

Bank Culture: A Competing Values Framework

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The 2007–09 Financial Crisis

- ❑ A lot of risks were exposed.
- ❑ Explosive combination of factors (extensively discussed in Thakor, “Bank Capital and Financial Stability: An Economic Tradeoff or Faustian Bargain?”, Annual Review of Financial Economics, 2014, and Thakor, “The Financial Crisis of 2007-09: Why Did It Happen and What Did We Learn?”, RCFS, 2015), led to...



Motivation

- Today I want to talk about a factor not discussed much in these accounts...

Bank Culture

⇒ “Banks and banking rely on trust. And while trust takes years to establish, it can be lost in a moment through failures caused by problematic ethics, values, and behaviors. Events that precipitated the global financial crisis and the subsequent issues that have emerged have revealed a multitude of cultural failures... A great deal rests on a firm’s culture... The banking community as a whole needs to repair the damage done by failures in culture, values, and behaviors, and should tackle the challenge with renewed vigor and purpose to achieve tangible improvements in outcomes and reputation.”

-Group of Thirty, Washington, D.C., July 2015

Emerging Importance of Corporate Culture As a Mediating Influence in Employee Behavior

- Federal Reserve and ECB recognized the importance of bank culture in microprudential regulation
 - Series of conferences and stimulation of research
- Why? Recognition that ignoring culture lessens effectiveness of conventional tools of microprudential regulation: capital requirements, regulatory monitoring, etc.

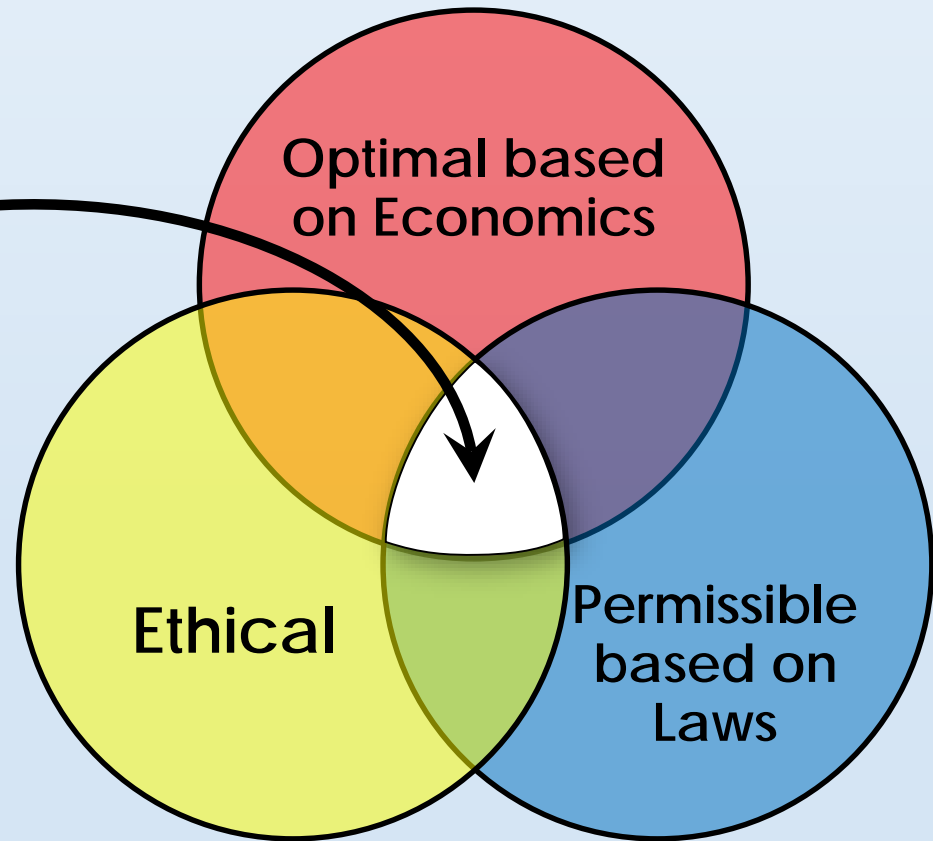
-Group of Thirty, Washington, D.C., July 2015

