the possibility of investing in a wide range of ethical funds and do have a number of credit lines especially devoted to environmental or social issues. But their general strategy has not changed. In their mind, the development of these new products must nonetheless serve the main invariable objective: more shareholder benefits. In fact, since the idea of greening the environment is now in fashion, commercial banks have used this tendency to win new clients and to cover a new demand, and thus make still more profit.

A simple way of checking if the CSR policies of a given bank are really integrated in the day-to-day operations is to examine the coherence of "good intentions" with banking practice as reflected in their financial statements. So moving from theory to practice, we will first analyze the balance sheet, the income statement and the off-balance sheet of the entire sample of German banks. Table 2 summarizes this information. The asset side of the balance sheet shows the following parameters: interbank operations, loans, financial participations and reserves. All figures reflect the percentage of each parameter to total assets. On the liabilities side, the following items are considered: interbank operations, deposits, financial transactions and equity. The figures are also calculated in terms of percentage to total liabilities.

Table 2. Financials Structure of various types of banks (in %, 2011)

	Assets				Liability				Off-BS
	Interbank	**Loans**	**Financial**	**Reserves**	**Interbank**	**Deposits**	**Financial**	**Equity**	
Germany									
Commercial	29	37	28	8	24	30	41	5	Assets x 5
Cooperative	24	49	22	5	30	30	34	6	Assets x 4
Savings	20	65	12	3	14	64	14	8	= Assets

Source: Deutsche Bundesbank 2011.

Focusing initially on the category of commercial banks, the first thing to notice is that the difference between client transactions on the assets side (loans) and on the liabilities side (deposits) is negative. This means that there is a deficit of resources due to a dominance of credit granting activities. This is fairly characteristic of commercial banks. A similar reasoning actually applies to the category of cooperative banks. The case of saving banks is somewhat different, namely because the difference between deposits and loans is quite the reverse. This

means that, when compared with their universal and cooperatives peers, savings banks are more focused on collecting deposits.

Another element worth examining is the level of financial transactions. As Table 2 shows, this item is considerably high in the case of commercial banks, both in the assets and liabilities sides. This fact clearly illustrates that raising capital from global financial markets is the core activity for this type of financial institution. Once again, cooperative banks do not seem very different in this regard, showing percentages slightly lower than commercial banks. Only savings banks, with percentages under 15%, seem somewhat at variance. This means that rather than focusing in the speculative operations of artificial secondary financial markets, the main activity of savings banks is concentrated on the traditional business of banks: savings collection and credit distribution. So much in line with their historical mission, savings banks are the champions of German retail banking.

The evidence which can be grasped from the column devoted to the off-balance sheet is very much in line with the previous argumentation. As can be seen in Table 2, the value attained by this item represents five times the value of the total assets in the case of commercial banks and four times in the case of cooperative banks. Nothing similar is observed in the off-balance sheet of savings banks. Since their financial transactions are more reduced and their core business is still locally oriented, it is not surprising to attest that their off-balance sheet does not exceed the value of the total assets.

All these facts seem to draw a panorama of the German banking industry where commercial and cooperative banks show a similar – though not exactly the same – business practice. Only savings banks are somewhat at variance from this mainstream model. The next section will show that this picture is incomplete and not entirely accurate. There is still another type of bank to be considered, ethical banks, whose CSR policies and banking practice still differ more radically from the mainstream business model.

5. ETHICAL BANKS: SINCERE CSR AS A *RAISON D'ÊTRE*

This section will demonstrate that ethical banks can be considered as a real alternative to the business model of conventional banks. They actually play the role that cooperative banks do not play anymore. Schulze's and Raiffeisen's original initiatives came to light because the existing institutions of their period failed to meet a segment of the population's needs and aspirations. Similarly, ethical banks were created in the mid- 1980s in response to a particular market niche so far unfulfilled: people who wanted to give real sense to their money and did not believe any more the good intentions generally conveyed by traditional banks in their CSR policies which are not followed by facts.

Without going into full details as regards their precise characterization (Relano, 2008; De Clerck, 2009), it is worth noting that the main difference of ethical banks is not based on the size of their CSR report. Since, as already seen, to obtain the appearance of a "green bank" is quite simple and not necessarily very expensive, ethical banks are not interested anymore in declarative paper policies. Table 1 shows that, in this regard, ethical banks are less performing than commercial banks. This is because they make little effort in communicating how virtuous they are in terms of social/environmental sustainability. Beyond the CSR rhetoric, ethical banks prefer to focus on the real impact of their banking activities.

The major divide of ethical and mainstream banks comes from a simple paradoxical fact: it is just impossible, at least in the short term, to satisfy the customers' simultaneous demand of increasing financial returns on the one hand, and greater ethical, social and environmental involvement on the other. In the face of such a conflicting dilemma, commercial banks have clearly taken up a stance in favour of profit maximization. Owing to the process of semi-demutualization and mimetic isomorphism, cooperative banks are increasingly making similar kinds of choices (Redler, 1994; DiMaggio and Powell, 1983; Cf. Palomo and Carrasco, 2001). Let us take, for example, the case of Dutch Rabobank, the most important cooperative banking group in Europe. Despite being a signatory of the Equator Principles and the general tenet of their CSR discourse, this bank is actively involved in the financing of the Singaporean company Wilmar International, whose activities in the palm oil business are clearing tropical forests and destroying endangered species like the orangutan (Van Gelder, 2007). More recently, US and European regulators have fined Rabobank over $1 billion for "inappropriate conduct" in a scam to manipulate the London Interbank Offered Rate (Libor). It is easy to say, afterwards, that such behavior is entirely contrary to one of their core values: integrity.

Beyond the pious words of moral declarations, ethical banks are the only financial institution to put profits at the service of ethics not just in theory but also in practice. They believe that profitability should not only be measured in terms of financial performance. Social and environmental returns should also be taken into consideration. In other words, ethical banks integrate ethics within their whole financial project. They are thus ready to accept the idea of working with narrower profit margins if this is compensated by further social or environmental added value. It would not be surprising, for instance, that they accept working with lower levels of financial collateral or higher monitoring costs if the project they finance is worth it in social or environmental terms. For ethical banks, this leading principle can be summarized in one single maxim: less profit, more sense.

In more precise terms, one of the most outstanding facts that make ethical banks different from other banking institutions is that they usually refuse to participate in the speculative operations of the financial market. Consequently, ethical banks

avoid investing in complex financial instruments that promise high profits but also imply greater risk. They consider that this economic logic is responsible for many international crises, social inequalities, ecological problems, etc. Ethical banks can occasionally hold financial products until maturity to cover potential liquidity needs, but unlike their traditional counterparts, their participation in the stock market is generally insignificant and confined to long-term and non-speculative operations.

As a result, ethical banks concentrate their activities on retail banking. In this regard, ethical banks privilege the social, ethical or environmental dimension of the projects they finance. So, unlike traditional banks, whose lending policies are normally based on a single bottom line screening (assessing exclusively the financial performance), ethical banks usually put in place a triple bottom analysis (environmental, social and financial performance). Particular attention is thus given to projects in areas such as social and ecological housing, organic farming, renewable energies, small and medium-size companies, etc. In these domains, ethical banks are ready to take higher risks and accept funding certain projects which have been previously refused by traditional banks. More generally speaking, ethical banks encourage solidarity between depositors and borrowers to enable loans at reduced interest rates for projects which are worthy in social, ethical or environmental terms. Eventual problems of imperfect or asymmetric information are counterbalanced by the general policy of focusing their activities at the local or regional level. It is because they know very well the region, the projects and the people they finance that social banks are ready to take higher risks. Very much like the original cooperative movement in the 19th century, this is entirely consistent with their community involvement.

All these characteristics shape a distinct business model, which is ultimately reflected in the structure of their financial statements. Table 3 shows the results of applying our analytical grid to the case of GLS Bank. If we make a comparison with the other two banks, one may immediately notice that, like cooperative banks, the balance between the client transactions on the liabilities side (86%) and the assets side (76%) is positive. This means that there is a dominance of savings activities. As far as the financial transactions are concerned, one can easily observe the existence of extremely low percentages (the exact figures are 0.57% on the asset side and 0.06% on the liabilities side). This fact indicates that, unlike other financial institutions, the participation of GLS bank in the global financial market is negligible.

