Banks as institutions, not firms

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Abstract

The 2007-8 global banking crisis and its aftermath have seriously undermined the prevailing organizational form and business model of retail banking, i.e. large, diversified, vertically integrated banking groups. While regulatory reforms in many countries have made diversification more difficult and vertical integration more susceptible to tighter supervision, some scholars have called for both a return to 'narrow banking' and greater efforts to streamline banking operations. These efforts, however, remain limited by a view of banks that is rooted in 1970s neo-classical theories of the firm. Indeed, contemporary banking theory relies on functional accounts of banks in financial intermediation theory (such as conceptions of banks as liquidity providers or delegated monitors) and on accounts of bank governance and organization based on agency theory and property rights theory. These approaches fail to explain the most important causes of the 2007-8 banking crisis, underestimate how profit incentives caused excessive risk taking by banks, and thus fail to provide sufficient means to develop theories of more sustainable bank business models. This paper explores alternative ideas based on institutional theories in the social sciences and heterodox theories of the firm. We explore the advantages of conceptualizing banks as deeply embedded institutions and highly connected entities that operate in social environments where the provision of funds is only one among multiple relations. Institutional banking theory may tap a wide variety of theories, concepts and methods from new institutional theories in economics and sister disciplines to better explain how banks work. This also brings into view how banks are accountable to a larger range of stakeholders than supposed by contemporary banking theory that restricts analysis to concepts drawn from shareholder based theories of the firm. Institutional banking theory may provide a paradigm shift to provide new concepts and methods better able to explain the origin, evolution and recent performance of banks and banking systems with important implications for banking studies and the governance and regulation of banks.

KEYWORDS: banking; banks; financial intermediation theory; neo-institutionalism

Introduction

It is not casual that banks are often called financial (or credit) institutions by scholars and non-scholars alike. Institutions, not firms. Firms are business enterprises in the sense of organizations engaged in 'making, buying or selling goods, or providing services in exchange for money.'[1] Institutions are organizations that serve a social purpose.[2] Thus money, government, and marriage are institutions. The reality that banks are commonly called institutions indicates the importance of their relations with other social institutions or entities such as government agencies and policies, interest groups, firms, social organizations, and households. However, standard approaches to banking theory and empirical studies of banks and banking systems treat banks exclusively as financial firms, such that the expression 'banking firms' often prevails. In contemporary banking studies, banks are *theorized as* profit maximizing financial firms. There is no doubt that banks (retail deposit institutions)[3] are almost always incorporated entities. Banks are, indeed, firms. But, the hypothesis presented in this paper is that banks are more than firms. Banks are also, and above all, institutions.

The tendency to see banks exclusively as profit maximizing firms introduces a *corporate bias* into analyses of banks with two important consequences. The first consequence is theoretical: Thinking of banks exclusively as financial firms makes it impossible to develop a more complete account of the origin, evolution, behavior and performance of banks and banking systems. In particular, as we argue in the next section of this paper, it prevents core advances in contemporary banking theory (qualitative asset transformation theory, inter-temporal risk smoothing theory, monetary theory of banking) to come to full fruition. The first (perhaps overly ambitious) aim of this paper is to disentangle the kernels of sound banking theory from the restrictive shell hardened by the corporate biases in contemporary banking theory.

The second consequence of the corporate bias in banking theory is practical and concerns banking regulation and policies. There are at least two strong relationships between banking theory and bank regulation. First, significant portions of banking theory include regulation in theorizing. For instance, the existence (or not) of deposit insurance informs theories of liquidity creation by banks (Diamond and Dybvig, 1983). Similarly, theoretical arguments about the 'uniqueness' of banks and bank loans are based on the existence of reserve requirements (Fama, 1985). These aspects are, already, an important signal of the institutional nature of banks. Second, the design of banking regulations by governments and international institutions has been, historically, strongly influenced by core ideas (and biases) in contemporary, capital market- and firm-based banking theory. There is, in other words, an important degree of performativity in banking theory. Flaws in contemporary banking theory such as the redefinition of banks as financial firms have had a detrimental impact on banking regulation. Several critical regulatory failures that have been identified at the root of the 2008 global banking crises can be attributed to the consistent incorporation, at the level of policies and regulation, of biased reasoning and skewed findings in contemporary banking theory and studies.

It is true that a significant process of re-thinking among bank theorists and policy-makers has occurred in the aftermath of crisis. 'Too big to fail' banking institutions, excessive diversification at bank level, and excessive homogeneity at industry level have been consistently raised as sources of macro-prudential risks and informed post-crisis regulatory reforms in the United States, United Kingdom and other countries. However, a corporate bias persists in both reassessments of banking theory and in debates about regulatory reform. We submit that the

[1] According to the Merriam-Webster definition of 'business'.
[2] These are temporary definitions. Further discussion of firms and institutions follows.
[3] Investment banks, therefore, will not be considered here.

serious problems that still plague banks and banking systems in many countries cannot be addressed unless this corporate bias in banking theory is removed.

The profound changes in banks and banking over the past decades do indeed require 'new conceptualizations of banking' (Berger et al., 2010). However, the 'new' concepts that have been proposed seem to draw on the very same problematic building blocks in financial intermediation theory as it emerged during the 1980s and 1990s (discussed below). And the assumption that recent transformations of banking imply that traditional concepts and theories about banks have become obsolete is debatable. For instance, Hardie and Howarth suggest that 'market-based banking' represents a significant new turn in the history of banking. However, such transformation echoes an observation by Knut Wicksell in the late 19th century: 'In our days banking and stock exchange activities merge into one another more and more as a medium of exchange and payment' (Wicksell, 1978: 73).[4] In this respect, both critical and mainstream accounts of banks have simply elevated longstanding practices of money-center banking and finance into a supposedly universal theory of banking. This fails to account for other types of banking institutions such as cooperative banks, government savings banks, and government special purpose banks that remain essential parts of many banking systems. It also fails to accurately place all banks in their social, political and economic contexts and explain institutional aspects of banking.

Our goal in this paper may appear similar to efforts undertaken by scholars and activists to re-think banking and redefine credit institutions as social banks or sustainable banks. However, ironically, these efforts may actually detract from and undermine a more fundamental reconsideration of banking theory which we suggest is urgently needed. This is because social or sustainable banks are usually identified on the basis of certain distinctive characteristics observed in a limited number of (usually small) banks. This may have the unintended consequence of marginalizing these questions to a very limited sphere where, here and here alone, banking may be practiced with more regard to ethical values or social objectives (Weber and Remer, 2011).[5]

This is not the approach chosen here: what we aim to do in this paper is to re-consider the ontology of banking that underlies both contemporary financial intermediation theory and ideas behind bank regulation. By drawing on institutional theories and a broader historical perspective we propose a new ontology of banking. The rich variety of concepts, theories and methods from new institutional theories promise to better explain the origin, evolution and recent performance of banks. Institutional banking theory should also lay the ground for a more radical regulatory overhaul that we see as necessary to encourage more stable and sustainable banking systems. In this sense, our argument is close to hypotheses put forward by legal scholars such as Pistor (2013) and Black (2013).