Motivation

- Culture is now a big issue in banking due to various spectacular cases involving big banks (Libor rate fixing, penalties for mortgage misrepresentation etc. >\$100 billion in fines).
- But spectacular cases of fraud are not limited to banks. Other firms have been involved in lying to customers and misrepresenting to governments: GM (defective ignition switches with >100 deaths), VW (software to misrepresent emission data), Roche (earlier price-fixing scandal)

A Practical Three-Dimensional Lens for Decisionmaking

Decisions must lie
in this area



Culture, Ethics and Economics

- While, as the previous slide shows, a lot of discussion of culture ends up being about ethics, morality, fraud, etc.

The theory I will discuss today is relatively “value free”.

- The theory is grounded in economics and broader than just enforcement/fraud elimination.

“Three pillars” : (i) enforcement
(ii) incentive comp ✓
(iii) behavioral norms ✓

To Develop a Broader Understanding of Culture, We Need a Theory...

- We need to develop an economic theory of banking culture... This leads to the research questions we confront...

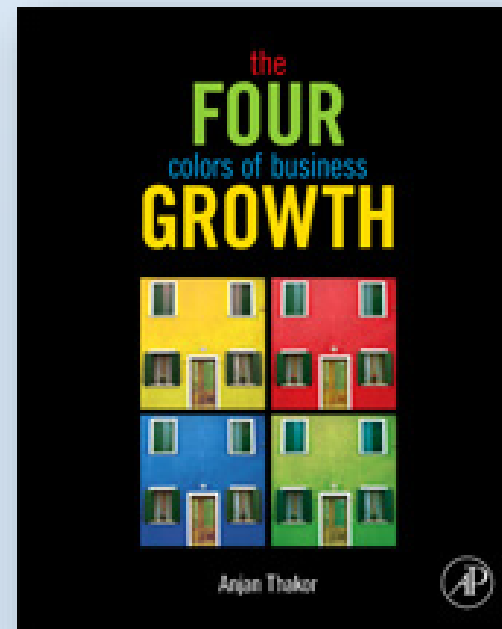
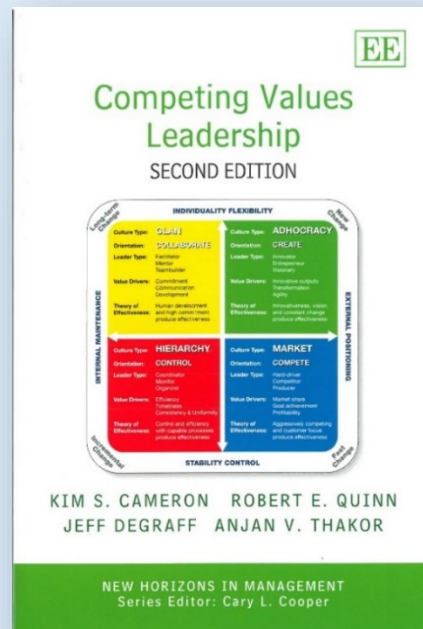
Research Questions

- Group of Thirty (2015) report points out: “Culture is defined as ‘the ideas, customs and social behavior of a particular people or society...’. Culture is what people do when no one is watching.”