Most importantly, Table 3 shows that GLS Bank does not conduct its business in the same manner as others banks do. If a final piece of evidence were necessary, it suffices to note that the value of the off-balance sheet in the case of GLS Bank bears no comparison to that of Deutsche Bank. The total amount of financial products contracted by GLS Bank to hedge the institution against different kinds

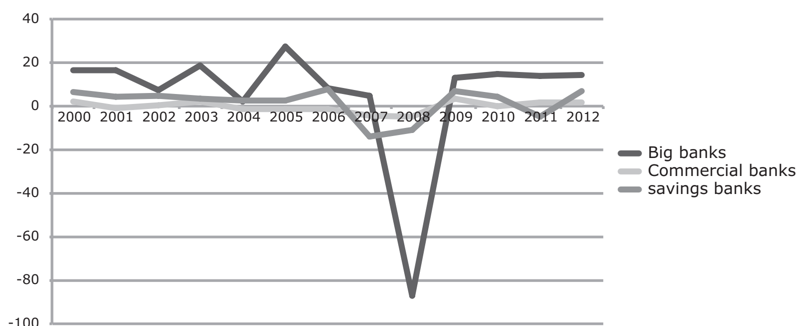
of risks just represents 13% of their total assets, whereas it is more than 500% in the case of Deutsche Bank (and it was still much higher before the subprime crisis). Big universal banks like Deutsche Bank are thus very dependent on the income resulting from their trading activities. In this regard, graph 1 show how the financial part of the operating income in case of the top five German banks (*Großbanken*) varies a great deal through time depending of the overall macroeconomic situation. Quite the opposite, the negligible participation of ethical banks in trading activities makes this type of institution very stable through time, whatever the global financial context (Paulet and Relano, 2011).

Table 3. Balance Sheet Structure: Deutsche Bank and GLS Bank (2011)

	Assets				Liability				Net income/ net interest income	Off-BS
	Interbank	Loans	Financial	Reserves	Interbank	Deposits	Financial	Equity		
Deutsche Bank	10	17	61	12	16	27	47	8	62	Assets x 5
Landesbank Baden Wûrtemberg	17	32	31	20	20	40	31	9	12	= Assets
GLS	24	76	1	8	7	86	0	7	80	13% Assets

Source: Own calculations, Annual reports of banks.

Figure 1. Net result from trading portfolio as a percentage of operating income



Source: Deutsche Bundesbank.

Leaving aside big commercial banks, the comparison of ethical banks with savings banks deserves particular attention. As already mentioned, both types of institutions are local and retail oriented. Unlike traditional commercial banks, both are also governed by a broader objective function than being merely profit or shareholder-value driven. Moreover, one can easily convey that both are inclusive financial institutions, savings banks focusing mostly in the dimension of financial exclusion and ethical banks in the sense of environmental and social criteria. And yet savings banks and ethical banks are not at all the same type of financial institution. The main difference is that the business model of savings banks still includes a significant part of operations in the financial market. In Germany, this kind of activity is carried out by Deka Bank, which on behalf of the whole savings bank group operates at a national level as a provider of investing products. Graph 1 illustrates this situation very well. The income of savings banks originating from trading activities is not comparable with that of big universal banks, but it is still noteworthy. Let it also be mentioned that the off-balance sheet of savings banks (attaining the same size of their total assets) is not as important as that of other types of banks, but it is still quite substantial, especially if compared with that of ethical banks (see tab. 2 and 3). Finally, it is perhaps not anodyne to state that the savings banks group has been indirectly affected – through the *Landesbanken* – by the financial turmoil associated with the subprime crisis.

Nothing of all this is to be seen in the case of ethical banks. Note that savings banks are indeed different from their cooperative and commercial peers, but still work within the same business model. They just represent variations within the same paradigm. Only ethical banks are really at variance in all respects. Since what really matters is not how banks use and distribute their profits, but rather how they earn their money, ethical banks represent an alternative distinct model to mainstream banking.

6. CONCLUSION

Ethical banks, commercial banks, cooperative banks and savings banks are all regulated by the same authorities. They all have to abide by the same rules and to compete in the same marketplace, but they are not essentially the same kind of financial institution. When looking at their sustainable development reports or their CSR communication, one might indeed be confused as to who is more deeply and sincerely committed to the perspective of responsible finance. But as the evidence of the financials shows, only ethical banks really “do” what they “say”. This is because their business model is substantially different.

The performance of ethical banks shows that sincere commitment to CSR makes business sense. This does not imply, however, that all financial institutions should

be ethical. In fact, non-sincere CSR commitment also makes full business sense to other segments of banks. In any event, financial pluralism is reinforced and, as textbooks in finance regularly state, the more diversified a banking industry is in terms of size, ownership, and business structure, the smaller is the systemic risk. There is thus a case for maintaining the pioneering business model of ethical banks, even if, ultimately, it is up to customers to decide the sense they want to give to their money.

Abstract

This paper analyses the difference in the CSR commitment between different types of banks, based on the German example. It compares the three traditional groups (Commercial, Cooperative and Savings Banks) and a new type of bank which emerged in the 1980s: ethical banks. For each of these four types of financial institution, the main objective is to see if there is a difference between what the banks declare (through analysis of CSR policies in their annual reports) and what the banks actually do (through analysis of their financial statements). The conclusion is that a sincere commitment to CSR involves a substantial change in the banks business model. An analysis of the banking industry shows that only a few institutions are ready to take a step forward in this direction.

Key words: Ethical banks, CSR in banking

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Josef Korte[*]

WHY CLOSING FAILED BANKS HELPS THE REAL ECONOMY

1. HOW DISTORTED INCENTIVES AROUND BANK INSOLVENCY HARM THE REAL ECONOMY

It is widely agreed that banks play a growth-enhancing role for the real economy. However, distorted incentives around bank insolvency may corrupt banks' credit allocation and monitoring – ultimately leading to suboptimal real economic performance. Theoretical research and empirical evidence provides some examples:

- Individual moral hazard ex ante (i.e. before insolvency): Since their failure has strong negative externalities, banks anticipate bailout. This can lead to excessive risk or complexity taking, unsound balance sheet blow-up, or insufficient screening and monitoring of the lending business, resulting in suboptimal credit allocation.[1]
- Individual moral hazard ex post (i.e. close to insolvency): Severely undercapitalized institutions can be seen as an option that creates value in volatility. Hence, incentives grow to further substitute risk for economic soundness or even to 'gamble for resurrection'. Distressed banks might also discontinue effective credit monitoring and roll over non-performing loans ('evergreening'), or even channel funds to related firms at favourable terms.[2]

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[1] Compare, e.g., Beltratti and Stulz (2009); Dell'Ariccia and Marquez (2006); DeYoung et al. (2013); Fortin et al. (2010).

[2] Compare, e.g., Caballero et al. (2008); Igan and Tamirisa (2008); La Porta et al. (2003); Peek and Rosengren (2005).

- Collective moral hazard: The time-inconsistency of bank closure decisions can lead to incentives for banks to herd into the same asset classes in an effort to be 'too-many-too-fail', effectively increasing systemic risk and distorting efficient credit allocation. Also, banks might collude to delay the recognition of bad loans and disclose them simultaneously to avoid individual blame.[3]

The outcomes of such distorted incentives are suboptimal credit allocation and monitoring – which is felt in the real economy: Not the projects and firms that need (and deserve) credit most on grounds of economic viability and profitability, but those that have particular risk- or asset-profiles are now favored by incentive-corrupted financial intermediaries.

2. WHY BANK FAILURE REGULATION FAILS

What is the usual regulatory answer to bank failure? All too often, bailout policies that aim at sustaining the financial intermediary more or less in its current form are the tool of choice. However, these bailout policies have been shown to amplify moral hazard and incentive distortions, consequently contributing to the suboptimal outcomes outlined before (Black and Hazelwood, 2012; Dam and Koetter, 2012; Dell'Ariccia et al., 2008; Giannetti and Simonov, 2011; Honohan and Klingebiel, 2003). This can be attributed to decision problems or incentive distortions gripping the regulators themselves: Even if regulators wanted to maximize welfare by counteracting distorted incentives, a commitment problem prevents them from doing so, as they have to trade-off preserving short-run financial stability (advocating for bailout) and preventing long-run moral hazard and distorted credit allocation (advocating for closure). On the other hand, in a political economy understanding regulators might also maximize their own utility functions, e.g. obscuring their own ineptitude, extracting rents from colluding with the industry, or forbearing closure decisions due to political reasons (Acharya and Yorulmazer, 2007, 2008; Brown and Dinç, 2005; DeYoung et al., 2013; Imai, 2009; Kane, 1990; Mailath and Mester, 1994).

3. HOW SCHUMPETER CAN BE APPLIED TO FAILED BANKS

Unlike the unimodal practice might suggest, other policy options are available in the toolkit of banking regulation, such as insolvency resolution regimes characterized by the end of existence of the financial intermediary as a separate legal entity, including equity wipeout and ousting of the management. These

[3] Compare, e.g., Acharya (2009); Acharya and Yorulmazer (2007); Brown and Dinç (2011); Kasa and Spiegel (2008); Rajan (1994); Stever and Wilcox (2007).

regimes particularly focus on purchase and assumption or closure and liquidation of failed banks.

Contrary to bailout policies, these insolvency resolution regimes can be thought of as a process of purgation, or 'catharsis', which realigns distorted incentives surrounding bank failure. Resolving failed banks in a rules-based and prompt way cleans out existing moral hazard and improves the functioning of the banking system, e.g. efficient credit allocation and effective monitoring. Ultimately, this should have positive effects on real economic performance. Put differently, this is another manifestation of Schumpeter's concept of creative destruction: Insolvency and resolution regimes promote an efficient reallocation of resources and thus function as a cleansing effect to financial intermediation that ultimately improves real economic performance. We could call this a form of catharsis in the banking system.

