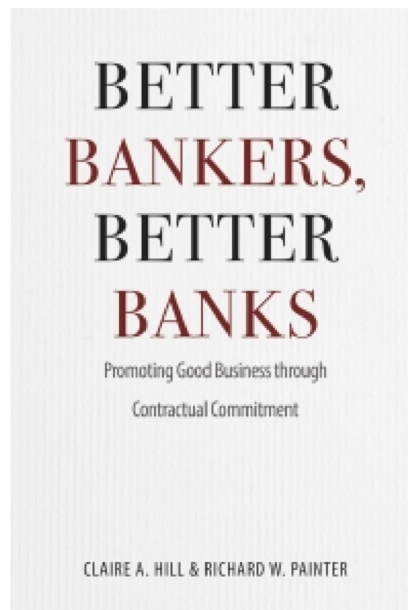
Book Review: Better Bankers, Better Banks: Promoting Good Business through Contractual Commitment by Claire A. Hill and Richard W. Painter

In **Better Bankers, Better Banks: Promoting Good Business through Contractual Commitment**, **Claire A. Hill** *and* **Richard W. Painter** *provide an account of the changes to banking that encouraged the risk-taking that became a factor in the global financial crisis, and propose a solution: 'covenant banking'. The authors' suggestion of binding bankers to contracts that encourage accountability to stakeholders and increase personal liability for losses is an essential contribution to debates over the regulation of the financial sector. However, the wider structural factors that enable excessive risk-taking behaviour remain somewhat overlooked, writes* **Mehmet Kerem Coban**.

***Better Bankers, Better Banks: Promoting Good Business through Contractual Commitment*. Claire A. Hill and Richard W. Painter. University of Chicago Press. 2015.**



History is marked by many turning points which we may call critical junctures. The global financial crisis has been one example. The crisis underscored various deficiencies in the financial and banking sectors as well as with the regulatory regime defining legitimate social behaviour within them.

Since the crisis, ordinary citizens are discussing how to regulate these sectors that have caused enormous social, economic and political consequences. *Better Bankers, Better Banks: Promoting Good Business Through Contractual Commitment* is not just another analysis of the causes of the crisis, but rather contributes to the debate on how to regulate the system. Claire A. Hill and Richard W. Painter have legal backgrounds, which makes the book rich in terms of court filings reporting systemic misbehaviour. They propose a 'covenant banking' whereby individual bankers (read: elite and highly-paid bankers) are liable to cover fees and sanctions and add capital to the bank in cases of insolvency. The authors reach this solution by showing changes in culture and business models that have led to greater focus on the material benefits that attract bankers compared to other-regarding motives of banking, a social practice whose primary traditional role is intermediation between savers and borrowers.

Let us focus on a few important pillars on which the authors build this solution. Firstly, the sector has undergone changes in culture. Investment banks used to be partnerships between individual bankers; however, since the 1970s, they are public companies where partners do not have to assume personal liability in case of failure. This has been accompanied by a rising trend in external financing leading to 'gambling' with others' money. Due to limited personal liability and more external financing, bankers have arguably changed the way that they interpret risk-taking and most probably redefined their risk preferences. What was neglected with this trend is that bankers (and banks) have more leverage with less equity and capital set aside, as Anat Admati and Martin Hellwig persuasively highlighted.

Secondly, the moral hazard problem has become more acute in various forms, including the mystification of banking services and the advice that bankers provide as well as the misrepresentation of their practice and its consequences. LIBOR manipulation is a showcase for this deterioration of values and social norms (49-53). Another example is the Lewin-McCain Report on JP Morgan. Even though they were aware of the low-quality credit profile of potential borrowers, bankers chose to ignore this fact (43-44).

Thirdly, the relationship between customers and clients and bankers has changed. Previously, relationship-based banking had prioritised the reputation of the bank and its bankers. However, since the advent of transaction-based banking, bankers lost the appetite to maintain their reputations. We should also note what the authors do not reflect, which is that transaction-based banking might have motivated borrowers to lose their loyalty to the bank with which they work. When both sides lose loyalty, each side will prioritise individual benefits without any regard to the interests of others. The consequence of bankers losing sight of the interests of others, such as taxpayers, homeowners, shareholders and stakeholders in society at large, is 'reputation mining', in the words of George A. Akerlof and Robert J. Shiller.

Image Credit: 'Wall Street Bull' (Sam valadi)

Some structural changes also contributed to bankers ignoring the consequences of their fraudulent practices. These involve rising competition not only at the domestic level, but also internationally, as well as regulatory changes and competition. When changes in the structure, culture and business model coincide with greater focus on material gains in terms of money, status and self-esteem, a less cautious attitude toward risk-taking and a sector ethos defined by profit-seeking with high leverage and excessive risk-taking behaviour, the interests of others can easily be ignored, while limited liability allows individual bankers to privatise gains but socialise losses.

The solution that Hill and Painter propose in the book is 'covenant banking'. The logic behind this is boosting ownership in responsible banking and accountability to stakeholders among individual bankers. For the authors, highly-paid bankers earning more than $3 million per year could be liable in cases of insolvency or financial charges; personal liability is specified in their contracts to make the commitment credible, while enabling legal procedure if bankers do not comply with the terms and conditions of the contract. The second solution is for bankers who are earning less than around $1 million per year to be given some of their annual pay in the form of assessable stocks so that they are invested in the resiliency of the bank (note that the authors do not clearly state how they find the $3 million and $1 million thresholds to be appropriate). Hill and Painter argue that although government and regulators can play an essential role in introducing, implementing and supervising such contracts, banks can adopt contractual employment schemes for their own benefit as bankers would be incentivised to take fewer risks. In the meantime, by paying less in cash but more in the form of assessable stocks, banks could increase retained earnings that may add up to equity and/or capital. Hill and Painter note that there might be objections to the solution mainly due to potential challenges in adoption, implementation and feasibility.

This solution is valuable insofar as changes in the banking sector and the ethos of profit-maximisation regardless of social and economic consequences – what the authors call 'promotion focus vs. prevention focus' – are considered. What could be further reflected upon is the bigger picture. Besides structural and cultural changes, a bigger picture would entail credit-debt growth as financial cycles have become much more credit-driven. From the perspective of individual households, as they feel more pressure on their purchasing power due to a lower pace of real wage growth, they become more dependent upon credit (see also Raghuram G. Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy*). Blaming bankers may not be the best way to address these systemic deficiencies, although attempts at boosting ownership and accountability, albeit imperfect, welcome further discussion on improving the regulatory framework. However, without addressing the major drivers of cultural change and business models that aim to adapt to particular macroeconomic and institutional conjunctures in the world, contractual commitments may not fully address the inner problem of excessive risk-taking and the rewards of such practices.

Finally, what is also paradoxical about the authors' solution is the claim that the law can crowd out morality. The solution seems like a legal mechanism to bind bankers to a more responsible banking, without considering the moral aspects, let alone concerns as to whether such commitments are credible. For example, contracts that bind bankers personally in cases of insolvency or coverage may not discourage them from taking excessive risks; instead, they may continue to do so and be paid highly. Bankers may leave money aside in case they have to step in to cover losses or fines. Consequently, without addressing major structural factors that lead bankers to take excessive risks, convenant banking could only remain as a minor and arguably negligible solution to bankers' immorally excessive, risk-taking behaviour.

Overall, Hill and Painter's contribution should not be overlooked. The book is an essential contribution to the current debate on policy and institutional design in financial and banking sector regulatory frameworks at the micro-level, compared to Basel-type macro-level regulations.

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