□ Questions

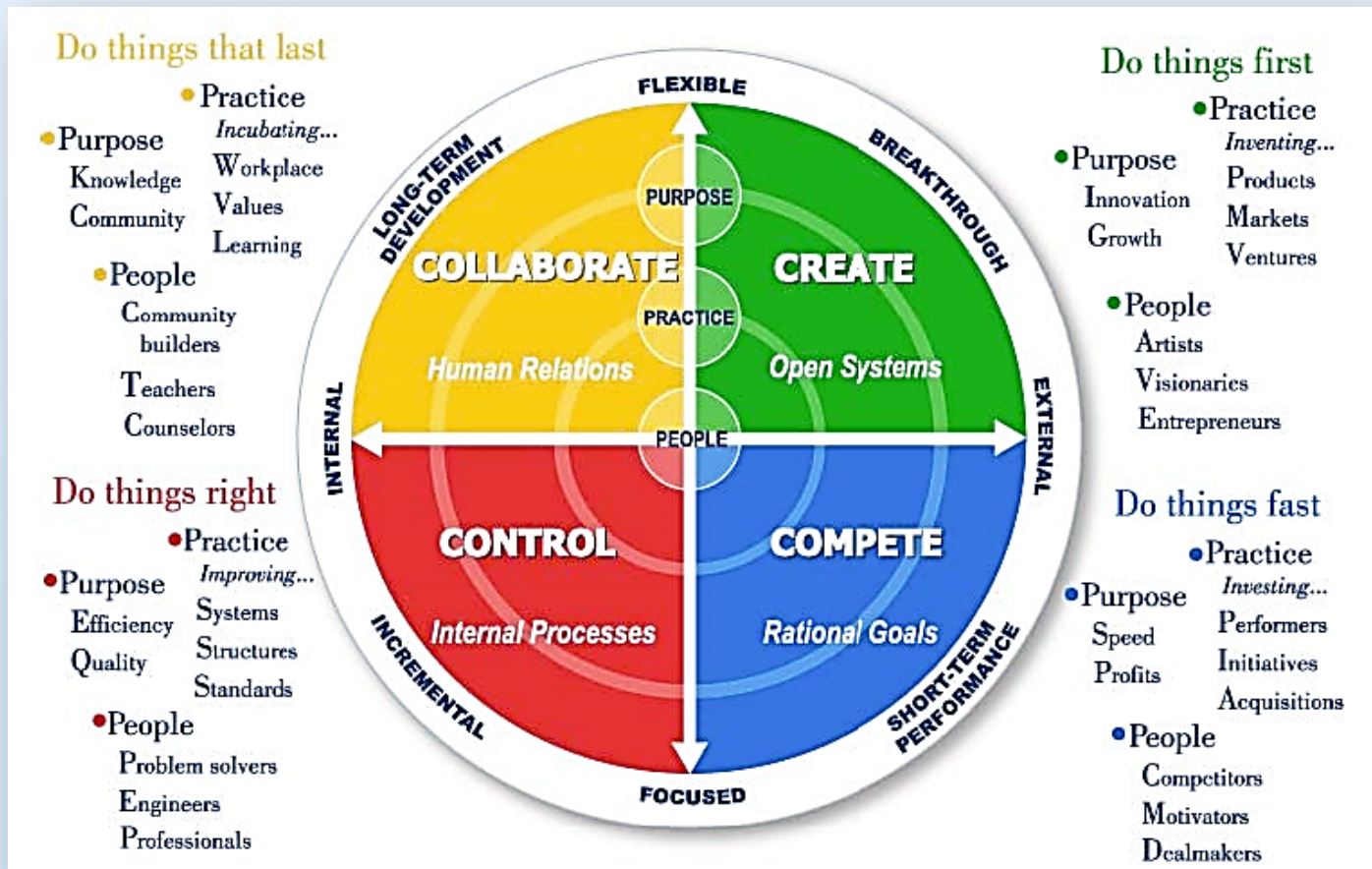
- What is bank culture, in a formal economic sense?
- How do we use this economic view of bank culture to improve our understanding of how banks choose culture?
- How does culture interact with forces like interbank competition, safety nets and bank capital?

- ❑ To address these questions, we begin with earlier work on culture in OB.
- ❑ Over the past many years, I have been working with organizations on organization culture and growth strategy, using a framework called The Competing Values Framework (CVF), developed in OB.