The following section clarifies the corporate bias in contemporary banking theory and its consequences. Section 2 brings a historical perspective to illustrate the institutional nature of banks and the institutional foundations of competitive advantage in banking. Section 3 presents our proposed analytical framework for institutional banking theory while section 4 draws out the

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[4] The original (Swedish) version of volume two of Wicksell's *Lectures on Political Economy* appeared in 1906 and was first translated into English in 1934.

[5] To re-formulate our position with regard to the works cited here: our aim is not to depreciate their contribution to contemporary debate about banking; rather, our view is that a more constructive theoretical effort should aim at re-thinking banking as a whole rather than further legitimate the constitution of enclaves within banking to the effect that while certain banks are ethical, it is perfectly OK for others (the non 'social' banks) not to be. In a previous work, we did explore the too little known world of what we then called 'alternative banks' (Butzbach and Mettenheim, 2014). Alternative banks were defined precisely in contrast with for-profit banks; but such contrast was not an ontological, and certainly less a normative one: in our view, alternative banks are more likely to embody, in practice, a more sustainable model of banking because their mission, their governance and their historical inheritance make them less susceptible than joint-stock banks to forego their institutional mission.

positive and normative implications of this paradigm shift for studies of banking and core ideas about bank regulation.

1. From intermediation theory to banking theory: imperfect information and neo-classical foundations

Contemporary banking theory is, first and foremost, a theory of financial intermediation welded to monetary theory. Indeed, an important impulse to contemporary financial intermediation theories was given in the 1960s by neo-Keynesian theories of money collectively known as the 'new view' of money and finance, associated with Tobin (1963) and Gurley and Shaw (1960). In a nutshell, these theories proposed to revisit postwar models in monetary theory by incorporating the active role played by (commercial) banks in creating money (Towey, 1973) and emphasizing the important role played by banks in transforming assets in the economy (Gurley and Shaw, 1990). Soon, however, as discussed below, monetary aspects of banking were sidelined in the literature on financial intermediation.

A more lasting impulse to contemporary financial intermediation theory was given by theories of information asymmetries (Leland and Pyle, 1977) and transaction costs (Benston and Smith, 1976).[6] As Leland and Pyle argued in their seminal paper, financial intermediation in general (not only banking) can be seen as a 'natural' response to information asymmetries (Leland and Pyle, 1977). At the same time, Benston and Smith conceived of financial intermediaries as firms that create specialized financial commodities, and whose *raison d'être* originates in the transaction costs inherent to financial transactions (Benston and Smith, 1976).

In 1980, Baltensperger noted that most theoretical works on banking in previous decades had indeed emphasized information problems (Baltensperger, 1980). A focus on transaction costs and information asymmetries continued to inform most work on financial intermediation theory in the two decades that followed; from Stiglitz and Weiss' landmark study on credit rationing (Stiglitz and Weiss, 1981) to Diamond´s much cited theory of banks as delegated monitors (Diamond, 1984). It is understandable, therefore, that syntheses of the literature in the early 1990s would focus primarily on information problems to explain the origins, nature, and functions of financial intermediaries and banks (Allen, 1990; Bhattacharya and Thakor, 1993).

However, research during the 1990s began to re-dimension the two original pillars of financial intermediation theory. For instance, Allen and Santomero pointed out that 'the decline in frictions [on financial markets, since the 1970s] which were allegedly the market imperfections that led to a need for intermediation services has not reduced the demand for them' (Allen and Santomero, 1998). Information asymmetries and transaction costs were not, therefore, apt theoretical representations of what financial intermediaries were actually doing in the decades since these two theories developed. Allen and Santomero proposed a focus on risk management and 'participation costs' to explain the nature and role of financial intermediaries; a more critical stance in financial intermediation theory that appears, today, to have been even more vindicated by the global financial crisis and its fallout. In other words, financial intermediation theory must draw on more than theories of information asymmetries and transaction costs. However, the corporate bias in contemporary banking theory that sees banks exclusively as profit maximizing

[6] The fact that most of the literature subsequent to the works of Leland and Pyle (1976) and Benston and Smith (1977) does not mention the macroeconomic, Neo-keynesian origins of financial intermediation theory is symptomatic, not of the irrelevance of the latter, but of the sidetracking of macroeconomic concerns in the microeconomic theories of banking, that is, until very recently (the 2008 crisis).

financial firms has proved an Achilles heel that keeps financial intermediation theory from developing in this direction.[7]

To sum up roughly, banks are seen in this perspective exclusively as financial intermediaries between the needs of savers/lenders and investors/borrowers. According to contemporary financial theory, financial intermediaries exist because of their superior ability and higher degree of efficiency with which they fulfill key functions in an economy characterized by imperfect information: Processing and transforming risk on the one hand and producing information on the other hand. This special ability of financial intermediaries arises because of imperfect information and imperfect markets. As Scholtens and van Wensveen put it, for theories of financial intermediation, financial intermediaries exist 'by the grace of market imperfections' (Scholtens and van Wensveen, 2000: 1245). We will come back to this point shortly, as this provides a first hint on the corporate bias of financial intermediation theory.

Of course, not all financial intermediaries are banks.[8] For instance, in discussion of information asymmetry theory as a component to financial intermediation theory, Allen specifies that such theory 'corresponds better' to firms such as mutual funds – not banks (Allen, 1990). Banks are a special kind of financial intermediary with a unique balance sheet structure.[9] In the case of deposit accepting banks, they are financial intermediaries with a monetary role. This, by itself, should have kept the study of banks and banking anchored in institutional premises (given that money is a social institution). However, this has not been the case, at least in mainstream financial intermediation theory. Indeed, the 'uniqueness' of banks, when it is acknowledged in the literature on financial intermediation, is related to the fact that their assets and liabilities are affected by specific regulations (such as deposit insurance or reserve requirements, see Fama, 1980 and 1985); and not due to the nature of what they do.

Contemporary financial intermediation theory thereby develops a functional ontology of banks: banks exist to fulfill certain functions that are instrumental in making modern economies work. From this perspective, three key functions are fulfilled by banks: (i) the provision of liquidity for the economy (liquidity creation; see Strahan, 2010); (ii) the production of information and monitoring services (Diamond, 1984); and (iii) the transformation of risk (see Allen, 2000). Each of these functions has given rise to a vast literature in well-recognized fields of inquiry. The first two functions were subsumed into a broader role of 'qualitative asset transformation' (Bhattacharya and Thakor, 1993); a category that has been widely used since.