Translating the Schumpeterian idea into applicable policy recommendations yields strict closure and liquidation policies that offer little room for regulatory discretion if intended to be effective (Kane, 2002). This concept materializes in tools such as a non-discretionary positive capital closure rule that stipulates prompt legal closure as soon as an institution undershoots a (positive) threshold capital ratio. Can the application of such a rule get the catharsis mechanism to work and improve outcomes in the real economy?

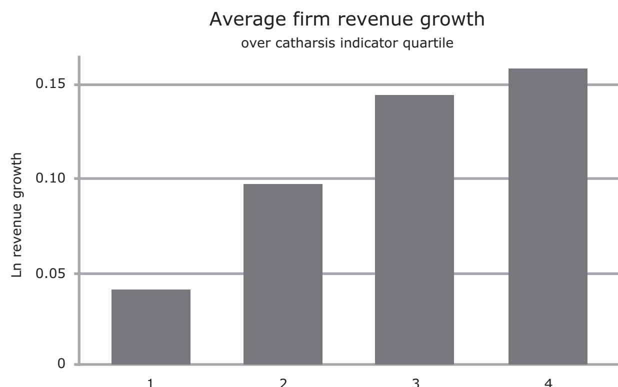
4. HOW STRICTER BANK INSOLVENCY RESOLUTION BENEFITS THE REAL ECONOMY (AND HOW WE CAN TRACE IT)

To cut it short: Yes, we find a stronger application of strict resolution regimes to ultimately improve real economic performance. However, the empirical test needs to overcome two main challenges. First, there is a measurement problem: How to measure the strength of resolution policy? Second, there is an identification problem: While we can easily detect a correlation between the characteristics of the financial system and growth, establishing a causal link is somewhat harder due to the endogenous relationship between the two.

Regarding measurement, we propose the 'catharsis indicator', defined as the ratio of total failed bank assets that have been resolved by closure policies and total bank assets that should have been resolved had a positive capital closure rule been in place. A more detailed discussion of the indicator and its shortcomings is presented in Korte (2013), but it follows a clear intuition: The catharsis indicator essentially captures the idea of how strictly the positive capital closure rule is applied. Figure 1 displays the average logged growth rate of nearly 2 million real firm-year observations over quartiles of the non-zero catharsis indicator computed for more than 30 European countries over 7 years. The message is intriguing:

Firms experienced higher growth rates in countries and years in which bank resolution followed the hypothetical capital closure rule more closely.

Figure 1. Average revenue growth by catharsis indicator quartile



Admittedly, this should not be interpreted as causal inference due to multiple sources of endogeneity – taking us to the second challenge: How to deal with the identification problem? In addition to controlling for covariates and fixed effects, and to using insolvency legislations as instrumental variables, we exploit an identifying assumption initially proposed by Rajan and Zingales (1998): Firms that are more dependent on bank financing (due to technological/industry characteristics) should experience stronger growth when the resolution regime for insolvent banks is stronger. Indeed, we find a positive and significant effect of the interaction between the catharsis indicator and firms' bank dependence. Evaluating the economic significance of these results, we find a difference of roughly 0.3–0.6% in the growth rate between a relatively bank dependent firm as compared to a firm with low bank dependence, if located in a country with a relatively strict application of the closure rule rather than in a country without cartharsis rules.

Now, what is the transmission channel between strict insolvency resolution regimes and real growth? In fact, we find a disproportionately positive catharsis effect on higher quality firms as those are the beneficiaries of uncorrupted credit allocation decisions. This 'smoking gun' provided by the firm quality channel should not come as a surprise: It would have been Schumpeter's prediction.

5. WHAT REGULATORS SHOULD TAKE AWAY

Our results strongly advocate putting bank insolvency and resolution regimes center stage in discussions towards reforming bank regulation. In the European

context, this calls for particular emphasis on the common resolution framework and the Single Resolution Mechanism as a vital part of the European Banking Union. Setting up incentive compatible bank insolvency regimes that facilitate the catharsis effect should be a focus of researchers' endeavours and regulators' travails.

Abstract

It is widely agreed that banks play a growth-enhancing role for the real economy. However, distorted incentives around bank insolvency may corrupt banks' credit allocation and monitoring – ultimately leading to suboptimal real economic performance. The outcomes of such distorted incentives are suboptimal credit allocation and monitoring – which is felt in the real economy: Not the projects and firms that need (and deserve) credit most on grounds of economic viability and profitability, but those that have particular risk- or asset-profiles are now favored by incentive-corrupted financial intermediaries. The results strongly advocate putting bank insolvency and resolution regimes center stage in discussions towards reforming bank regulation. In the European context, this calls for particular emphasis on the common resolution framework and the Single Resolution Mechanism as a vital part of the European Banking Union.

Key words: Bank insolvency, bank resolution, growth

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CHANGING BANK RESOLUTION REGIMES – THE U.S. CASE[1]

1. INTRODUCTION

Existing resolution tools proved mostly inappropriate when governments were confronted with seriously distressed banks during the global financial crisis and the subsequent European sovereign debt crisis. A comparison of the failure resolution of Lehman Brothers and Washington Mutual in September 2008 illustrates the insufficiencies of applying corporate bankruptcy mechanisms to bank insolvencies as opposed to bank-specific resolution mechanisms. When Lehman Brothers filed for Chapter 11 bankruptcy protection on September 15, 2008, the bankruptcy filing constituted a default action in derivative contracts, leading to massive terminations of derivative positions. As Lehman Brothers was not allowed to provide liquidity to its subsidiaries, its foreign legal entities entered bankruptcy proceedings as well. At the time of Lehman Brother's failure, Washington Mutual experienced a bank run and was put into Federal Deposit Insurance Corporation (FDIC) receivership by its regulator, the Office of Thrift Supervision, on September 25, 2008. FDIC sold Washington Mutual's assets, deposit liabilities and secured debt immediately to JPMorgan Chase and the remaining holding company filed for

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[1] This article summarizes and refers to our latest working paper that can be obtained at: https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1659.pdf.

bankruptcy protection the next day. Although Washington Mutual's business had been materially different from Lehman Brothers', its banking business continued to operate without major interruptions, unlike the failure of Lehman Brothers.[2] Since then bank regulators and legislators have realized the importance of effective and appropriate bank resolution mechanisms and brought into force significant changes to resolution regimes in an effort to prevent future crises. Have these enabled regulators to resolve failed banks more effectively? What are the implications of such changes on bank behavior?

This article deals with the question whether resolution mechanisms can discipline banks. We revisit economic theory to determine the requirements for resolution mechanisms to induce incentives for prudent bank behavior and apply this concept in order to examine one particular change in resolution regulation, the introduction of the Orderly Liquidation Authority (OLA). In section 2, we present the theoretical foundations regarding bank resolution and its implications for bank behavior. In section 3, we study the OLA and discuss whether this can be regarded as an effective and credible improvement in resolution technology. The link to new empirical findings is provided in section 4. Section 5 concludes.

2. THEORETICAL BACKGROUND REGARDING RESOLUTION AND BANK BEHAVIOR

Resolution of distressed banks is probably the most intricate regulatory area regarding incentives for prudent bank behavior. Overall, there are two (opposing) regulatory approaches to handling a distressed bank: bailing out the bank in order to preserve it as a going concern and resolving the bank either through acquisition by another financial institution (i.e. purchase and assumption) or straightforward closure and liquidation. Economic theory predicts that the expectation of being bailed out increases banks' moral hazard as creditors anticipate loss protection in case of bank failure and have little incentives to monitor the bank. Empirical evidence tends to support the view that bailout guarantees an increase in bank risk-taking and moral hazard in the long run.[3] Conversely, when bailout guarantees cease to be implicit through a credible and enforceable improvement

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[2] FDIC (2011) provides an extensive discussion of the differences between Lehman Brothers' bankruptcy under Chapter 11 and a hypothetical resolution under a special bank resolution regime, i.e., the Orderly Liquidation Authority.

