On Shareholder vs. Stakeholder finance

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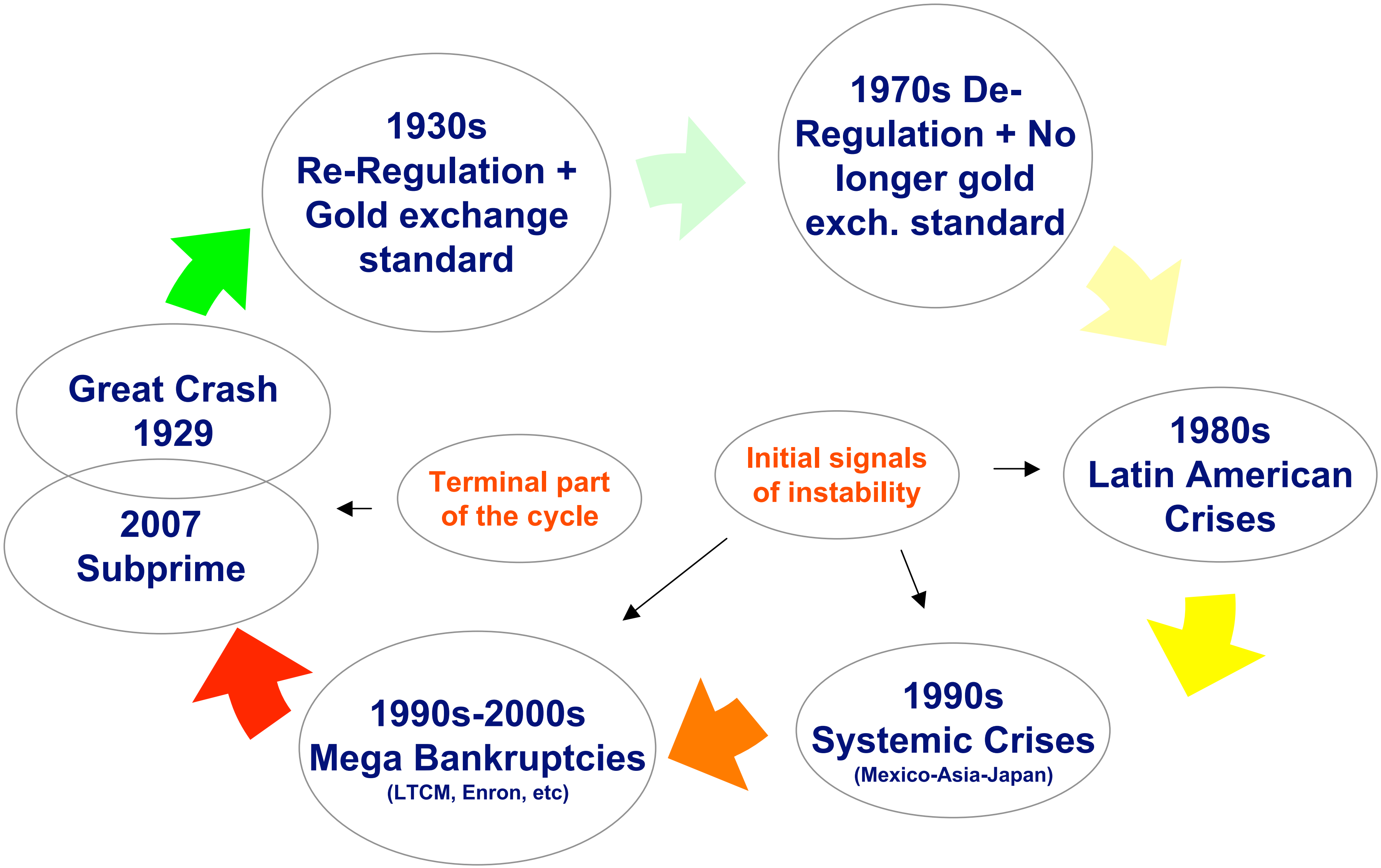
Outline

- Have we reached the end of a Political Economy Cycle of Finance?
- The Minsky Model
- From OTH to OTD finance in banking: theoretical and regulatory mistakes
- On the merits of different governance structures in banking finance
- Sustainability of cooperative banking

The Political Economy Cycle of Finance



The Minsky Model: Expansion

Starting Point:
-Low inflation
-Low unemployment

The Great Moderation
(Bernanke ’04)

Positive Shocks:
-deregulation
-Financial innovation
-Capital inflows
-Low interest rates

Politicians & economists
theorize the beginning
of a new Era
(e.g. New Economy)