By contrast, the transaction facilitating function of banks (what Bhattacharya and Thakor call banks' 'brokering role') has been ignored by the literature on financial intermediation. Furthermore, the role of banks in facilitating payments is also not central to the theoretical understanding of payments systems by economists (Humphrey and McAndrews, 2010). Thus banking theory (that is, financial intermediation theories of banks) has almost exclusively focused on the information transmission role of banks. This indicates the continued influence of theories

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[7] For example, in successful textbooks such as Matthews and Thompson (2008), the theoretical bases of financial intermediation predominate. In addition, Allen and Santomero explicitly reject an 'institutional' approach to understanding financial intermediaries, somehow related to what we are attempting here, in favour of a 'functional' approach, on the basis that, in their words, 'over long periods of time functions have been much more stable than institutions' (Allen and Santomero, 1998: 1465-1466.) Our take on institutions is different, and our hypothesis is that the institutional features of banking are as old as their functions. More on that below.

[8] It is important, for our purpose here, to acknowledge that, first, banks are not the sole organizations performing the tasks identified above; and, secondly, that the actual role banks play with regard to these functions empirically vary across countries (and across time). For historical and institutional reasons, certain financial systems are more 'bank-based' (for instance, Germany) than others (for instance, the United States; for a good comparison see Allen and Gale, 2001).

[9] 'Illiquidity of assets provides the rationale both for the existence of banks and for their vulnerability to runs.' (Diamond and Dybvig, 1983: 403).

about information asymmetry; banks are seen largely in terms of their ability to generate and transmit information from and about borrowers. Information-laden theory has led authors to see banks as, alternatively, delegated monitors (Diamond, 1984), coalitions of information-sharing agents (Boyd and Prescott, 1986), and screening devices (Stiglitz and Weiss, 1990).

The corporate bias in contemporary banking theory

At the beginning of contemporary financial intermediation theory, Benston and Smith expressed their agreement with authors who criticized the then prevalent view of banks as passive conduits of monetary policy: 'since financial intermediaries are *firms*, they should be analyzed with the microeconomic tools that have been employed to analyze other industries' (Benston and Smith, 1976: 215; italics added). This is, indeed, what ensued. In mainstream banking theory, banks tend to be modelled as business enterprises seeking to maximize utility; utility being defined as profit or revenue. This is the basic premise of Klein's famous model of bank behaviour (Klein, 1971). This assumption of revenue maximization was borrowed from neo-classical models of the banking firm prevalent at that time. Although subsequent critics such as Baltensperger argued that Klein´s model ignored resource costs (Baltensperger, 1980), the neo-classical assumptions of the model never came under question. In this respect, institutional theory provides opportunities to reassess this limited conception of banks as financial firms.

A second manifestation of the corporate bias in contemporary banking theory can be seen in heuristics used to explain the emergence of banks and financial intermediaries: Economic agents with different needs (for instance lenders and borrowers), *form* a bank to solve problems that arise from uncertainty or imperfect information. Such idealized, bottom-up, functional accounts may explain the existence of firms;[10] but it is not consistent with the institutional nature of banks, at least if one considers institutions outside of the North-Williamson "new institutional economics" framework (where institutions can be, indeed, endogenously generated from repeated transactions between economic agents).[11] This is the case in most theories of banks as solutions to information collection problems (Diamond, 1984; Diamond and Dybvig, 1984; Boyd and Prescott, 1986; Stiglitz and Weiss, 1981 and 1990). The historical methods associated with institutionalism provide a more accurate and more complete account of the emergence and evolution of banks.

A third manifestation of the corporate bias in banking theory is that the role of banks in money creation is downplayed or disregarded. By contrast with the information production focus of a good part of the literature, some authors have insisted in associating the 'uniqueness of banks' (to paraphrase James) with specific characteristics of transaction services provided by banks, either on the asset or liability side (James, 1987; Fama, 1980 and 1985; Stiglitz and Weiss, 1990[12]). However different these views are, they nonetheless ignore institutional dimensions of banks. Fama builds on neo-classical financial economics to argue that banks are but passive portfolio managers; 'the maintenance of a system of accounts in which transfers of wealth are carried out with bookkeeping entries' (Fama, 1980: 39). Banks embody a moneyless or a purely nominal monetary economy. Indeed, while 'unregulated banks' do not have anything to do with money, 'in practice, however, banks are forcibly involved in the process by which a pure nominal commodity or unit of account is made to play the role of numeraire in a real world monetary

[10] Even if this is questionable too: See Biondi et al., 2007.

[11] As will be made clearer below, our conception of institutions draws on neo-institutional traditions in sociology and political science, which are fundamentally at odds with NIE.

[12] Actually, Stiglitz and Weiss establish a rare connection between information production and transaction facilitation teorie of banking: banks' screening and monitoring function is presented by them as a further specification of banks' monetary role (Stiglitz and Weiss, 1990).

system.' (Fama, 1980: 40). Such extreme views have been long questioned in the financial intermediation literature (see Allen and Santomero, 1998) – but, once again, not on the grounds of their view of banks as firms. Other authors see the importance of bank liabilities as a monetary medium of exchange as dependent on the cost of transactions (Santomero, 1984).

Neo-Keynesian monetary economists have, in the tradition opened by James Tobin decades earlier, placed banks at the heart of monetary policy (Stiglitz and Weiss, 1990), thereby sharing premises of the vast literature on credit channels in monetary policy (for an early example see Blinder and Stiglitz, 1983). However, this also failed to produce a re-conceptualization of banks as institutions. On the contrary, this innovative line of research in monetary economics became, over time, completely separate from research on banking. A broader institutional theory of banking may capitalize on recent advances in monetary economics to account for the causes and consequences of banking in business cycles and as agents of adjustment policies through credit and interest rate channels.

Further problems arise because empirical studies of banking also use neo-classical theories of the business firm in the form of principal-agent theory and property rights theory. This is the case of studies that compare the performance of different types of banks such as La Porta et al (2002). Similarly, Berger et al (2005) use differences in bank size to explain varying capacity to perform relationship banking by drawing on the Grossman, Hart and Moore paradigm. Strong claims about the superior performance of private banks and shareholding governance have proven excessive, flawed both because statistical inferences from aggregate cross national data tend to conceal rather than reveal causal processes and because the severity of the 2007-8 crisis has produced a (critical) reassessment of profit maximizing strategies at banks.

To sum up, the empirical and theoretical literatures on banks see banks as interconnected entities; entities deeply involved with the functioning and the maintenance of key economic institutions such as money. In many ways, therefore, contemporary financial intermediation theory may help to develop institutional banking theory. However, it systematically fails to do so because banks are treated exclusively as firms.

2. An institutional theory of banking – a few propositions

If banks are to be seen as institutions, what kinds of institutions are they? What would an institutional theory of banking look like? At the outset of this paper we defined institutions[13] as organizations with a social purpose in contrast to profit maximizing firms. This definition requires two specifications. First, we must establish the institutional characteristics of banks and banking, perhaps best seen as a question of micro, meso and macro levels of analysis or, perhaps, in terms of universals and particulars. The distinction between large banks and banking systems is much less sharp than the dichotomy between "general social rules" and "institutional arrangements" that informs both old and new institutional economics (Rutherford, 1993: 182, note 1). This is because many banks tend to be so large that phenomena on the organizational or micro level of analysis tend to produce consequences on the meso or macro levels. Banking, as a general institution, is in any case enacted locally by banks, as particular institutions. However, the set of functions attached to banking can be performed only in a systemic way. Banks are not stand-alone entities: they function within a broader network of banks (the banking system) as described in proposition 2 below.

