Anjan V. Thakor, *The purpose of banking: transforming banking for stability and economic growth*

Oxford University Press

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Published online: 27 November 2020
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The 2007–2008 global financial crisis and the recessions it spawned led countries around the world to reexamine the role of banks (and bankers) in their societies. This book explores a central question arising from this discourse: How does society design a banking system to achieve a proper balance between financial stability and economic growth?

The author, Anjan Thakor, provides a comprehensive, cogent, and accessible analysis of the issues with a narrative grounded in academic research. Along the way, he provides the reader with a deeper understanding of the core functions of banking, often by using intuitive and fun historical analogies. While reading, it became quite clear to me why the author has been such a prolific banking scholar and decorated teacher.

Thakor makes a compelling case that, in the long run, countries will have greater economic growth with greater financial stability. Unsurprisingly, bank capital plays a central role in promoting financial system resiliency in this narrative. However, the author also explores supporting behavioral aspects, specifically bank higher purpose and bank corporate culture.

1 Bank capital requirements and shadow banking

It is well understood that government safety nets for banks provide incentives for institutions to engage in excessive risk-taking through their investment and financing choices. Such risk-taking incentives form the policy basis for safety-and-soundness regulations, the most fundamental of which

are minimum capital standards. In his book, Thakor reminds us that the question of socially optimal bank capital structure is contentious. Much of the debate centers on a perceived trade-off: more capital improves financial stability but at the expense of less lending and liquidity. In other words, there is an inverse relationship between stability and growth. Thakor sees this as a false choice and argues—with support from the voluminous literature on the topic—that banks with more capital actually lend more, create more liquidity, make less risky investment decisions, attract more relationship borrowers, and are more likely to honor their loan commitments. He adds that banks' desire to keep capital requirements lower than socially optimal simply reflects their desire to increase the value of the safety net put option. Overall, Thakor joins those who call for much higher bank capital requirements.

This is where my mind wandered to the cost of intermediation via banks versus non-bank financial institutions and regulatory capital arbitrage. Financial sector competition is very acute, especially in the United States where capital markets are especially deep. Bank capital requirements are relatively static when compared to those implied by capital markets, which suggests some cyclicity to financing advantages and ultimately where financial risks migrate. Put differently, material changes to capital requirements can have implications for bank portfolio size and composition.

There may also be differences in capital requirements across classes of regulated entities for the same risk (e.g., residential mortgage assets for banks versus Fannie Mae/Freddie Mac); or even differential treatment within bank capital requirements for the same risk held in different forms. The author touches on these issues at various points, although they may be more important to discussions of socially optimal bank capital requirements than is presented.

This leads to an important point made by Thakor: non-bank financial institutions not only compete with banks, but are also bank customers. Non-banks often rely on bank

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warehouse lending facilities for the short-term financing of their loans prior to securitization or sale. Banks with broker-dealer affiliates also provide financing for securities holdings by investors. In the event of a large negative financial shock, non-banks can find themselves in desperate need to shed assets to meet liquidity needs with bank balance sheets absorbing loans and securities. We saw this in 2007 with the private-label residential mortgage market and in 2020 with mortgage REITs and hedge funds.

One possible reason for our slightly different perspectives is that Thakor seems to view lending by banks and non-banks to be fundamentally different. Here he distinguishes between human capital-intensive “relationship lending” versus technology-driven “transactional lending.” While I am sympathetic to this dichotomy, it feels like the last 30+ years has seen a larger share of lending becoming transactional. Virtually all retail lending is underwritten using scoring systems, and capital markets seem to be funding an ever-increasing share of wholesale lending through various institutional constructs. As technology continues to commoditize banking products, it may also erode bank charter values and lead to additional consolidation and risk-taking incentives.

2 Bank higher purpose and bank corporate culture

After discussing the important role of capital for bank performance and stability, Thakor explores two inter-linked concepts that have garnered policymaker attention in recent years: Bank higher purpose and bank corporate culture. As described by the author, a bank’s higher purpose is the reason for the institution to exist. This is typically a pro-social goal and not about the acquisition of resources, but instead about creating resources for society. The author defines corporate culture as the collective assumptions, expectations, and values that reflect the explicit and implicit rules determining how employees think and behave within the organization. Clearly, a bank’s higher purpose has a huge impact on its culture.