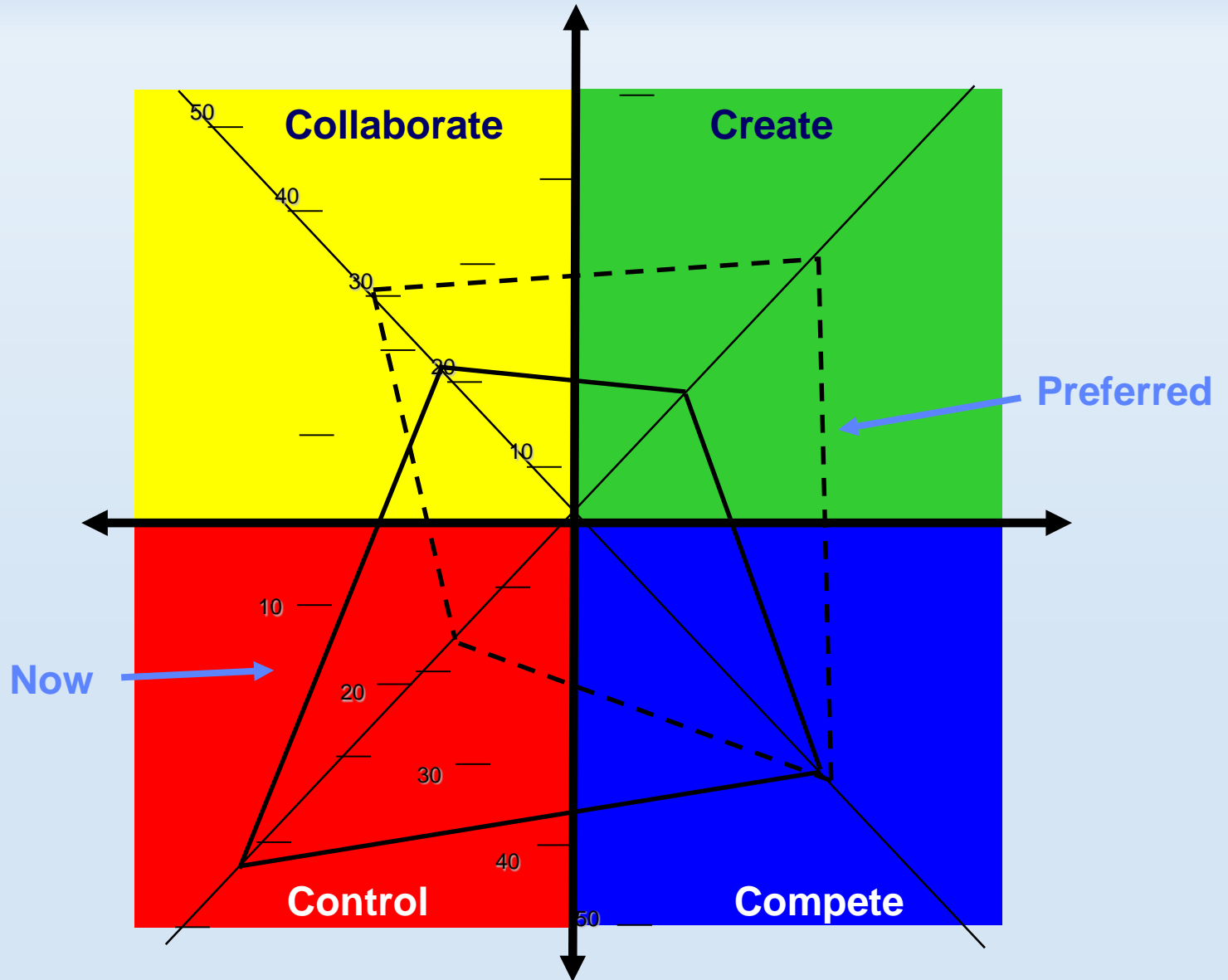
To Summarize...