Financial Sector:
-Rising demand for credit
-Risk underestimation
-Rising supply of credit

Balance sheet channel
Lending channel
Financial accelerator
(Bernanke-Gertler,’95)

Financial Markets:
-Rising asset prices
(shares & real estate)
-Wealth increases
-Debt increases

-Covered
-Speculative
-Ponzi

Real Economy:
-Consumption rises
-Investment raises
-Lower savings
-Rising current account deficit

Animal spirits
(Akerlof-Shiller, ’09))

Boom:
-Economy overheats
-Real and/or financial imbalances grow
-Financial structure becomes fragile

Global Imbalances
(Bernanke ’07)

The Minsky Model: Contraction

Starting Point:
-Rising interest rates
-Sudden change in expectations

Default of Ponzi units

Negative Shocks:
-Capital flows away from more speculative investment

Financial Sector:
-Pessimistic evaluation of risk
-Lower demand for credit
-Lower supply of credit (crunch)

Financial Markets:
-Lowering asset prices
-Lowering wealth
-Debt deflation
-Real debt increases

-Central Bank
-Government
-Regulation

Real Economy:
-Lower consumption
-Lower investment
-Rising savings
-Lower current account deficit

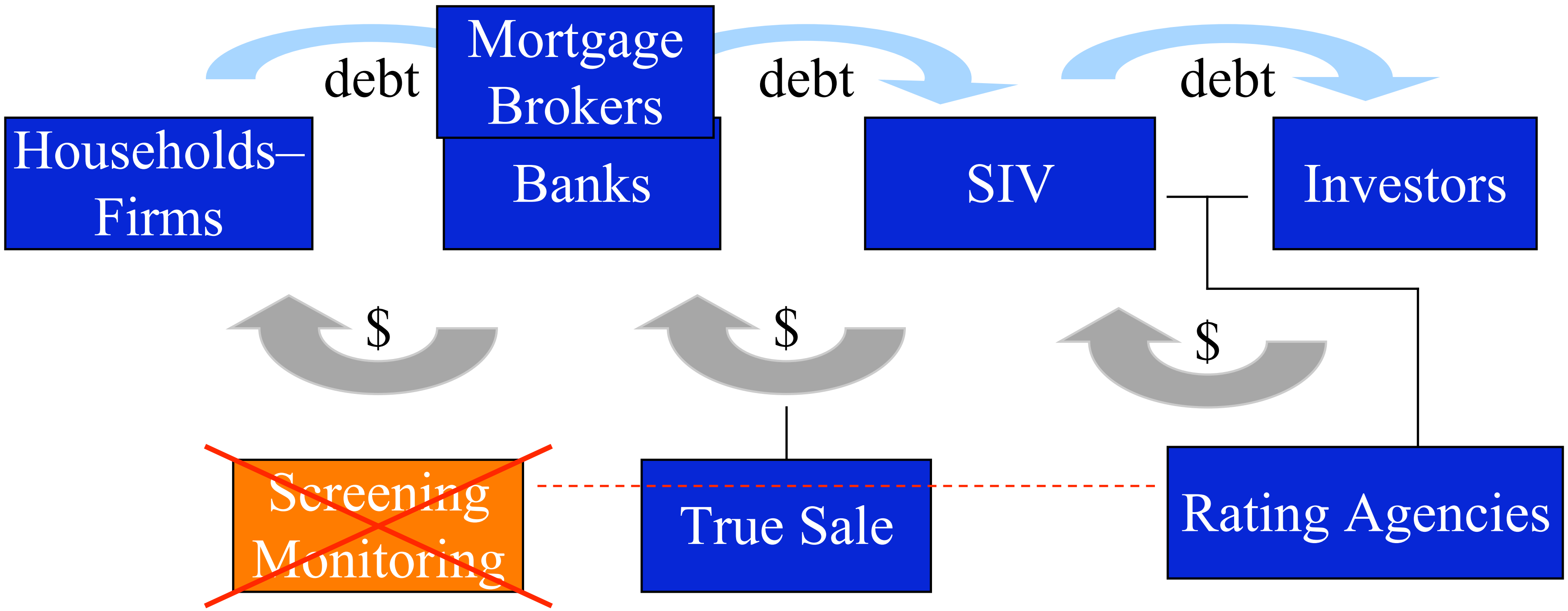
Debt Spiral
a la Fisher 1933

Burst:
-Banking crisis (bank runs)
-Recession

Deflationary Spiral

Securitization & Lenders' Irresponsibility

➢ From the "*originate to hold*" model to the "*originate to distribute*" model.