[13] As organizations, not as general principles; in this respect we might speak more accurately of banks as institutional organizations or, more simply, organizations.

The second specification concerns what we mean by institutions. By choosing to give a content-definition of institutions, we did not mean to ignore the constitutive element meant by most social scientists when they speak of institutions as ***sets of rules***. Banks and banking, as institutions, are also a set of rules; rules concerning the granting of credit; rules concerning the creation of liquidity and reserves; rules concerning the rights of depositors and individual savers; rules concerning corporate cultures and governance. However, theories of institutions as sets of rules vary widely, from the "rules of the game" as theorized in new institutional economics to broader definitions as "humanly devised constraints that shape human interaction" (North, 1990: 3). We suggest below that the wide variety of such views of institutions may best be dealt with through a division of intellectual labor among sister disciplines of economics, sociology and political science whose different theories, concepts and methods are best able to capture broader institutional phenomena.

The following propositions help map a tentative framework for developing an institutional theory of banks and banking.

Proposition 1: *Banks are* ***particular institutions*** *whose twin social function is to make the credit and monetary systems work.*

This proposition implies a shift in theoretical emphasis and methodology away from methodological individualism as applied to corporate firms and from utility functions as a basis for modeling bank behavior.

Proposition 2: *Banks are* ***highly connected*** *with each other and form, therefore, an* ***institutional system*** *whose interdependencies are constitutive of the particular nature of individual banks.*

Proposition 3: *given their central role in the monetary system, banking institutions are* ***organically tied to the state*** *as a universal institution.*

Proposition 3 does not imply that we should embrace Knapp's state theory of credit or neo-chartalist views of banking formulated a century ago; however, it does imply that we cannot conceive of banks in a context devoid of state institutions and government policy; and that relationships with state regulations and public agencies are constitutive of banking.

Proposition 4: *The theoretical building blocks of contemporary financial intermediation theory are valid, for banking theory, as long as they are consistent with Propositions 1, 2 and 3.*

The following section explores the implications of these four propositions through a review of the different types of banking institutions that have emerged in history to retain significant market shares in many banking systems today.

3. Banks in institutional-historical perspective

A historical institutional approach to the origin, evolution and performance of banking suggests that, in addition to private banks that are exemplars for contemporary banking theory, a succession of different types of banking institutions appeared in the past and persist today. First, during the 15th century, Monti de Pietá pawn and savings banks emerged throughout Italian states, often as the consolidation of pawn institutions managed by religious orders that date further back in history. Second, in the late 18th and early 19th century, savings banks grew out of

municipal savings agencies and philanthropic initiatives first in Northern Germanic states then quickly throughout Europe. Third, amidst economic crisis, hunger and the 1848 revolutions, cooperative banks were founded by protestant and catholic movements in German speaking regions to share risk and provide credit to farmers and others not served by private banks and largely urban savings banks. Fourth, after the Credit Mobilier mobilized capital in France to accelerate industrialization in the 1820s, development banks and special purpose banks were founded by governments across continental Europe during the 19th century and developing countries in the 20th century. Fifth, after the UK post office savings bank was founded in 1862, governments across Europe used the branch office networks of postal services to mobilize popular savings for public finance; both at home and in colonial holdings. Five types of banking institutions thereby emerged differently than the account of commercial banks and merchant banks that tends to be the exclusive focus of contemporary banking theory, a bias that has been shared by most critical studies of banks and financialization.

A historical institutional approach also helps explain how these different types of banks acquired institutional foundations of competitive advantage. Recent studies of alternative banks (i.e. non-joint stock banks) suggest seven institutional foundations of competitive advantage; stakeholder governance, two-tier organizational structures, long-term profit sustainability orientations, relationship banking, greater trust, and lower cost of capital. Tracing the growth of these different types of banks across time reveals how they developed institutional solutions to agency risks, transaction costs, liability risk, and other matters at the core of banking theory. Empirical studies of balance sheets, annual reports and public documents of these banks suggest the following observations about banks as institutions.

Savings banks emerged with strong roots in local communities, political movements and public agencies.[14] Cooperative banks were created by the Raiffeisen and Schultz-Delitz social and religious movements. Savings banks and credit cooperatives thereby acquired, over time, powerful competitive advantages in terms of retail networks and relational banking in local communities. Independent local savings banks and cooperative banks then created a second tier of shared joint operations for giro payments and wholesale banking services to reduce costs, increase scale and manage risks.[15] The social missions of savings banks and cooperative banks also sustained socially oriented corporate cultures and long-term profit sustainability orientations that helped to manage risks and avert losses in capital markets.

The lean organizational structure of development banks created by Continental European governments provided a different competitive advantage. Without expensive branch office networks or large staff and operational costs, and with access to official savings and other sources of capital at low or zero cost, special purpose banks were able to direct credit to strategic economic sectors at below market rates, a powerful comparative advantage for Continental European policy makers and governments.[16] Special purpose banks multiplied the resources available for public policies to help alleviate fiscal constraints. A core idea about banks is that they are uniquely able to multiply money. It follows that development banks were, and continue to be, uniquely able to multiply funds for public policy.

Four different institutional theories about these historical trajectories promise to expand the scope of inquiry of banking theory. The first is social economy. For theories of social economy,

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[14] This section draws on material in "Alternative Banking History", K. Mettenheim & O. Butzbach in Butzbach and Mettenheim, (eds). (2014). *Alternative Banking and Financial Crisis*. London.

[15] On the second tier of cooperative banks, see: Guinnane, T.W. 'Delegated Monitors, Large and Small: Germany's Banking System, 1800-1914.' *Journal of Economic Literature*, (2002), 40(1): 73-124

[16] Aghion, B. 'Development Banking', *Journal of Development Economics*, 58 (1999), pp. 83–100. Diamond, W. *Development Banks*. (Baltimore, MD: Johns Hopkins University Press, 1957). Zysman, J. Governments, Markets, and Growth: Financial Systems and Politics of Industrial Change. (Ithaca, NY: Cornell University Press, 1983).

savings banks and cooperative banks are institutions that were founded to help farmers and others not served by private commercial banks. Special purpose banks are institutions that were founded as agents of national or regional development and financiers of public policy. From the perspective of theories of social economy, these banks are not designed to maximize profits. These institutions were founded to assist those excluded from banking and grew as they realized this mission. Savings banks and cooperative banks should therefore be evaluated by the degree to which they help excluded groups to accumulate savings and obtain credit, finance and other banking services. Similarly, special purpose banks should be evaluated by how they contribute to development or their specific policy mission.