[3] Black and Hazelwood (2013) and Duchin and Sosyura (2013) provide evidence that (at least large) TARP-funded U.S. banks increased risk-taking after the capital injection. Dam and Koetter (2012) exploit a dataset on capital injections in Germany and find that bailout expectations (through observed capital injections) increase risk-taking in the whole banking sector (measured as probability of default).

in bank resolution regimes, banks should change their behavior towards more prudent behavior and lower probability of distress. A comprehensive theoretical model of how improvements in resolution regimes interact with bank behavior was recently offered by DeYoung et al. (2013). Building on the time-inconsistency problem of bank closure decisions formulated by Mailath and Mester (1994) and Acharya and Yorulmazer (2007), the authors model the regulatory closure of a bank as a trade-off between short-term liquidity and long-term discipline. The model assumes banks that are inherently fragile and suffer from moral hazard with regard to excessive risk, complexity, and volatility. Essentially, there are two alternatives for the regulator to deal with this. On the one hand, banks can be disciplined by a strict closure and resolution policy in case of failure. Unfortunately, this discipline only materializes in the long run. On the other hand, while they help to establish discipline, available resolution technologies usually suffer from limitations. These limitations, such as slow processes, missing information, or legal limits to available regulatory instruments, might (temporarily) lead to illiquidity in the case of bank closures. This might result in a detrimental impact on the economy as a whole (e.g. Ashcraft, 2005). Hence, the regulator – despite knowing about the long run benefits of discipline – also has an intrinsic motivation to prefer bailouts or forbearance over straightforward closure. DeYoung et al. (2013) model the outcome of this trade-off as determined by two parameters. The first one is the time discount rate of the regulator – the higher it is, the stronger is the regulator's preference for liquidity, i.e. bailout. Effectively, this discount rate proxies for the pressure for immediacy that regulators and economic policy makers are experiencing, e.g. political pressure to preserve liquidity during a crisis.[4] The resolution technology available to the regulator is the second parameter determining the trade-off. The better this technology is, the faster and more efficient a bank closure can be executed, the more liquidity is preserved. Consequently, regulators with better resolution technologies at hand are – under the assumption of an equal time discount rate – more induced to enforce discipline, i.e. closure.

This model provides several implications. First, improvements in resolution technology, such as legal changes or operational empowerment of the regulator, make a regulatory policy preferring discipline (i.e. closure in case of failure) more likely. If the technological improvement is known and credible to banks, they will act rationally by adjusting their behavior towards more discipline ex ante. Hence, an improvement in resolution technology should induce more prudent behavior, ceteris paribus. Second, this outcome depends on the credibility of the application of the new resolution technology. The new policy instruments will only be effective

[4] Several empirical studies confirm the tendency for bailout and forbearance in times of macroeconomic or systemic stress. Brown and Dinç (2011) and Kasa and Spiegel (2008), for example, find that regulators are less likely to close a bank if the whole banking system is in a crisis.

and thus credible when complemented by political will, i.e. a low time discount rate that increases the willingness of regulators to accept potential short-term illiquidity following bank resolution for long-term gains in discipline.

3. DISCUSSION OF THE ORDERLY LIQUIDATION AUTHORITY AS AN IMPROVEMENT IN RESOLUTION TECHNOLOGY

In this section, we evaluate whether the introduction of the Orderly Liquidation Authority in the U.S. constitutes an improvement in resolution technology that can create a credible resolution threat in order to discipline bank behavior. The OLA has been established as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA) and signed into law by President Obama on July 21, 2010 with immediate effect. In general, the OLA enables the FDIC to seize control and liquidate any financial institution in distress through its administrative resolution regime.

When the financial crisis hit in 2008 (and surely before), U.S. bank resolution law suffered from two significant shortcomings. We will argue that the OLA represents a significant technological improvement on these two issues. As a first issue, financial institutions in the U.S. were subject to two different insolvency and resolution regimes. One pillar of bank insolvency legislation was the Federal Deposit Insurance Act (FDIA) that covered all insured depository institutions, particularly commercial banks, thrifts, and savings banks holding a national or state charter. The FDIA stipulates a special resolution regime for these institutions – an administrative insolvency procedure. The existence of this special bank resolution regime stems from the conviction that banks are somewhat distinctive, particularly with regard to insolvency. Marinc and Vlahu (2011) provide a detailed analysis of the characteristics of banks that advocate a special resolution regime – among the most important ones are (1) the inherent instability of banking and the threat of runs, (2) particularly negative externalities of bank failures, and (3) the potential for moral hazard due to deposit insurance schemes or implicit guarantees. While the corporate insolvency law does not cover these aspects explicitly, the FDIA regime takes the special role and functioning of financial institutions into account. It is designed to allow timely intervention and resolution of insolvent banks while limiting moral hazard as well as potentially detrimental effects to liquidity, sound banks, and the real economy. In order to achieve the goal of a least cost (and least adverse effects) resolution, the special resolution regime deviates significantly from the regular, judicial insolvency procedure with regard to insolvency triggers and initiation conditions, resolution instruments, financing, and possibilities for appeal and review (Bliss and Kaufman, 2006; Marinc and Vlahu, 2011). Under these provisions, the Federal Deposit Insurance Corporation (FDIC) has

powers to promptly intervene upon certain initiating conditions, such as critical undercapitalization, without having to wait for the filing of a default event or for court decision. In this case, the license of the bank can be revoked by its primary regulator and the FDIC can be determined as the conservator or receiver, ousting management and shareholders, taking over the bank, and ultimately preparing it for purchase and assumption by another financial institution or for closure and liquidation. In order to preserve liquidity, charter value, and operations of the bank, the FDIC typically intervenes overnight or over the weekend and is able to pay off all insured depositors – if need should be – from the Deposit Insurance Fund previously collected from insured institutions (Bliss and Kaufman, 2006; DeYoung et al., 2013).

While the FDIA covers insured depository institutions under national and state bank charters, the FDIC did not have legal powers for intervention when it comes to the failure of bank holding companies, financial holding companies, or other non-bank financial institutions. Instead, the default legal provisions of corporate insolvency law, i.e. the insolvency procedures according to Chapter 7 and Chapter 11 of the U.S. Federal Bankruptcy Code, applied. These procedures typically protect the owners from creditors, take long time periods for resolution, during which funds for depositors and borrowers might not be available, and require a restructuring plan as a precondition before making decisions on larger asset sales (DeYoung et al., 2013). Since the financial holdings and non-bank financial institutions in question – among them several of the institutions that have been identified as systemically important – exhibit similar characteristics to banks as described by Marinc and Vlahu (2011), an application of these corporate insolvency procedures might cause severe disruptions.[5] While these institutions were effectively exempted from the special bank resolution regime, the default corporate law was apparently inappropriate to efficiently resolve their insolvency. Hence, this was widely considered as a major deficiency in the resolution regime for financial holdings and non-bank financial firms, which might have even protected these institutions from actual failure by making bailout the only available choice (FDIC, 2011; Marinc and Vlahu, 2011).

Moreover, even if the FDIC had been legally empowered to apply its resolution procedure to non-bank financial institutions, there would have been a financial limit as to which institutions it could have effectively taken over: While the Deposit Insurance Fund amounted to a record high of USD 52.4 billion at the onset of the financial crisis, the deposits of Bank of America alone were about 10 times larger than this (albeit not all insured). The sheer order of magnitude of this difference

[5] In fact, several studies examine the inapplicability of corporate insolvency law to financial institutions, e.g. referring to one of the few bankruptcy cases of financial firms: Lehman Brothers Holding Inc. (FDIC, 2011).

illustrates the second significant issue gripping the resolution technology available to U.S. regulators before 2010: Not just incomprehensive legal provisions, but also insufficient financial endowment of the regulator prevented an effective application of bank resolution and made bailout the regulator's preferred choice in most cases for financial holdings and non-bank financial companies.

Recognizing the need for alterations in bank resolution law and for stepping-up the operational and financial capabilities of the regulator, U.S. federal legislators passed the Orderly Liquidation Authority as part of a wider financial sector reform package, the Dodd-Frank Act (DFA, Title II). The new provisions stipulated by the OLA can be considered as an improvement regarding the two significant shortcomings of U.S. bank resolution law. First, the OLA extends a special insolvency and resolution regime to financial institutions previously uncovered by bank resolution law. More specifically, it stipulates that any firm determined as a covered financial company according to Sec. 201 and 203 of the DFA can be put into an administrative insolvency and resolution procedure. Effectively, this provision covers any financial institution in the United States.[6] The determination of a financial institution as a covered financial company is made by the Secretary of the Treasury, following the vote of the FED board and FDIC board, and in consultation with the President. It initiates the orderly liquidation procedure, with only limited judicial appeal ex ante.[7] Technically, this procedure is very similar to the existing FDIA regime, with the FDIC being appointed as receiver of the financial company. Once under receivership, the FDIC is empowered to close and liquidate the firm, to pursue a purchase and assumption resolution, or to set up a bridge financial institution. These resolution instruments also resemble the FDIA regime insofar as they cause losses to shareholders and unsecured creditors, replace the management, and protect liquidity in a way that is superior to regular insolvency law.

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6 The determination as a covered financial company essentially requires three conditions to be fulfilled. Firstly, the firm in question needs to be a financial company, i.e. a bank holding company, a non-bank financial company supervised by the FED board, or any company predominantly engaged in financial activities. Secondly, it is not an insured depository institution covered by the FDIA regime. Finally, the determination is made provided the existence of all criteria outlined in Sec. 203b, i.e. the firm is in (danger of) default, the resolution according to otherwise applicable legal provisions would have adverse consequences for financial stability, there is no viable private sector alternative, the impact on creditors and shareholders is appropriate, all convertible debt has been ordered to be converted, and the OLA is deemed effective (DFA, Title II, Sec 201, 203).