The Competing Values Framework

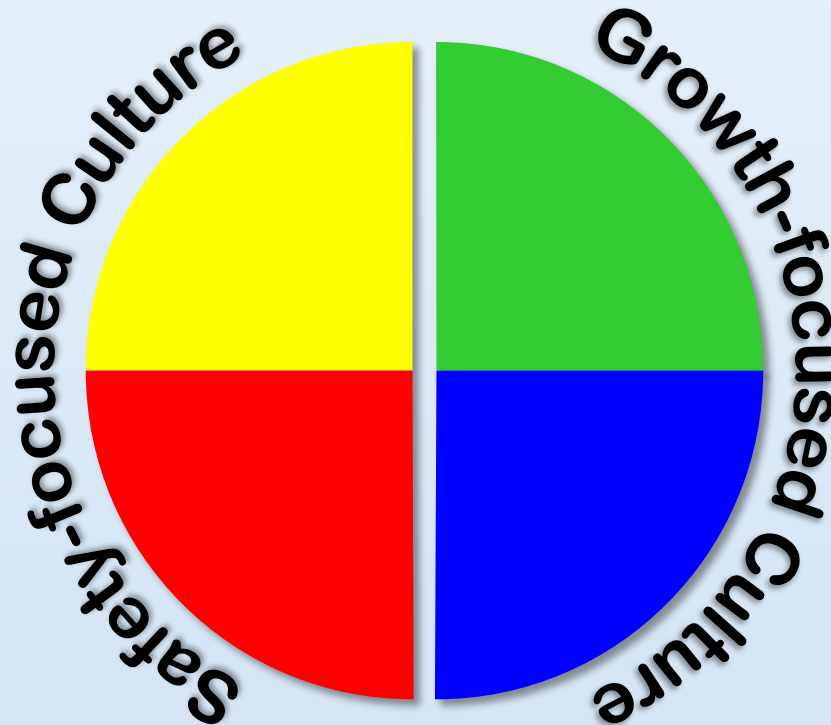


aka The Value Creation Genome

Now and Preferred Culture Profiles



- Essentially, for banks the tradeoff is between growth and safety ...



- CVF says that a stronger orientation in one direction will mean giving up something in the other.

- We focus on a bank that hires an employee who must be incented to provide unobserved effort. The bank can optimally design its compensation to incent the employee, but it is a multi-tasking problem in which the employee must choose: (i) the total effort to expend; and (ii) how to allocate the chosen effort between safety and growth.
- Effort allocated to growth increases probability of finding a loan, and effort allocated to safety increases probability of screening out a bad loan.
- We also allow the bank to optimally design the managerial wage contract.

Key Results

- The optimally-designed managerial wage contract in the second-best case has inefficiencies. For instance, in the second-best, more effort is allocated to growth and less to safety than in the first-best.
- In the second-best, the effort allocated to growth is decreasing in bank capital and increasing in the probability of a government bailout/rescue.
- With multiple banks, there is “herding”—each bank tilts even more toward growth \Rightarrow marginal value of safety as perceived by banks is lowered in more competitive growth environments. That is, competition for loans makes all banks compete more aggressively for loans in a symmetric Nash equilibrium.

Modeling Culture

- ❑ The inability of wage contracting to eliminate distortions (due to multi-tasking) provides room for culture to improve the outcome.
- ❑ We rely on the Akerlof-Kranton view of “identity economics” to model culture, i.e., culture determines the “identity” the employee develops and hence the utility he/she derives from choosing the action consistent with the culture. This means a disutility for the employee from choosing an effort that is incompatible with the culture. The stronger the bank’s culture, the larger the disutility.

Key Results

- ❑ Strong culture can attenuate herding tendencies and lead to greater heterogeneity in growth vs. safety choices in the cross-section of banks, i.e., culture helps banks resist temptation to tilt excessively in favor of growth.
- ❑ This is especially important in banking because the compromising of safety by even lower-level employees has the potential to “blow up” the organization—more so than in non-financials. So both culture and compensation should account for it.
- ❑ Culture in our model serves an “assortative matching” role—matching workers with a given set of beliefs with firms that have similar beliefs.

Conclusion

- ❑ Culture is not just about integrity, lack of fraud, ethics, etc. There are many different choices of cultural orientation, and each has its strengths and weaknesses.
- ❑ A culture focusing on internal processes to enhance safety is in tension with one focused on organic, innovation-based growth. A culture focused on acquisition-oriented growth is in tension with one focused on employee harmony and morale.
- ❑ At a very high level, growth-oriented and safety-oriented cultures are in tension, and it is challenging to have both operating effectively.

Conclusion (cont'd.)

- ❑ Nonetheless, a strong culture can (partially) overcome the limitation of explicit wage contracting in inducing banks to focus more on safety.
- ❑ Higher bank capital tilts the scale in favor of a safety-oriented culture, which in turn reduces systemic risk.
- ❑ We also find that to strengthen safety-orientation, regulators should: increase capital requirements and reduce safety nets...
- ❑ This means that regulators can use familiar tools to influence bank culture...therefore side-stepping—at least at the outset—the thorny issue of culture measurement and the deployment of this measurement for sup & reg.

Thank you!