The second insight from institutional theory is that of political capture. Savings banks and cooperative banks were founded with social missions. However, once these institutions obtained substantial market shares in domestic banking systems, their liabilities and assets, policies and investment capacity attracted the attention of monarchs and politicians. Italian savings and pawn banks were used in the 18th century to finance war and defeat revolutions. Postal banks were used in the 1890s and 1900s to bypass parliament and provide funds for imperial expansion and war. Savings banks and cooperative banks helped mobilize savings to purchase government bonds, most notably to finance military mobilization during the first and second world wars. In the 1920s and 1930s, fascist movements and governments took over cooperative banks and savings banks. Political capture thus haunts the history of many banking institutions.

A third group of insights from institutional theory comes from banking theory proper. Banking theory clarifies how banking institutions must perform adequately as banks to realize their social and public policy missions. Banking theory often provides powerful micro explanations for why alternative banks succeed or fail. Fundamentals from banking theory about asset and liability management, corporate governance, balance sheet mismatch, credit risk, liquidity risk, and further concepts about agency costs and transaction costs are particularly helpful to explain how balance sheets grew and new bank strategies, rules and procedures emerged historically as institutional responses to central problems of banking.

Fourth, theories of institutional foundations of competitive advantage in comparative political economy promise to extend banking theory to include the broader social, political and public policy settings of banks. To date, most research in this tradition has focused on firms or organizations such as labour unions or industry associations rather than banks (remarkably, just as the debate about bank-centered versus market centered financial systems raged in neighboring comparative financial economics). Concepts and theories about institutional foundations of competitive advantage nonetheless appear especially promising to explain how savings banks, cooperative banks and special purpose banks have acquired competitive advantages over private banks. Because of the greater trust of clients, consumers and depositors, alternative banks are able to manage liability risk and avert runs on deposits better than private banks. Because of their presence in social and political networks and government policy making, alternative banks retain further competitive advantages in relational and retail banking. Again, the small central offices of special purpose banks provide cost advantages over private banks forced to retain large bureaucracies and expensive branch office networks. And while savings banks and cooperative banks often remain smaller independent local and regional banks, they nonetheless reduce costs, achieve scale and scope, and improve control of risk and management by *sharing* wholesale banking operations and other services. A note on the historical development of each of these types of banking institutions is in order.

Monti de pietá

Savings and pawn banks emerged across medieval Italy as the consolidation or expansion of charitable institutions of the church. Recent research dates the development of monte di pieta during the 15th and 16th century alongside the development of merchant banking and commercial banking in Italy well before the emergence of modern banking in Northern Europe.[17] The monte di pietà were encouraged by the church, despite concerns about usury, because the endowments and savings held by these institutions sustained operations and provided viable alternatives to moneylenders, often Jewish, that dominated pawn services and savings and credit in medieval Italy. By the 17th and 18th century, monte di pietà had accumulated significant capital reserves and large deposit bases and became important sources for mortgage lending and public finance. For example, the Bank of Naples became primary source for lending to elites and the King of Naples for defeat of revolts during the 18th century, most markedly the 1799 revolution.[18] Savings and pawn banks survived fascism and war to shape the post-war social economy of southern Europe and have been reformed in a variety of ways since 1990 amidst European integration toward a single currency, unified bank regulations, an open market for banking and transformation into joint stock banks; the latter modified to ensure funding of social missions through the creation of savings bank foundations to hold shares from privatizations.

Savings banks

The second institutional innovation in banking treated herein is the emergence of savings banks in the late 18th and early 19th century across Northern Europe created by local public agencies and social and religious movements.[19] Savings banks left a written record of founding ideas, social missions, organizational strategies, balance sheets and the social composition of clients. These institutions grew to obtain large market shares of banking in many European countries during the 19th century and remain central to social and political economy thereafter. The first savings banks were often philanthropic entities or benevolent associations and linked to protestant or catholic churches. Later, savings banks tended to be created within municipal administrative entities or as municipal corporations backed by legal guarantee of operations. District savings banks (*Kassen der Kreiskommunalverbande*) were created first in Prussia then throughout German states by district associations that pooled guarantees from local governments. During the 19th century, savings banks accumulated savings, credit portfolios and reserves to become central players in banking throughout German states.[20] From 1839-1913, the increase from 85 to 1,765 Sparkasse savings banks with over 14 million savings accounts holding over 13 billion marks indicates how local and regional savings banks emerged to become one of three pillars of banking system in Germany.[21]

Sparkasse savings banks were designed with social missions and mandates to contribute to the improvement of lower and middle classes. Credit was to be directed to the same classes that deposited savings.[22] Legal mandates reaffirmed the social mission of savings banks throughout the 19th century. However, two developments cast doubts about the ability of savings banks to fulfill social mandates. First, the influx of large deposits was seen as usurpation of these institutions by

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[17] Bergier, J. 'From the Fifteenth Century in Italy to the Sixteenth Century in Germany: A New Banking Concept' in *The Dawn of Modern Banking*, (Los Angeles, CA: UCLA Center for Medieval and Renaissance Studies, 1979).
[18] Simone, E. *Il Banco dela Pieta di Napoli*, *1734-1806*. (Naples: Arte Tipografica, 1987).
[19] Vogler, B. (ed). *L'histoire des caisses d'epargne Europeenes*, (Paris: Les editions de l'epargne, 1989-98, 5 editions). Mura, J. (ed.). *History of European Savings Banks*. (Stuttgart: Steiner Verlag, 1996).
[20] Ashauer, G. *Von der Ersparungscasse zur Sparkassen-Finanzgruppe: Die deutsche Sparkassenorganisation in Geschichte und Gegenwart*. (Stuttgart: Deutscher Sparkassenverlag, 1991).
[21] See Schmidt et al.
[22] Prussian regulations of savings banks in 1838 stated: 'It must be remembered that the institution is intended primarily for the needs of the poorer classes, in order to extend to them the opportunity for depositing small savings. Any deviation from this policy must be avoided' (Seider, 1908, p. 350)

upper classes and capitalists in search of safe, often guaranteed deposits. Second, the investments of Sparkasse savings banks appear often strayed beyond lending to the lower and middle classes, becoming important sources for small and medium businesses and government bonds and public finance.

Early in the 20th century debate ensued about whether savings banks had strayed from their social missions to become deposit banks for the middle class and capitalists.[23] Evidence turned on the evolution of the average value of savings deposits over time. In 1908, Seidel calculated the increase of average value of deposits at Sparkasse savings banks from 195.4 - 909.4 marks 1850-1913 to see if this increase can be explained by compound interest over time or, instead, by an increase in the values deposited.[24] For Seidel, 909.4 marks remained just *below* the 925.82 marks that would have accumulated exclusively from compound interest of 2.5 percent per year 1850-1913. Moreover, if, on average, depositors were to deposit and additional 20 marks of savings per year 1851-1913, this would bring the average balance of savings accounts to *3,916.3* marks, well above the 909.4 mark average reported in 1913. Seidel concludes that Sparkasse savings banks continued to serve workers and farmers rather than being dominated by larger depositors from the middle and upper middle classes or capitalists. Chapter eight traces the evolution of German Sparkasse and debates about these institutions as one of three pillars in German banking until today.