7 In fact, the board of the determined covered financial company can ask the Secretary of the Treasury to petition for a formal authorization by the U.S. district court in the District of Columbia. This court can order the authorization after finding that the determination as a covered financial company is not arbitrary and capricious. If the court does not decide within 24 hours, the authorization is automatically granted by the operation of law (DFA, Title II, Sec. 202).

Second, Title II of the DFA sets up a new Orderly Liquidation Fund that also financially enables the FDIC to act as the receiver and pursue the orderly liquidation of covered financial companies. While the fund is set up in the Treasury, the FDIC is authorized to borrow from it for covering the cost of orderly liquidation and administrative expenses.[8] Moreover, the FDIC is empowered to charge ex post risk-based assessments to financial companies in order to repay the Orderly Liquidation Fund (DFA, Title II, Sec. 210).[9]

4. EMPIRICAL FINDINGS ON THE IMPACT OF RESOLUTION ON BANK BEHAVIOR

So far empirical evidence on resolution policies has been mostly limited to the (non-)application of resolution rules (Brown and Dinç, 2011; Kasa and Spiegel, 2008; Korte, 2013). To the best of our knowledge, there has not been any study that empirically investigates the impact of changes or improvements in resolution regimes on prudent bank behavior with the exception of Ignatowski and Korte (2014). In their recent paper, the authors empirically test the effects of the introduction of the OLA on bank risk-taking by exploiting the differential relevance of the regulatory change for different types of banks and show that banks that are more affected by the introduction of the OLA significantly decrease their risk-taking and shift towards more prudent business models. Their findings support the view that the Orderly Liquidation Authority can be considered as an effective improvement in existing resolution technology that creates a credible threat for banks and induces incentives for prudent behavior. However, the authors also show that this effect does not hold for the largest and most systemically important banks, concluding that the OLA appears to have left the problem of too-big-to-fail unresolved.

5. CONCLUSION

Taken together, we find that the Orderly Liquidation Authority can be interpreted as a significant improvement to the U.S. resolution regime in at least

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8 The fund is set up as a theoretically unlimited credit line from the Treasury. Sec. 210 allows the FDIC to borrow funds not exceeding 10% of the to-be-resolved financial company's total consolidated assets during the first 30 days of closure. Thereafter the borrowing amount is limited to 90% of the fair value of the total consolidated assets of the to-be-resolved financial company that would be available for repayment of the funds.

9 More specifically, Sec. 210 stipulates that the assessments are to be imposed on large non-bank financial institutions, precisely bank holding companies with consolidated assets exceeding USD 50 billion and non-bank financial companies supervised by the FED board.

two dimensions. The OLA can be interpreted as an improvement in terms of legal authorities as it alleviates the previous limitation of the FDIC to only place a certain group of financial institutions into a special bank resolution procedure. Rather than focusing only on insured depository institutions, the special resolution regime is now extended to other financial companies as well. Moreover, the establishment of the Orderly Liquidation Fund significantly improves the financial and operational capacity of the FDIC to effectively act as receiver and liquidity guarantor. This leaves the FDIC with less reason to prefer bailout over resolution when financial institutions fail. Ultimately, this should induce more prudent behavior of those banks that are most affected by these changes.

Based on our analysis and the previous literature, we emphasize two fundamental features of effective bank resolution regimes that, in our view, can set incentives for prudent behavior and thus help to prevent future financial crises. First, a bank resolution regime that takes into account the special role of financial institutions (beyond regular and often inapplicable corporate bankruptcy law) and that commands sufficient legal and financial resources is essential to creating a credible resolution threat for financial institutions. Second, comprehensive coverage of financial institutions in general will avoid incentives to shift risks into non-resolvable subsidiaries. A bank resolution regime that incorporates these elements can be an effective and credible threat that disciplines banks towards more prudent behavior.

Abstract

Existing resolution tools proved mostly inappropriate when governments were confronted with seriously distressed banks during the global financial crisis and the subsequent European sovereign debt crisis. Bank regulators and legislators have realized the importance of effective and appropriate bank resolution mechanisms and have brought into force significant changes to resolution regimes in an effort to prevent future crises. This article deals with the question whether resolution mechanisms can discipline banks. We revisit economic theory to determine the requirements for resolution mechanisms to induce incentives for prudent bank behavior and apply this concept in order to examine one particular change in resolution regulation, the introduction of the Orderly Liquidation Authority. Taken together, we find that the Orderly Liquidation Authority can be interpreted as a significant improvement to the U.S. resolution regime.

Key words: bank resolution, Orderly Liquidation Authority

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Mateusz Folwarski[*]

THE IMPACT OF THE FINANCIAL CRISIS ON THE REGULATIONS OF MANAGERIAL STAFF REMUNERATION IN FINANCIAL INSTITUTIONS

1. REMUNERATION REGULATIONS IN THE FINANCIAL SECTOR BEFORE THE CRISIS

Regulation and supervision of the banking sector in the modern economy is a standard that has been formed for many decades. Its purpose is to maintain security, which can be simply defined as a desire to minimize the number of bankruptcies in the banking sector (Iwanicz-Drozdowska, 2012). Regulations regarding banks are based on the assumption of market imperfection, the existence of externalities, associated with bank insolvency or banking crises and information asymmetry (Miklaszewska, 2004). The United States was an example of a country with very strict regulations introduced concerning the principles of managerial remuneration. The provisions referring to public companies subject to the regulations of the Securities Exchange Commission have been included in the *Code of Federal Regulations, Regulation SK* (Urbanek, 2010). This regulation describes in detail how the structure of managerial staff remuneration in every public company should be presented. The remuneration committee should be appointed as part of the company, which is required to annually provide a report to shareholders on the principles of remuneration of the key managers in the

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company. The company is required to disclose the detailed remuneration of the CEO and at least four main managers of the company. In companies there is no obligation to publish the remuneration of individuals who in a given financial year received a remuneration lower than 100 000 USD (*Code of…*, 2003).

Before the financial crisis of 2007–2009, the European Union regulated remunerations in a single directive (Directive 2001/34/EC) and two particular recommendations (Commission recommendations 2004/913/EC, 2005/162/EC). The directive of the European Parliament in 2001 (2001/34/EC) had a considerable impact on the regulations regarding publication of the amount and structure of managerial staff remuneration in companies listed on the stock exchange. The directive stated that the remuneration paid and benefits in any form granted during the last completed financial year and included in the fixed costs or paid as part of the retained earnings to the members of the administrative body, management and supervisory bodies representing in total the total amounts – must be indicated in the financial statement.

In 2004 the European Commission issued a recommendation (2004/913/EC), which became the basis for regulation of managerial staff remuneration in the European Union. In the recommendation of the European Commission, the information concerning remuneration can be divided into three parts: the remuneration policy, the remuneration of particular directors and remuneration based on shares. The most important issues relating to the remuneration policy in this recommendation were focused on:

❖ disclosure of the remuneration policy pursued by directors in the annual financial statement or in the notes to the annual financial statements of the company and on the website of a company listed on the stock exchange,
❖ document disclosing the remuneration policy should contain specific information about the relationship between work productivity and remuneration, explanation concerning the annual bonus scheme and other non-cash benefits, information on the duration of contracts with executive directors, the applicable notice periods and severance payment provisions for termination of the contract.

The global financial crisis has changed the situation of banks in the global financial market and has identified the need for fundamental changes in both regulatory systems and strategies of the banks themselves (Miklaszewska, 2010). In response to the financial crisis, the regulators have proposed a modification or a major change of the existing legal solutions intended for e.g. increasing the sense of security among the customers of financial institutions (Zaleska, 2010).

In October 2008, the president of the European Commission – J.M. Barroso, entrusted the function of directing a group of notable specialists in the field of finance to Jacques de Larosiere – former president of the European Bank for Reconstruction and Development. This team was appointed to prepare a report

presenting the essential proposals and recommendations on the future regulations of the financial market and financial supervision in Europe (Kasiewicz et al., 2013). The final document was published on 25 February 2009 (De Larosiere report, 2009). The report included 31 recommendations, one of which concerns the managerial staff remuneration in financial institutions:

– recommendation 11: in the light of the ineffectiveness of corporate order exposed by the current financial crisis, the group is of the opinion that the motivation system by remuneration should in greater amount include the interests of the partners and the shareholders and the profitability of the whole enterprise in the long term. For this purpose, the structure of the remuneration scheme in the financial sector should be based on the following rules; when specifying the amount of the premium, the long-term time horizon should be taken into account, and the payment of premiums should be spread over the entire business cycle. The same rules should relate to entities performing operations on their own account and entities managing the assets. The premiums should reflect the actual achievements and should not be guaranteed in advance. The supervisory authorities should control whether the remuneration policy in the financial institutions is suitable, request for its correction if it encourages taking excessive risk, and – if necessary – impose additional capital requirements on the basis of the second pillar of Basel II regulation, when the proper corrective actions have not been taken.

