

Banking Beyond Bucks

Citation for published version (APA):

Chalabi, J. (2019). *Banking Beyond Bucks*. [Doctoral Thesis, Maastricht University]. Maastricht University. <https://doi.org/10.26481/dis.20191107jc>

Document status and date:

Published: 07/11/2019

DOI:

[10.26481/dis.20191107jc](https://doi.org/10.26481/dis.20191107jc)

Document Version:

Publisher's PDF, also known as Version of record

Please check the document version of this publication:

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Research Impact

Two of the most pressing issues in the world are (i) climate change and (ii) the sustainability and stability of the global economy. In recent years, these two facets have become increasingly interlinked, with a strong push from both regulators and the public on companies and national economies to become ‘greener.’ Progress has been slow, but is gradually accelerating to a point where companies, particularly those in the public eye, are making real efforts towards sustainability.

Of course, the increased demand for sustainable practices is a business opportunity. Some companies take these opportunities and aim to actually offer sustainable products or services. Other companies put most of these investments towards the marketing budget, without making a real effort to improve their practices. The latter is often referred to as ‘greenwashing’ or ‘window dressing,’ the practice of making an unsubstantiated claim about the environmental or social benefits of a product or service.

The movement towards more environmentally friendly or sustainable services and practices has also reached the banking sector. Dutch examples include Triodos and ASN bank, who claim to be pioneers in “ethical banking.” More recently, 130 international banks, amongst which many Dutch banks including ABN AMRO, ING, and Rabobank signed on to the “Principles for Responsible Banking’, whose aim is “to help banks align their business strategies with society’s goals” as set forth in the Paris Climate agreement (UnepFi, 2019). According to UnepFi (2019), “the Principles provide a framework for sustainable banking, and help the industry to demonstrate how it makes a positive contribution to society.”

Chapter 2 of this thesis aims to investigate to what extent banks behave ethically, or sustainably, behind the scenes. That is, are these sustainable initiatives restricted to the consumer side of businesses that is visible to the public, or do they extend to the business-to-business operations of corporate lending? We analyze the interest rates firms pay on their large corporate loans, and in particular to what extent the rates differ for so-called “sin-firms,” firms in the alcohol, tobacco, and gaming industry, from all other firms. Against all expectations, we find that banks actually charge these firms less than their non-sin counterparts, suggesting that the portrayed public image of banks differs from their actions. From a purely business standpoint, it is not entirely surprising; many of these industries will perform well in any economic climate, making them less risky. This does however not explain the full discount they receive. An important footnote is

that our sample ends in 2014, preceding the acceleration of the green and sustainable boom. However, we find no evidence that the discount has reduced as time progressed in our sample, which started in the 1980s.

The chapter highlights that we should be more critical of business practices in the financial industry. The rates set by the banks do not reflect the full cost to society, and consumer banking is only a small part of their full operations. Recent initiatives such as green bonds, the Equator Principles, and the ‘Principles for Responsible Banking’ are a step in the right direction, but generally, sustainability and banking are still two concepts which are hard to integrate.

The second major issue is the stability of the global economy, which has been an almost continuous problem over the last decade. Starting with the financial crisis in 2008, followed by the European sovereign debt crisis around 2011, and more recently because of “Trumponomics” and Brexit. The severe magnitude of the first on this list was caused by underestimation of risk, and the resulting excessive risk taking of large financial institutions. When the risk materialized, Bear Sterns, and subsequently Lehman Brothers were insolvent, which triggered a worldwide financial crisis. In subsequent years, a regulatory push was made to address these shortcomings and prevent a similar event from occurring by the Obama administration. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was introduced in 2010. Unfortunately, many of these regulations have been reversed in the relentless pursuit for economic growth. In 2018, a decade after the global financial crisis destabilized the US economy, the US House voted a regulatory rollback on Dodd-Frank, which significantly waters down the Obama-era rules governing the banking industry in search of greater stability (Rappeport and Flitter, 2018).

The European Commission is also actively working toward sustainable finance. One of the main examples of this is the EU High-Level Group on Sustainable Finance (HLEG). It is involved in steering capital flow toward sustainable investments, identifying steps necessary to protect the financial system from sustainability risks, and deploying these policies on a pan-European scale. Among the issues the HLEG focuses on are credit ratings. The report writes “CRAs are systemically important institutions, and their risk assessment methods influence the sustainability and stability of the financial system.” The goal of the HLEG is to make the focus of these ratings less narrow and to include ESG information into credit ratings (European Commission, 2018).

Chapters 3 and 4 try to shed some light on some aspects of banks’ role in these events. The former investigates how banks assess the risk of their borrowers, and the role large Credit Rating Agencies, such as Moody’s and Standard & Poor’s, play in this assessment. We find that banks strongly rely on these outside assessments. Given the inadequacy of their risk assessments preceding the financial crisis this is somewhat troubling.

The second of these chapters studies how the banks’ core operations contribute to this risk. During the financial crisis, Lehman Brothers was injected with money by the gov-

ernment for the fear of a domino effect. The operations of banks are strongly intertwined through continuous collaborations, such that the failure of one bank may easily propagate to the next. We investigate one of these collaboration channels, the joint issuance of large corporate loans, and find that these offer a credible threat to financial stability. The loan portfolios of different banks are very similar, such that all banks may be faced with (the same) problems at the same time. After Lehman's failure, investors appear to be aware of this, and react strongly to large increases in this interconnectedness.

The two chapters highlight channels through which the bank impacts the economy beyond their own income statement. They play a crucial role in the economy and the risks they take therefore impact all of us.

Correspondingly, the analyses and conclusions put forth in this dissertation are of relevance to the broad public, but especially to regulators in charge of the banking sector's stability. Chapter 2 shows that banks are, almost naturally, primarily driven by pure profit motivations. Chapters 3 and 4 show that banks appear to have learned little from the financial crisis and have resumed their practices as before, some of which caused, or at least escalated, the crisis.

The conclusion is that banking still hardly looks beyond the bucks.