On the merits of different governance structures in banking - 1

- The evolutionist theorem – suggesting that banks should give way to financial markets – had a lemma regarding the bank's company model: the most appropriate company model to support financial development was for the bank to be established as PLC, bearing the objective of maximising shareholder value
- The model of the coop bank – the prototype of stakeholder value banks – was then depicted as archaic since, assigning value (also) to objectives different from maximising short-term profit and putting on the same par (at least in their statutes) – especially via the principle "one head one vote", irrespectively of the amount of shares actually held – the weight of each shareholder in the bank's choices, allows representing a larger set of the bank's stakeholders.
- The corporate governance of the coop banks is under discussion

On the merits of different governance structures in banking - 2

- Some observers hold that it contributes to generate untouchable directors who will rarely be replaced and, thus, may act in a self-referential way
- Though there is some truth in this claim, this reasoning neglects the possibility that the long tenure of coop banks' directors is the inevitable price to pay to allow a wider representation of stakeholders
- Evidence shows it's the governance model of the coop banks that seems at the basis of their lower profit volatility and that likely allows these banks to pursue longer-term objectives. It is also their governance that makes it more sustainable for the coop banks to do business on the basis of a banking model which is not only OTH but features the deep rooting of relationship banking.

On the merits of different governance structures in banking - 3

- Thus, being more devoted to relationship banking and, so, better able to reduce the information asymmetries on borrowers, coop banks are better able to overcome the market failure at the origin of the establishment of the bank
- However, irrespective of this, for many years we have seen a substantial dislike of coop banks by lawmakers/supervisors
- This determined a double subordination for the coop banks: as their shareholder value homologues they were increasingly subordinated to financial markets in terms of their business model and, on top of that, they were also subordinated to the shareholder value banks in terms of their company model.
- The crisis urges abandoning that negative prejudice
- It is not by chance that coop banks were less penalised than shareholder value banks during the crisis: they are better inclined to follow a business model having longer-term objectives and, as such, better suited to strengthen relationship banking and thus to favour responsible behaviour, in lieu of that irresponsible behaviour at the origin of the crisis.

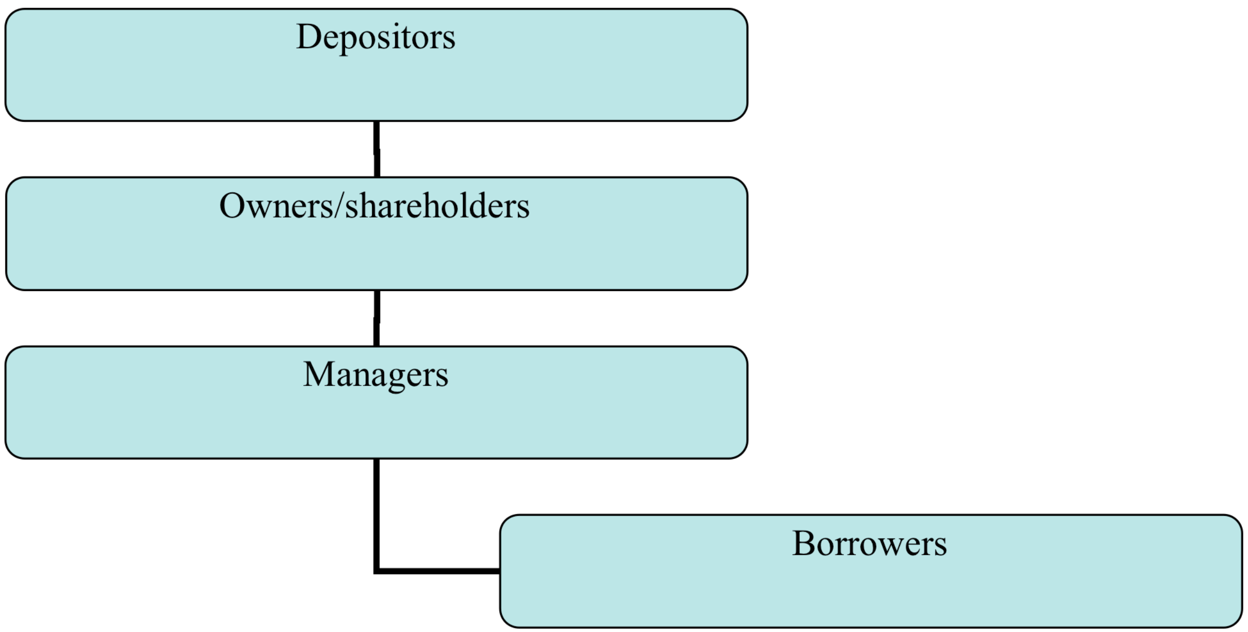
On the merits of different governance structures in banking - 4