In April 2009, in response to the financial crisis, the European Commission issued two recommendations on remuneration in the financial services sector (Commission recommendations 2009/384/EC, 2009/385/EC). In the recommendation on the remuneration of directors of listed companies on the regulated market, the main aim was to ensure transparency of practices in the area of remuneration. The cause of the necessity to implement this recommendation was a change in the structure of remunerations, which under the influence of the financial crisis underwent a further-reaching complication and excessive connection with short-term results. The recommendation proposes that:

❖ the structure of the remuneration of directors favour the long-term stability of the company,
❖ it is necessary to guarantee that the severance payment does not constitute a reward for failure,
❖ the systems of remuneration of directors with shares, should be more closely related to the results of the company.

These recommendations are an important direction of the changes that were set by the European Commission before the managerial staff in listed companies. However, these recommendations were only an outline of the changes that should be made, simultaneously not providing specific solutions in the field of remunerations.

2. EUROPEAN UNION POST-CRISIS REGULATIONS OF MANAGERIAL STAFF REMUNERATION IN BANKS

The situation in the European financial market in 2009, as well as discussions on the level and structure of managerial staff remuneration in banks, led to work on the EU directive within the regulation of remuneration in financial institutions. In June 2010, the European Commission published a so-called green paper (Green paper 2010). In this document, the EC referred to the de Larosier report, pointing to the need for regulation in order to prevent possible irregularities in the system of corporate order in the banking sector. The management of financial institutions has been subjected to criticism in the green paper. This organ has been criticized mainly for the following:

- ❖ lack of sufficient diversity of the management board composition. This lack resulted from the omission of gender balance, social background, cultural affiliation and education of the members,
- ❖ lack of profound analysis of the management board as a whole and its individual members,
- ❖ boards were unable or unwilling to watch over the appropriate frames of risk management.

In the Green Paper it was suggested that a new category of shareholders be created. They show little interest in the long-term objectives of corporate order in enterprises/financial institutions in which they invest, and they can encourage excessive risk-taking due to the fact that their investment horizon is relatively short (3 months or half a year) (Khuran, Zelleke, 2009). The European Commission has started a debate on excessive remuneration, where as a basis for discussion two statements were taken:

- ❖ a significant increase in the variable component of the managerial staff remuneration in companies listed on the stock exchange, which took place from the end of the eighties, raises the question as to the detailed rules for the content of management activities assessment,
- ❖ remuneration policy in the financial sector based on short-term profits, without considering the associated risk contributed to the financial crisis.

The impact of the financial crisis on managerial staff remuneration played a key role in the shape of a directive regulating remuneration policy in financial institutions. The most important reason for the creation of the directive was tackling the inconsiderate and excessive risk in the banking sector, which was mainly due to the inadequate remuneration structure of some financial institutions. Remuneration policy encouraged to take on risk that exceeds the general level of risk tolerated by the institutions (Directive 2010/76/EC). The subjective scope to which this directive relates contains at least:

- ❖ senior management,

- persons making decisions about risk,
- staff dealing with control,
- any employee whose total remuneration, including unspecified pension benefits is at the same level of salary scale as the remuneration of senior management and persons making decisions about risk.

The main purpose of the regulation was to indicate clear rules concerning the correct system of remuneration intended to ensure that the structure of remuneration does not encourage individuals to take excessive risk. Total remuneration should not constitute a moral hazard and must be related to the risk taken by the financial institution. The main changes that entail the adjustment can be divided into three parts; provisions regarding not complying with the guidelines, information requirements related to financial institutions and regulations concerning variable remuneration. Failure to adjust to the guidelines involves a number of consequences. National authorities may impose financial or non-financial penalties, in the situation of not having a remuneration policy which is consistent with the guidelines. In the financial institution which does not fulfil the provisions of the directive, it may be necessary to limit the variable remuneration to a percentage of total net income.

Numerous information obligations have been imposed on financial institutions. The proper national authorities need to gather information about individuals whose earnings exceed 1 million EUR. Banks must at least once a year announce: the composition and scope of function of the remuneration committee, the major parameters and justification of any kind of variable remuneration systems, quantitative information on remuneration (including remuneration for the given year) – divided into fixed and variable remuneration, the amount and form of variable remuneration (including cash, shares and share-linked instruments), the amount of deferred remuneration – divided into parts already eligible and not eligible, and the amount of payments connected with the termination of employment contracts. The most significant and extensive changes are connected with variable components of remuneration. Guaranteeing variable remuneration is not possible. Apart from one exception, which is guaranteeing variable remuneration in the first year of work, but this should be used only in exceptional situations. A substantial part of the variable remuneration payment – 40–60%, should be spread over a period of not less than 3 to 5 years. A large part of any variable remuneration exceeding 50% should be composed of shares or corresponding property rights of the financial institution. There is a possibility of reducing the variable remuneration in the situation where the financial institution gets weaker or yields negative financial results. This concerns both the current premiums and reductions in payouts of amounts previously earned, among others by reduction of remuneration (malus) or clawback of a previously paid premium (clawback).

Introduced provisions were supervised by the European Banking Authority. In issued reports (EBA, 2011) concerning the amount of wages in the financial

institutions of the EU, a specific description of the level and structure of managerial staff remuneration was presented. The number of people employed in the financial sector with high incomes – more than 1 million EUR per year is presented in Table 1. Of all the EU countries, only two did not disclose the information about the number and level of remuneration in the year 2010, one in 2011, whereas all countries revealed this information in 2012. In 2011, only Poland did not release this information.

Table 1. The number of people employed in financial institutions of the EU receiving an annual remuneration of more than 1 million EUR

Member States	2010	2011	2012
Austria	14	10	19
Belgium	13	8	15
Bulgaria	0	0	0
Cyprus	3	4	3
Czech Republic	0	0	0
Denmark	29	33	48
Estonia	0	0	0
Finland	5	3	6
France	292	162	177
Germany	195	170	212
Greece	0	2	1
Hungary	1	8	9
Ireland	21	21	17
Italy	119	96	109
Latvia	0	0	0
Lithuania	0	0	0
Luxembourg	6	10	15
Malta	0	0	0
Netherlands	43	36	27
Poland	2	4	7
Portugal	13	11	6
Romania	1	0	1
Slovakia	1	2	1
Slovenia	0	0	0
Spain	133	125	100
Sweden	14	15	20
United Kingdom	2525	2436	2714
UE 27	3430	3156	3507

Source: own presentation, based on: EBA Report High Earners 2010, 2011 and 2012.

The largest number of people who are rewarded for their work in financial institutions with over 1 million EUR per year, is in the UK. In this country, the number of people rewarded with over 1 million EUR constituted 77% of all persons rewarded with more than this amount all over the European Union. Among the 27 EU countries, in seven countries in the years 2010–2012 there was not a single person who earned over 1 million EUR in a financial institution. It is worth noting that Poland in 2010–2011, and Hungary in 2010, did not reveal the list of persons rewarded with more than 1 million EUR in financial institutions. The data presented in the table indicates the amount reported by other EU countries, which have subsidiaries in these countries. Table 2 shows fixed and variable remuneration that was received by all persons rewarded with over 1 million EUR, employed in financial institutions. In the years 2010–2012, variable remuneration received by the staff rewarded by financial institutions in the EU, was on a much higher level than the fixed remuneration obtained by these people. In 2010, it was a difference of 5 billion EUR in 2011 2.3 billion EUR, and in 2012 3.4 billion EUR.

Table 2. Fixed and variable remuneration of people rewarded in financial institutions with over 1 million EUR (in million EUR)

Fixed remuneration	2010	2011	2012	Variable remuneration	2010	2011	2012
Austria	12	10	19	Austria	11	9	16
Belgium	8	5	8	Belgium	10	6	11
Bulgaria	0	0	0	Bulgaria	0	0	0
Cyprus	2	4	3	Cyprus	1	3	3
Czech Republic	0	0	0	Czech Republic	0	0	0
Denmark	17	30	37	Denmark	26	19	33
Estonia	0	0	0	Estonia	0	0	0
Finland	3	1	3	Finland	3	2	4
France	73	54	58	France	449	203	219
Germany	85	86	106	Germany	298	226	224
Greece	0	2	0	Greece	0	2	1
Hungary	0	3	4	Hungary	1	9	11
Ireland	8	7	7	Ireland	24	22	17
Italy	94	83	80	Italy	154	75	100
Latvia	0	0	0	Latvia	0	0	0
Lithuania	0	0	0	Lithuania	0	0	0
Luxembourg	3	7	8	Luxembourg	8	10	16

Fixed remuneration	2010	2011	2012	Variable remuneration	2010	2011	2012
Malta	0	0	0	Malta	0	0	0
Netherlands	24	23	23	Netherlands	49	30	17
Poland	1	2	4	Poland	2	5	10
Portugal	6	5	5	Portugal	13	13	3
Romania	1	0	1	Romania	0	0	0
Slovakia	1	0	0	Slovakia	0	3	1
Slovenia	0	0	0	Slovenia	0	0	0
Spain	91	107	91	Spain	209	198	126
Sweden	8	14	16	Sweden	8	8	13
United Kingdom	817	784	1127	United Kingdom	5000	2718	4169
UE 27	1255	1226	1601	UE 27	6265	3561	4995

Source: own presentation, based on: EBA Report High Earners 2010, 2011 and 2012.