Cooperative banks

Credit cooperatives were founded by Raiffaissen and Schulze-Delitz social movements to support rural workers and farmers in the wake of crop failures and potato blight in 1846-7 and the economic crisis that followed.[25] The rapid increase in number of credit cooperatives (133-1245), members (31,603-746,058) and accumulation of assets (66 million – 1.7 trillion marks), credit (61 million -1.2 trillion marks) by 1915 suggest the importance of cooperative banks that retain large market shares across European banking systems despite liberalization, monetary unification, and crisis in the 21st century (Groeneveld, 2014). The growth of local credit cooperatives during the 19th century with traditional deposit-taking loan making balance sheets provided the basis for creation of shared wholesale and giro operations, a development that would remain a profound competitive advantage of cooperative networks. Unlike private banks forced to maintain both retail and wholesale networks, local and regional credit cooperatives in Germany shared the cost and reaped the benefits of central giro and other wholesale activities in specially created institutions with stakeholder governance structures and corporate cultures based on core values of cooperative movements. The single Prussian central cooperative bank served to centralize giro transactions, currency exchange, securities, inter-bank credit and other instruments across credit cooperatives in Germany, reaching over a billion marks on balance sheets by 1920. A full 46 other central banking operations were created by networks of credit cooperatives in other German provinces, summing to 472 million marks on balance sheets by 1920.

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[23] Sieder cites Rauchberg´s 'The Savings Bank Question' *(Sparkassenfrage)* published in the *Oesterreich Rundschau* that posed the following questions: 'Were the savings banks really losing sight of their original aim? Was that aim to be impressed upon them only through state interference? Which was more expedient: To force them back into the old rut, or let them develop in their newly adopted course?' Sieder, *op cit*, p. 68.

[24] Seider´s calculations are part of the US National Monetary Commission report available online from the St. Louis Federal Reserve Bank.

[25] Faust, H. *Geschichte der Genossenschaftsbewegung*. (Frankfurt: Knapp, 1977).

Data collected by the Bundesbank from 1876-1976 and additional sources going further back in time indicate the evolution of alternative banking business models and the acquisition of institutional foundations of competitive advantage. The growth of balance sheets at cooperative banks and savings banks suggest simple, stable and viable bank business models and institutional rules, procedures and strategies that value solid deposit bases (that reduces liquidity risk and funding costs) and *shared* wholesale operations that reduce costs for independent local and regional banks. Shared second tier operations provide scale and reduce costs while retaining local relational banking and other institutional foundations of competitive advantage in social and political networks.

Official postal savings banks

Savings banks and cooperative banks were founded by local public authorities and social and religious movements. Once established, the funds of these institutions attracted the attention of central governments that, in response, created official postal savings banks to compete with regional and local alternative banks. In 1840, this already struck Alexis de Tocqueville as a dangerous development:

> 'In some countries these benevolent associations [savings banks] are still completely distinct from the state; but in almost all they manifestly tend to identify themselves with the government; and in some of them the government has superseded them, taking upon itself the enormous task of centralizing in one place, and putting out at interest on its own responsibility, the daily savings of many millions of the working classes. Thus the State draws to itself the wealth of the rich by loans, and has the poor man´s mite at its disposal in the savings banks.[26]

Further study of the diverse national trajectories of savings banks, cooperative banks and postal savings banks is required. However, review of the secondary literature and comparative data collected by the US National Monetary Commission in 1910 suggest the following institutional dynamics of such banks in major European countries and colonies before 1913:[27]

1) Official postal banks tended to crowd out cooperative banks and regional and/or local savings banks by offering higher interest rates on savings deposits.
2) Deposits of alternative banks, especially postal banks, became an important source for public finance and funding for war.
3) National experiences differed. In Britain, France and Italy, official postal savings banks appear to have crowded out local savings banks. However, the Prussian Savings Bank Association vetoed creation of a similar national postal bank.

Founded in 1862, by 1908 deposits in the UK Postal Savings Bank reached over US$781 million and the number of accounts over 11 million (while traditional trustee savings banks retained below two million accounts). Postal savings banks were also founded in Belgium (1870), Japan (1875), Italy (1876), Netherlands (1881), France (1882), Austria (1883), Sweden (1884) and Hungary (1886) as well as colonies Australia (1863), (Canada, 1868), New Zealand (1867), New South Wales (1871), British India (1876), Ceylon (1885) and the Philippines (1906).

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[26] Tocqueville, A. *Democracy in America*. Vol. 2, 306-7. Cited in Wadhwani, R.D. 'Institutional Foundations of Personal Finance.' *Business History Review*. (2011), 85/3: 507

[27] National Monetary Commission. 'Notes on the Postal Savings-Bank Systems of the Leading Countries.' (Washington, DC: Government Printing Office, 1910).

The number of branch offices suggests the institutional breadth and reach of postal savings bank points of sale. In the UK, Postal Savings Bank offices reached over 15,000 by 1907, with other European governments recording similar branch office networks in per capita terms.

In France, savings banks (Caissed D´Epargne Ordinaires) were also crowded out by a new network of National Savings Banks (Caisses D´Epargne Nationale).[28] Founded in 1872, French National Savings Banks grew to 7,938 branch offices, 5.29 million passbook savings accounts and US$296.9 million in deposits by 1909. In comparison, ordinary local and regional savings banks retained just above two thousand outlets and fewer than a million passbook savings accounts.[29] Funds from the Caisse D´Epargne Nationale reached *one half* of French government receipts by 1882, peaking at *94 percent* of government receipts in 1899. The French national government postal savings bank also funded government through purchase of Credit Foncier Bonds and holding saving account deposits at the Bank of France and Treasury.

Although the Prussian savings bank association *vetoed legislation* to create an official postal savings bank in 1885 and 1905, Imperial Prussian Federal Cooperatives for agriculture were created in 1892 that appear to have crowded out local and Schulze-Delitsch cooperatives.[30] By 1906, members in official credit cooperatives surpassed one million, while members in Schulze-Delitsch credit cooperatives remained below 600,000. However, deposits held by Schulze-Delitsch credit cooperatives grew to over 180 million marks by 1906, far above the 20 million marks held in official cooperatives; with similar trends for credit provided by these institutions.

