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Risk-taking by banks: the impact of founders' logics

Some banks embrace risk while others play it safe. Why? It's connected to financial or community logics, and the founder's shadow of influence can be long.

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Which factors create a risk-seeking or risk-averse culture in banking? A study of local banks

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in the United States by IESE's **John Almandoz** (published in *Administrative Science Quarterly*) explores their corporate priorities and values as influenced by their founding teams.

A key factor when it comes to risk, the study finds, is the founders' driving logics — be they financially or community focused.

With the financial crisis of 2008 laying bare the consequences of risky bank practices, research into the factors that lead banks to take on increasing levels of risk is timely and important. Understanding and managing the founding teams' motivations may help board members and regulators rein in risk going forward.

Local banks in the United States tend to be "hybrid organizations" that combine competing financial and community logics, as they vie with larger banks and pursue profits while serving community banking needs.

The founding teams of local banks are often made up of some people motivated by a financial logic (who see the bank as an investment vehicle and seek to maximize profit) and some motivated by a community logic (who are driven to meet community needs and focus less on profits).

Almandoz finds that where financial logics are better represented on founding teams, the bank is more likely to engage in risky activities. That risk profile is lower where community logics are better represented.

Note that these trends are especially evident when the founding teams are larger, consisting of 12 members or more.

Brokered deposits referred to as "hot money"

Between June 2006 and September 2009, 420 local banks were established in the United States. Almandoz examined 225 of those young banks via more than 2,100 documents to learn about the founding teams and the risk practices. Interviews were also conducted with 73 bank founders.

To learn about risk practices, Almandoz focused on the banks' use of brokered deposits — money the local banks received from outside brokerage firms rather than directly from their own customers' regular checking or savings account deposits.

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Brokered deposits were considered "a quick and easy way to fund growth," in the words of one interviewee. But they were also referred to as "hot money" because they entailed added risk, since these deposits were more likely to vanish or become much more costly in an economic downturn. Reliance on brokered deposits has become a red flag for bank regulators and a proxy for risk-taking.

In the study, the banks' risk profiles were defined according to their position on brokered deposits, and these results were then analyzed along with their founding members' backgrounds and associations.

Founders with financial careers (such as investment bankers, accountants or insurance providers) were counted as representing a financial logic. Those who were involved with many voluntary community associations (such as the Boy Scouts, Red Cross or country clubs) were seen to represent a community logic.

See also, "What are the logics driving your firm?"

The bigger the team, the stronger the group logics

Banks tend to be founded by groups of people, not lone individuals. The founding teams' stronger internal representation — be it financial or community — influenced their policies on brokered deposits.

Banks founded by more people with financial backgrounds tend to favor extensive use of brokered deposits. This reflects their interest in growing the business quickly, rather than waiting to build a local deposit base, because returns to investors are maximized when a bank reaches an appropriate size to sell faster.

By contrast, banks whose founders had more community involvement tend to shy away from such risks. More than short-term profit, they were motivated by the bank's capacity to enrich the local community. The emphasis was, therefore, on running the bank sustainably for the long term.

When banks had larger founding teams, group logics were felt more strongly. This may be in part because individuals on larger teams may feel less accountable in group decision-making.

Based on the statistical model he developed, Almandoz compares large teams, with 12 members, and small teams, with seven members.

On large teams, financially and community-oriented individuals seem to adjust their views to be more in line with what they see as the appropriate attitude based on their backgrounds. Previous studies suggest that individuals on larger teams may rely more on cues derived from stereotypical institutional logics and less on individual discretion.

On the flip side, when the group of founders was smaller, the effect of the founders' logics was much less pronounced in predicting the risk profile of the bank.

Applicability to other organizations with competing logics

Almandoz's paper contributes to wider questions about the management of hybrid organizations that serve competing purposes.

Like local banks, private schools and utility companies are examples of hybrid organizations that must contend with both profit-making and community obligations. How might the backgrounds of their founding members affect their business plans?

Meanwhile, back in the banking sector, there are many opportunities to do things better. Perhaps these insights about founding teams' alignment with driving logics can help assess their predispositions toward risk.

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