Swiss society in early 2013 stated that it is important to introduce the regulation of remunerations in the Swiss financial system. Swiss law is constructed in such a way that in fact citizens make decisions on important issues connected with the functioning of their country. In Switzerland, every three months, a nationwide referendum is held in which citizens opt for settling two to five essential cases. What is the most important: the decisions of the population are binding to the Swiss parliament. In order to discuss a given project in a referendum from the initiative of citizens, it is necessary to collect 100 000 signatures within 18 months. In February 2013, Swiss citizens voted in a referendum on a draft concerning limiting the remunerations of Swiss managerial staff. Nearly 70% of the population was in favour of limiting the salary of managerial staff. The introduced changes are set to revolutionize the amount of remuneration of managerial staff. The draft indicated that:

- the shareholders at the general meeting will vote on the remuneration of board members and supervisory board – voting will be binding and will be possible to be held electronically,
- a general meeting of shareholders each year will decide on the composition of the supervisory board, including its chairman and the composition of the committee for remuneration,
- the practice of representation at the general meeting of institutional shareholders by the board of directors is prohibited,
- severance payment, advance payment and premiums for the purchase and sale of companies are prohibited,

- ❖ not complying with the implemented law is to be punished with imprisonment – up to three years, and a financial penalty – up to six annual salaries.

At the end of 2012, the European Banking Authority issued guidelines on the assessment of the qualifications of the management body members and the people performing the most important functions (EBA, 2012). The document specified the criteria and processes to be followed by financial institutions in assessing the qualifications of the proposed and appointed members of the financial institution management body performing both a managing and supervisory function. The guidelines suggested that each institution had a policy of selection and assessment of management body members, which should contain, at least:

- ❖ the person or unit responsible for making the assessment of qualifications,
- ❖ the relevant internal procedure for the assessment of member qualifications,
- ❖ the competences and skills of the management body member necessary to presume that a member has sufficient expertise,
- ❖ information and evidence that a member of the management body should present to the credit institution to assess,
- ❖ if a member is to be appointed by the shareholders, the measures taken to ensure that the shareholders were informed of the requirements regarding the position and profile of the candidates before their appointment,
- ❖ situations in which it is necessary to reassess the qualifications, along with measures to identify such a situation,
- ❖ ways of providing opportunities for training by the institution in the case of specific training and development needs of the management body members.

The criteria for assessing the member of the management body according to the guidelines of EBA are divided into three parts: criteria relating to reputation, criteria connected with experience and criteria for management. The essential issue in the criteria relating to reputation is good repute. The guidelines were issued to pay special attention to factors that may question the good repute of a member such as; judgment or prosecution of a criminal offence, significant current or future investigations to enforce the law in relation to a member, or the imposition of administrative sanctions for failure to comply with all provisions regarding financial activity. The criterion connected with experience pays specific attention to the educational profile of the management body member. Education related to banking and financial services, is considered as education in the field of banking and finance, economics, law and administration of financial regulations and quantitative methods. The management body member, apart from a theoretical education, should have practical education, where important are the following: the period of holding their position, the range of competences, decision-making authority and responsibilities, the number of subordinates and technical knowledge acquired in the position concerning the activity of the credit institution and understanding risk in the activity of credit institutions. The criteria for

management place particular emphasis on personal, professional or other economic relationships with the members of the management body and shareholders having a controlling packet. All EBA guidelines should be implemented by the competent authorities and institutions by 22 May 2013.

The European Union, from the beginning of 2013, has worked on tightening the provisions of managerial staff remuneration. It proposed that from January 2014 the maximum premium level – calculated as a percentage of the basic remuneration – be implemented. Presently, the bonus is an average of about 140% of the basic salary in European banks. The European Union has proposed limiting premium to 100% of remuneration in the form of annual salary. Nevertheless, it will be possible to raise the percentage limit to the level of 200% with the approval of shareholders. The United Kingdom was against such restrictions, but British finance minister George Osborne at this stage could not do anything because ECOFIN makes the decisions through majority vote. G. Osborne has already announced that it "would be silly" to oppose the regulation. The mayor of London Boris Johnson called the cuts "the silliest thing Europe has seen since the days of Diocletian, who wanted to regulate the prices of vegetables". No wonder he thinks so – bonuses in London city are at a very high level. Barclays intends this year to spend 800 million pounds from its profit on a dividend. The regulation will not affect all employees of banks, but senior managers and risk takers, including traders. The regulation will affect from 300 to 500 workers in each big bank, in London alone it will be 5000 people, depending on how the definition of risk taker will be clarified. The law must still be approved by national governments and voted on during the 15–18 April session, but it is believed to be just a formality. The law would enter into force at the beginning of 2014. The consensus is a great victory of the European Parliament, which subordinated the support for the CRD IV directive to cuts in bonuses. This directive is a milestone in the regulation of the financial sector, as it implements the establishing of a Basel III compromise (*UE: Dyrektywa…*, 2013). The discussions shaping the text of the directive, having a significant impact on the level of managerial staff remuneration in banks, were completed in June 2013. On 26 June 2013 a directive was announced on the conditions of admission of credit institutions to conducting business activity and the prudential supervision of credit institutions and investment firms (Directive 2013/36/EC), and the regulation on prudential requirements for credit institutions and investment firms (Corrigendum to Regulation (EU) No 575/2013).

These documents signalled numerous obligations that should be fulfilled by institutions covered by this directive and regulation. Changes concerning the remuneration policy in the financial institutions have been described in articles 92–95 of the directive. The remuneration policy has been specifically associated with the risk of business as well as strategy and long-term objectives of the institution. The conducted remuneration policy should be verified at least once a year. The

European Union has placed a strong emphasis on reporting and transparency in publishing information concerning remunerations. It was highlighted that remuneration policy should be published with a clear separation into at least two components of remuneration:

- basic fixed remuneration – which should reflect relevant professional experience and the scope of organizational responsibility anticipated in the job description as part of the terms of employment,
- variable remuneration – which should reflect results that have been balanced and adjusted to risk, and also achieved results beyond the scope of the obligations expressed in the job description as part of the conditions of employment.

The directive made the variable remuneration highly conditional and significantly limited it. In determining the level of variable remuneration, the essential thing should be an assessment of the performance of the employee and the entire institution. This assessment should be carried out over several years, rather than based on short-term (annual) results. The directive emphasizes the prohibition of guaranteed variable remuneration. The most important change that has been implemented is to determine the ratio of variable remuneration in relation to fixed remuneration. The institutions determine the appropriate ratio of constant components of total remuneration in relation to variable components, keeping in mind that:

- the variable component shall not exceed 100% of the fixed component of total remuneration of each person,
- member states may implement a lower maximum percentage,
- member states may allow shareholders, owners or stockholders to approve the maximum level of the fixed component of remuneration to the variable remuneration, provided that the overall level of the variable component shall not exceed 200% of the fixed component of each person's total remuneration.

The shareholders, owners or stockholders, by raising the level of the ratio of variable remuneration in relation to the fixed remuneration to a level higher than 100%, must constitute a majority of at least 66%, provided they represent at least 50% of the shares. Variable remunerations in the form of early contract termination have also been limited. Severance payments should not reward poor performance and failures. An essential part of any variable remuneration component, constituting in each case at least 50%, should consist of shares or corresponding titles of ownership. A large part that is at least 40% of the variable remuneration component should be deferred for a period of not less than three to five years. Variable remuneration may be withdrawn at 100% or reduced if the member has participated in activities which resulted in considerable losses to the institution or did not meet the relevant standards concerning competence and reputation.

Verification of remuneration structure – an appropriate level of variable remuneration in relation to the fixed remuneration – forcing EU countries, by the

CRD IV directive, will be necessary in many financial systems of European countries. The ratio of variable remuneration in relation to fixed remuneration paid to individuals in financial institutions of more than 1 million EUR is presented in Table 3.

Table 3. The relationship of variable remuneration to fixed remuneration of persons paid more than 1 million EUR in financial institutions of the EU (in %)

Member States	2010	2011	2012
Austria	93	93	84
Belgium	131	118	143
Bulgaria	0	0	0
Cyprus	41	74	100
Czech Republic	0	0	0
Denmark	147	64	89
Estonia	0	0	0
Finland	115	136	138
France	615	373	375
Germany	350	263	211
Greece	0	75	302
Hungary	528	75	260
Ireland	299	336	235
Italy	163	90	124
Latvia	0	0	0
Lithuania	0	0	0
Luxembourg	230	158	220
Malta	0	0	0
Netherlands	202	132	76
Poland	143	277	278
Portugal	226	240	63
Romania	34	0	0
Slovakia	0	1911	571
Slovenia	0	0	0
Spain	229	185	136
Sweden	100	56	82
United Kingdom	611	346	370

Source: own presentation, based on: EBA Report High Earners 2010, 2011 and 2012.