Moreover, as theories of policy capture in political economy suggest, postal savings banks also came to hold government bonds that the market refused. Offering higher interest rates on savings deposits combined with purchase of untradeable government bonds soon ate up capital reserves and produced losses, attracting attention from the press and parliament especially after deficits were reported in 1900.[31] Postal savings bank losses are explained by members of a Parliamentary Commission and observers as a mismatch of returns from investments in government bonds (imposed on the bank by Prime Ministers without parliamentary approval). And removal of a cap on the size of deposits in 1893 was seen to have produced an influx of large deposits that increased liquidity risk. According to the 1858 Select Committee on Securities:

> 'It thus appears that large financial operations have been carried on by means of the capital of savings banks, which was at the command of the Exchequer, in purchasing, selling and varying securities.'[32]

Gladstone clarified the consequences:

> 'This deficiency (the postal bank deficit), in truth, is a concealed portion of the National Debt, of which the House takes no cognizance in the course of its ordinary proceedings, and it is never brought before it as a portion of the national obligations.'[33]

While benchmark UK consol bonds had for some time paid 3 percent interest, during the 1880s rates declined to 2.5 percent; the same interest rate paid on savings deposits by the Postal Savings Bank.

For Prime Minister William Gladstone, the creation of the UK Postal Savings Bankwas designed to increase the power of finance ministers in money markets:

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[28] Christen-Lécuyer, C. *Histoire sociale et culturelle des Caisses d'Epargne en France 1818-1881*. (Paris: Economica, 2004). De Llamby, L. *Les métamorphoses de l'épargne*. (Paris: Gallimard, 2003).

[29] On passbook savings, see: Caisse des dépôts et consignations. *Le Livret A : une histoire de l'épargne populaire*. (Paris: Caisse des dépôts et consignations, La Documentation Française, 1999).

[30] Blomer, M. *Die Entwicklung des Agrarkredits in der preussischen Provinz Westfalen im 19. Jahrhundert*. (Frankfurt: Fritz Knapp Verlag, 1990). Thiolon, J.P. *Les Caisses d'Epargne*. (Paris: Berger-Levrault, 1971).

[31] Marks, A. *The Position of the Post Office Savings Bank*. (London: Clement Wilson, 1905), p. 23

[32] *ibid*, p. 36.

[33] *ibidem*, p. 38

> ‘It was necessary to provide for the savings of people with safety, cheapness and convenience… Behind this I had an object of first rate importance which has been attained, to provide the Minister of Finance with a strong financial arm, and to secure his independence of the City by giving him a large and certain command of money.[34]

The large deposits of the postal savings bank were critical for the government to reduce the interest rates paid by government bonds. However, this left a vast sum of non-liquid, non-marketable bonds in the portfolio of the post bank. And interest rates on bonds were not sufficient to meet obligation to savings depositors. The UK Postal Savings Bank thereby reported losses of 11 million pounds sterling in 1902.

A debate ensued in Parliament that remains relevant today. For Lord Moneagle, Exchequer 1835-9 and author of 1858 Select Committee Report on Savings Banks, the savings bank model is flawed because deposits flow into the bank during good times (when asset prices are high) but flow out during bad times (forcing the bank to liquidate assets when prices are low). Seidel differs about savings banks in business cycles:

> ‘A close scrutiny of the oscillation of deposits reveals the fact that there is always a counterbalance between the large and small deposits. At times of economic prosperity wages rise, and small deposits are predominant, since the large capitalists then find investments in commerce and industry more remunerative. Contrariwise, economic depression brings large idle funds into the savings banks and checks the small savings.’[35]

This cuts to the question of counter cyclical lending. Recent evidence suggests that Seidel may have been correct: Alternative banks appear to be counter cyclical in comparison to the pro-cyclical behavior of private banks (Schclarek-Curutchet, 2014).

Development banks and special purpose banks

Special purpose or development banks describe a variety of institutions that financed infrastructure and industrialisation across Continental Europe and in many developing nations.[36] Governments created special purpose banks to provide finance and credit on terms beyond the reach of private banks or markets. This suggests precisely the reverse causal direction asserted by theories of financial repression.[37] It is because private banks avoided long-term investments in infrastructure that Continental European governments founded development banks in the 19th century.[38] Development banks in Europe, in turn, became models for institutions such as the Industrial Bank of Japan and Industrial Bank of India.[39] Development banks adapted to the challenges of the 20th century. They were founded after World War I to provide cash, subsidised

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[34] Morley, E.J. The *Life of Gladstone*, (Toronto, George N. Morang, 1903). Vol. II, p. 52.

[35] Seider, *op. cit*., p. 354

[36] Aghion, B. ‘Development Banking’, *Journal of Development Economics*, 58 (1999), pp. 83–100 and Cummings-Woo, M. (ed.). *The Developmentalist State*, (Ann Arbor, MI: University of Michigan Press, 1999)

[37] ‘The existing commercial banks were unable to provide industry with long-term finance for two main reasons. First, they were unwilling to bear the inevitable risks associated with the financing of new enterprises. Second, they lacked the specialized skills required to deal with the higher risk long-term investments....’ Aghion, *op. cit*., p. 3.

[38] Sylla, R. ‘The Role of Banks’, in Sylla,R. and G. Toniolo (eds), *Patterns of European Industrialization in the 19th Century*, (London: Routledge, 1991), pp. 45-63. Aghion notes: ‘The oldest government-sponsored institution for industrial development is the Societe General pour Favoriser I’Industrie National which was created in the Netherlands in 1822. However, it was in France that some of the most significant developments in long-term state-sponsored finance occurred. In this respect, the creation in 1848–1852 of institutions such as the Credit Foncier, the Comptoir d’Escompte and the Credit Mobilier, was particularly important’, Aghion, *op. cit*., p. 3

[39] Diamond, W. *Development Banks*. (Baltimore, MD: Johns Hopkins University Press, 1957).

loans and guarantee of private bank bonds for industrial reconstruction.[40] After World War II, the Kreditanstalt fur Weidaraufbau (Reconstruction Credit Agency, KfW) and Japan Development Bank were created to channel Allied funds for reconstruction. Newly independent countries in Africa and Asia also created development banks to channel World Bank loans and foreign aid.[41] In the 21st century, old ideas about industry and infrastructure have been replaced by new theories of environmental sustainability, community development and human capital. Development banks also proved critical agents of counter cyclical lending after the global financial crisis produced credit crunches and downturns in these countries.

Institutional theories in political economy also draw attention to the downsides of development banking. Development banks may leverage large industrial groups with bank credit. This leads firms to avert going public through issues of equities.[42] The massive scale of political and economic interests associated with development banks often increase moral hazard and require costly bailouts. Development banks can protect outmoded industry, impede innovation and produce bad equilibrium. Large scale development projects are also notorious for their impact on the environment. Without transparency and democratic accountability, development banks may channel popular savings through obscure credit and finance operations and unfairly transfer the cost of risk through inflationary finance (that monetizes bad credit), or through government infusions of equity (that hides losses in government accounts). Development banks may indeed produce financial repression, rent seeking and unfair subsidies to industry, agriculture and service industries. However, we lack evidence. Despite their large size and critical importance in advanced and developing countries, development banks and special purpose banks have nonetheless failed to attract in depth case studies and academic research. In the face of this lack of evidence, institutional banking theory may provide alternative hypotheses to the dominant view of these banks in financial intermediation theory; that development banks cause financial repression.