I appreciate the attention to higher purpose and corporate culture, although both issues fall principally in the domain of management studies. In terms of the underlying economics, the author points to the need for bank management to focus on their institution’s higher purpose and corporate culture in an effort to generate ‘trust.’ This trust is presumably akin to intangible equity and hence value enhancing. However, because banks in many jurisdictions maintain access to government safety nets, customer trust may simply reflect the presence of sovereign guarantees (explicit and implicit).

The experience of Fannie Mae and Freddie Mac during the 2000s provides an interesting counter-example to the notion that higher purpose and corporate culture lead

to stability. The U.S. Congress chartered these two government-sponsored enterprises (GSEs) and ascribed very explicit higher (public) purposes: to enhance the liquidity and stability of the U.S. secondary mortgage market and thereby promote access to mortgage credit, particularly among low-and-moderate income households and neighborhoods. Fannie Mae and Freddie Mac have also long maintained progressive corporate cultures. Nonetheless, both GSEs found themselves embroiled in accounting scandals during the early 2000s, insolvent with the housing bust in the late 2000s, and remain in federal conservatorship.

Developing and socializing a pro-social higher purpose and corporate culture may be difficult at larger banking organizations given that many are quite complex, tend to be more transaction-focused, and are subject to strong equity market discipline. The author notes that cooperatively owned and/or community-focused depository institutions may be the best positioned to articulate a clear higher purpose and integrate this with their business strategy. I agree and might further narrow this to a sub-set of institutions best positioned to be purpose-driven: community banks in rural areas, community development financial institutions, and credit unions with narrowly defined fields of membership. In other words, settings where the social value of the bank is very clear to all stakeholders.

3 Misdiagnosis of the 2007–2008 crisis and liquidity regulation

I am very sympathetic to Thakor’s view of the 2007–2008 global financial crisis being principally a solvency crisis. In the United States, vast amounts of public sector liquidity were provided in the form of Federal Home Loan Bank advances and Federal Reserve discount window lending (broadly defined) and swap lines with foreign central banks. Moreover, the Federal Reserve embarked on its large-scale asset purchase programs that initially helped to improve market functioning. However, these actions did not change the fact that many large banks were financially distressed during this time, with some failing and others requiring direct investment to bolster their capital positions. Put differently, the liquidity strains principally reflected underlying solvency problems and government liquidity support largely acted to slow the speed of contagion. While the United States was at the center of the crisis, global banking implies the transmission of shocks across borders. In Europe, for instance, large banks were adhering to Basel II risk-based capital standards (and no simple leverage ratios) and many such institutions were extremely leveraged and vulnerable with the onset of the crisis.

Following the financial crisis, the Basel Committee introduced a myriad of proposed reforms, including liquidity

regulations. One of these, the “liquidity coverage ratio” requires banking organizations to hold historically high buffers of government-backed debt securities (e.g., U.S. Treasury and Agency securities) with the purpose being their availability for sale in the event of a liquidity shock. However, this seems an unlikely response in the U.S. context for various reasons, not the least of which being that banks have access to low cost financing collateralized by a range of eligible assets via Federal Home Loan Bank advances and Federal Reserve discount window lending. Moreover, as we have recently witnessed with the onset of Covid-19, liquidity demands within the financial system broke down the functioning of cash markets for U.S. Treasury and Agency mortgage-backed securities. This required the Federal Reserve to purchase hundreds of billions of these assets. How did the banks ultimately address their liquidity needs? By borrowing from their regional Federal Home Loan Bank and/or Federal Reserve Bank.

Thakor discusses recent failed referendums in Iceland and Switzerland motivated by the view of the 2007–2008 financial crisis as principally reflecting a liquidity crisis. While I am not well-versed in these cases, the referendums (as described) envisioned moving deposit accounts to the central bank and then having banks bid for these deposits to fund loans. These proposals may reflect these jurisdictions not having deposit insurance systems in place before the last crisis and that their banking systems were especially large

relative to their economies. In this case, bank deposits were truly at risk and hence runs would have been likely. Looking ahead, the possibility of central bank deposit accounts for households and firms may arise in other contexts, such as the issuance of digital currencies.

4 Conclusions

The *Purpose of Banking* provides a solid foundation for those interested in better understanding the social value of banks and the role of bank capital in supporting financial system resiliency and economic growth. Such grounding is crucial for properly evaluating the social benefits and costs of technological and regulatory innovations that are rapidly changing the financial services landscape.

Acknowledgements Vice President, Federal Reserve Bank of Dallas. The author thanks Kevin Kliesen and Larry Wall for helpful comments. The views expressed are my own and are not necessarily those of the Federal Reserve Bank of Dallas or the Federal Reserve System.

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