The ratio of variable remuneration in relation to fixed remuneration which does not meet the criterion of 100%, did not meet the requirements of the CRD IV directive in at least 13 countries in 2012. It should be noted, nevertheless, that even in 8 countries individuals who are rewarded more than 1 million EUR were not identified. Therefore, this ratio is at the level required in the directive only in 6 countries. The relationship of variable remuneration to fixed remuneration, of more than 200% occurs in as many as 9 countries belonging to the European Union. The biggest challenge in meeting regulatory requirements will based by financial institutions conducting their operations in France and the UK. In Poland, this ratio is over 270%, and what will be required from shareholders/owners is permission for the ratio of variable remuneration in relation to fixed remuneration above 100%, and a reduction in variable remuneration or increase in fixed remuneration, so that the relationship of these variables is not higher than 200%.

Examples of poor practice are presented in the guidelines on principles and practices regarding remuneration, prepared by the *European Securites and Markets Authority* (*Guidelines on remuneration*…, 2013). The following were primarily considered bad practices:

- use of quantitative data as a criterion for variable remuneration assessment,
- lack of monitoring of risk assessment linked with the relation of variable remuneration with quantitative data,
- focus of the strategic objectives on trade and financial aspects, without taking into account the potential harmful actions directed towards the client.

In the ESMA guidelines the levels are highlighted leading to a conflict of interest, which is hard to manage. One of the most notorious conflicts is linking remuneration to the sale of individual products. For example, the institution pays the people engaged progressive motivation benefits for every product sold during a given quarter according to the following rules:

- achieving a goal 0 – 80% – no benefits,
- achieving a goal 81 – 90% – 50 euros for each transaction,
- achieving a goal 91 – 100% – 75 euros for each transaction,
- achieving a goal 101 – 120% – 100 euros for each transaction,
- achieving a goal > 120% – 125 euros for each transaction.

A motivation system constructed in such a way may lead to a desire to sell the largest number of products without taking into account ethical considerations.

3. POST-CRISIS REMUNERATIONS REGULATIONS IN THE UNITED STATES

Post-crisis regulations of managerial staff remunerations in the United States are based on the Dodd – Frank Act – reform of Wall Street (Dodd-Frank Act, 2010).

The act was signed by the president of the United States on July 21, 2010. This document was put into practice with the consumer protection act. The legal acts were a response to the problems of carrying out bank insolvency in the United States. The main purpose of the implemented changes was to promote financial stability by improving the transparency of financial markets and responsibility of financial institutions for their actions. Wall Street reform is described in the document in sixteen sections, which cover more than eight hundred pages. In this act, one section was devoted to remuneration of board of directors. In the definition of the members of the board of directors, it was noted that the regulation applies to all persons who sit on the board of directors.

The act changes numerous rules and customs of financial institutions. It is possible to reclaim the compensation granted to each director who is involved in a working relationship with the institution, and that of those who are not working in the institution. Any form of remuneration may be reclaimed (premiums, bonuses, severance payments, deferred remuneration, benefits and profits earned from the sale of securities). At least once every three years, each institution is required to submit to a shareholder vote the level and structure of managerial staff remuneration.

The Act emphasizes the special role of remuneration committees. The legislation stipulates that every company should have a remuneration committee and the lack of such a committee entails the necessity of informing of the reasons for this state. Each member of the committee should be independent. Establishment of an independent member profile, however, is not obvious. Independence should be determined primarily by the remuneration which a member should obtain only for advisory services. An independent member should not be linked to any other subsidiary company of the capital group. Such a person should not have any business relationships with the financial institution and the managers of this institution either. The committee should operate within the board of directors, so it is possible to obtain the advice of external consultants. Consultants and independent legal advisers should receive a remuneration that is at a fair level and reflects the market, paid within the work of the operating committee. The remuneration committee is responsible for appointing top managers, the level and structure of managerial staff remuneration and supervision of the remunerations of the board of directors.

The need for publication of the remuneration of the board of directors was reiterated along with the need for it to be transparent terms of the level and structure of said remuneration. It was also necessary to link the level of remuneration with the financial results of the company, paying special attention to the change in the value of shares and paid dividends. The need for publication of remunerations is not limited to the remunerations of the board of directors. Companies are required to publish:

- the medians of the total annual remuneration of all employees of the institution (excluding remuneration of the general director, or a person occupying an equivalent position),
- the annual amount of remuneration of the general director, or a person occupying an equivalent position,
- the ratio of the annual remuneration of the general director to the median of annual remuneration of all employees.

The company should announce (in order to disclose such information to shareholders), whether any of the staff (especially the members of the board of directors), made any purchases of financial instruments that were designed to hedge against a decline of the market value of the company. Federal regulators determine whether the persons managing the company have significant variable remuneration in the form of various financial instruments which may result in financial losses to the institution. The main regulator has the right to verify the level of remuneration which may be determined to be too high. The definition of the main regulator is described by the act through the following institutions:

- *the Board of Governors of the Federal Reserve System,*
- *the Office of the Comptroller of the Currency,*
- *the Board of Directors of the Federal Deposit Insurance Corporation,*
- *the Director of the Office of Thrift Supervision,*
- *the National Credit Union Administration Board,*
- *the Securities and Exchange Commission,*
- *the Federal Housing Finance Agency.*

Institutions with assets of less than 1 million USD are not subject to the regulations in this section.

The Wall Street reform led to the release of numerous documents, which introduced the provisions of the signed act. Some of the essential provisions include the following documents of the Securities and Exchange Commission:

- On 4 April, 2011, the Securities and Exchange Commission (SEC) issued a final agreement on the changes relating to remuneration (*Shareholder approval…*, 2011). It recommended the need for a separate shareholder vote on managerial staff remuneration of the company. It was marked, however, that the vote on the level of remuneration is not binding either for the issuer or the management of the company. Moreover, it was ordered to introduce to the document *Proxy statement* a subsection relating to the financial instruments held by the management, which in the case of mergers, acquisitions or consolidations may affect the investment decisions of the company. The disclosure should relate to remuneration for possible dismissal to all members of the board of directors. Such information should include data on the amount of remuneration, the structure and terms of acquisition of the rights to individual components of

the remuneration. The results of non-binding votes should also be published in the annual statement of the company.

❖ On 20 June, 2012, the SEC issued amended rules for the disclosure of information in the *proxy statement* (*Listing Standards*…, 2012). The new rules were considered necessary to announce the role and powers of the remuneration consultant supporting the remuneration committee. There should also be disclosed information concerning the form of arrangement and recommended level of remuneration of executive directors. However, it is not necessary to disclose this information if the consultant of the organization only dealt with issues of discrimination. The information of the consultant, who drew attention to the link between the remuneration of executive directors with the issuer, which may lead to a conflict of interest, should be disclosed. It was necessary to disclose the relevant information concerning the remuneration committee:
  - information concerning the independence of the members of the committee,
  - financing the committee and the people supporting their activities,
  - analysis of the independence of the consultants that support the activities of the committee,
  - the way of remuneration and supervision of the consultant.

The recommendation of the independence committee on remuneration relates to all committees apart from limited partnerships, enterprises in bankruptcy and any foreign entities, in which there will be revealed the causes of the lack of an independent committee in the annual financial statement. The necessity of linking the members of the committee for remuneration with the company is connected with the notice (*Notice of*…, 2013) of the Securities and Exchange Commission in adapting the role of committees to the regulation Dodd – Frank Act. The document stated that each member of the remuneration committee should sit on the board of directors (as a non-executive director).

4. CONCLUSION

The financial crisis has highlighted the faulty structures of managerial staff remuneration systems in financial institutions. Unreasonable levels of remuneration could lead to a decline in the security of bank activity. The regulators in the European Union and the United States have introduced a number of regulations regarding the levels and structures of remunerations of executives in financial institutions. The effectiveness of these regulations may result in increased security of banks and linking remuneration with the results of the institution.

The European Commission should implement the recommendation on the need for the annual publication of a document on the remuneration policy of a given company. A separate document should contain all information received,

the annual remuneration and the implementation of other benefits from working for a company, each member of the management board and the supervisory board. Such a document should be published by a remuneration commission in the form of an annual activity report of the committee.

Abstract

The financial crisis has highlighted the faulty structures of managerial staff remuneration incentives and systems in financial institutions. Consequently, regulators in the European Union and the United States have introduced a number of regulations regarding the levels and structures of remunerations of executives in financial institutions. However, these recommendations were only an outline of the changes that should be made, not providing specific solutions in terms of implementation. Consequently, the paper analyses the effectiveness of these regulations and presents some recommendations.

Key words: Remuneration of bank managers, regulation of financial remunerations

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