- The arguments against the coop governance model may be phrased in terms of the asymmetric information theory
- Complex organizations systematically suffer from a moral hazard problem between owners and managers
- An organization with a clear and unambiguous, measurable, objective has some advantages. Profit lends itself nicely to the definition of targets for the managers and therefore curtails discretionary behaviour and rent extracting by the managers
- However, for banks, this approach is too a simplistic
- The existence of banks depends on another sort of asymmetric information, the one between lenders and borrowers and to scale economies in monitoring and screening activities. Also, the fact that banks mainly borrow capitals form depositors makes them agents rather than principals in another relationship, the one between owners and depositors.

On the merits of different governance structures in banking - 5

- The owners/managers moral hazard is still relevant, but judging the governance of banks on the basis of this only is absurd
- We need a more general analysis to assess the ability of different models to overcome difficulties in the various imperfections the banks face. Unsurprisingly, then different types of institutions seem better suited to overcome different information problems

Figure 1. Agency Relationships in for-Profit Banks



On the merits of different governance structures in banking - 6

- At each stage the link between the upper and the lower level features at least an agency relationship with moral hazard
- The lower level is the most studied agency relationship so far, the one between borrowers and lenders. Dealing with this is the key reason behind the existence of banks
- So, Banks' Owners & Managers are there to mitigate the basic agency conflict that exists between Depositors and Borrowers
- There is a depositors/bank-owners agency conflict too
- In turn, there is an agency conflict between bank owners (focusing on profit maximisation only) and managers (driven by other objectives, e.g. size and perks, raising intermediation costs): the for-profit banks seem to have an advantage only to deal with this conflict
- Note that managers may be more interested than owners in the stability of the bank and, therefore, their presence may mitigate the owners' conflict with depositors

On the merits of different governance structures in banking - 7

- In sum a for-profit bank, as an organization that substitutes for markets, is useful and welfare-enhancing if the costs from the additional conflicts that it causes is lower than the costs of the original unmediated agency relationship
- So, the organizational structure should be evaluated on the total agency costs it delivers (not on a single stage of the chain) and analysing banks as other firms in competitive markets not plagued by asymmetric information markets is highly misleading
- The approach used to dismiss the coop bank governance is not based on economic theory and simply reflects a prejudice
- The key feature of coop banks is that distinctions become more blurred: depositors/shareholders and members/borrowers often overlap. This dampens some conflicts of interests.
- Opportunistic behaviour is less likely as coop bank members usually feature a network of linkages beyond the pure lending relationship have two positive effects: a) the stigma associated with a default is possibly larger; b) facilitating both screening and cross monitoring among members/borrowers. This favours SMEs

On the merits of different governance structures in banking - 8

- So, the coop bank governance is appropriate at least sometimes
- Thus, the most sensible policy approach is not to choose a fixed governance as the one preferable in every context
- It's reasonable encouraging governance diversity to ensure that the most appropriate ones emerge naturally as the winners. Of course, here levelling the playing field would not necessarily entail enforcing the same regulation on every type of intermediary
- As seen, the perils for bank instability come mainly from bank owners' perverse incentives and, therefore, from the agency problem between them and depositors. This problem seems less important in coop banks as the Owners-Members are, for an important part, also Depositors
- Also, the fact that profit is not the (only) objective of coop banks considerably dampens the incentive to increase risk taking
- Prudential regulation is thus less necessary for this type of intermediaries. Limits to the discretion of Managers on the contrary may be more useful than in traditional for-profit banks (Cuevas and Fisher, 2006).

Sustainability of cooperative banking

- While financial markets tend to be more cyclical than banks, even within banks some types may be less pro-cyclical than others
- Banks maximising stakeholder value (coop banks) may be better able than shareholder value maximising banks to overcome the asymmetric information problems between depositors and borrowers, while reducing also the overall conflicts of interests affecting the entire intermediation chain
- Thus, coop banks should be more stable than the other banks, as risk tends to be pro-cyclical. Also, when the economy's price system is distorted by a financial bubble the risk-seeking incentive for shareholder value banks is amplified too as it becomes very difficult for supervisors to spot it and curb it
- This finds support in various papers (published at the IMF and by independent academics) concluding that coop banks tend to be more stable because of their lower return volatility. While coop banks' larger focus on traditional bank intermediation – and less on financial market related activities – explains part of this, the literature also finds that some of their lower volatility is germane to their coop corporate governance model