In sum, four traditions in institutional theory provide promising research agendas to explain the emergence and evolution of banking institutions; social economy, political capture, balance sheet approaches, and the new institutionalism in comparative political economy. The 'back to the future' modernization of different types of banking institutions since liberalization and the information revolution that has fundamentally changed banking suggest that expectations of convergence toward private, joint stock banks are overestimated. Instead, the corporate missions, social insertion, public policy functions, and other institutional characteristics continue to define a wide variety of banks in the 21st century.

4. Institutional Banking Theory: Positive and Normative Implications

Institutional banking theory promises to build on contemporary banking theory by extending models beyond the narrow view of banks as profit maximizing financial firms. Institutional theories in economics help explain critical dimensions of banking. However, given that institutional realities necessarily involve social and political phenomena, a full account of banks requires use of further concepts and methods from institutional theories in sociology and political science. A wide variety of approaches, concepts and theories are available to explore the broader dynamics of banking. However, a core divide must be recognized. Since the work of Max Weber, a fundamental

[40] Aghion cites the Societe National de Credit a I'Industrie (Belgium, 1919), Credit National (France, 1919), 1928, National Bank, Poland, 1928), 1928, Industrial Mortgage Bank (Finland, 1928), Industrial Mortgage Institute (Hungary, 1928), 1933, Instituto Mobiliare Italiano (Italy, 1933), Instituto per la Reconstructione Industriale (Italy, 1933).

[41] 'Probably the aggregate resources provided by the development banks have been small, but the fact that there were made available at particular times for strategically important enterprises and industries gave them a significance far greater than the amounts involved suggest', Diamond, *Development Banks*, pp. 38-9.

[42] Cummings-Woo, M. (ed), *The Developmental State*. (Ithaca, NY: Cornell University Press, 1999)

difference has been recognized between social action based on economic calculations of utility and market prices, and other types of social action that cannot be explained by such calculations alone. This implies that institutional banking theory necessarily involves trespassing across economics, sociology and political science; *and* expanding the scope of inquiry beyond limited views of banks as profit maximizing firms.

Traditionally, banks were seen as deposit taking and loan making institutions that differed from other businesses in terms of the composition and character of assets, liabilities, governance, risk management, and performance. Since the 1980s, contemporary banking theory has redefined banks as firms specialized in financial intermediation between clients, money markets, and investment funds able to manufacture assets. Table 1 enumerates seven differences between contemporary banking theory that sees banks as financial firms and institutional banking theory proposed herein that brings different concepts and theories to the analysis of banks. Contemporary banking theory emphasizes shareholder governance, profit maximization, the manufacture of assets, strategies of leverage, quantitative methods of risk management on efficient financial markets, core ideas from the theory of financial intermediation and expectations that banks would converge toward market-based banking. In contrast, institutional banking theory emphasizes stakeholder governance, the production of sustainable returns over time, traditional, more conservative balancing of assets and liabilities, moderate leverage, the use of soft information and relationship banking, the reality of uncertainty and theories of institutions that combine to expect persistent variety in banking rather than convergence.

Table 1) Banks as financial firms versus banks as institutions

	Financial firms	*Institutions*
Governance	Shareholder	Stakeholder
Mission	Profit maximization	Profit sustainability
Business Model	Manufacture assets	Balance asset and liabilities
Strategy	Maximize leverage	Moderate leverage
Risk Management	VaR or risk model	Relationship banking & soft info.
Theory	Financial intermediation	Uncertainty and institutional theory
Expected Change	Convergence	Persistent variety

Institutional banking theory provides new perspectives on critical problems in the microeconomics and macroeconomics of banking. Historical and comparative institutional analysis may improve understanding of how banks manage liquidity risk and build trust that is essential for banking operations. Case studies and small n comparisons seem especially well suited to clarify how institutional rules and procedures in banks align incentives of owners, managers and staff through corporate cultures that go far beyond profit maximization. The research methods of institutional and organizational studies can explain how banks develop mechanisms to reduce transaction costs and agency costs. The time series data on bank balance sheets that are

increasingly available from banks and monetary authorities also provide opportunities to explain both the origin and evolution of banks in the past and current transformations underway as banks adapt to liberalization and adopt new technologies. Case studies and focused comparisons of banks also seem especially suited to explain how the institutional characteristics of banks use soft information and insertion in social and political life to realize competitive advantages. The large scale and scope of banks also appear to be institutional characteristics necessary for the macro functions of banks such as counter cyclical lending and shock absorption. This provides an analytic advantage. Although large banks are amenable to micro or organizational analysis, their size means that the effects of individual bank behavior and performance are often felt on the mezzo and macro levels.

Empirical studies of banks also suggest the persistence of diversity alongside processes of convergence. We are not advocates of nationalism. However, the consolidation of a select number of large domestic banks continues to be a priority for most governments and business communities. Despite the forces of globalization and the liberalization of many domestic banking markets, banking continues to be shaped, in this respect, by views of banks as institutions that are critical not only economic reasons but also for reasons of geopolitics and conceptions of national interest.

Bank change has also differed in another way. Instead of institutional convergence toward private bank practices, the revolution in information technology and the liberalization of banking has led to a 'back to the future' modernization of traditional banking institutions of all types and in many ways. Instead of convergence toward private banking, shareholder governance and market-centered banking (that was expected by critical and contemporary theories of banking alike), a wide variety of banking institutions have instead persisted since liberalization of the industry and the 2007-8 global crisis. In this respect, both critical theories of market based banking and contemporary banking theory appear to have elevated money center banking to universal theory, ignoring the institutional variety of banks that often continue to provide between one and two thirds of credit and banking services in many countries.

Institutional theory may renew the microeconomics and macroeconomics of banking and capture the wide range of developments that have redefined the industry during the last decades. Institutional theory may focus on banks as organizations to explain the origin, emergence and 'back to the future' modernization of large, longstanding traditional banks as they adapt to both more open competitive landscapes and the one hundred fold cost reduction may be realized with the implementation of new technologies. The latter begs for theories of industrial organization to be brought back into banking theory. Institutional theory may also improve understanding of the broader setting of banks, especially themes such as counter cyclical lending that banks, as institutions rather than profit maximizing firms in financial markets, may provide in order to both avert the formation of asset bubbles and ameliorate downturns once they burst. Theories of banks as public policy instruments belie erroneous charges of inefficiency in government banking to explain how special purpose banks may multiply budget lines to overcome fiscal constraints and improve contractual control and public accountability during public policy implementation. Institutional banking theory may also broaden views of financial inclusion beyond the corporate bias toward the private sector and capital market based microfinance that pales in comparison to both recent large scale initiatives in developing countries and past experiences with social banking in advanced economies.

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