Selectivity and Transparency in Social Banking: Evidence from Europe

Simon Cornée, Panu Kalmi and Ariane Szafarz

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JEL Classifications: G21, L33, M14, L31, D63, D82

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Selectivity and Transparency in Social Banking: Evidence from Europe*

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Abstract

How do social banks signal their social commitment to motivated funders? This paper hypothesizes that two main channels are used, namely selectivity and transparency. We test these predictions using a rich dataset comprising balance-sheet information on 5,000 European banks over the 1998-2013 period. The results suggest that social screening leads social banks to higher project selectivity compared with mainstream banks. Social banks also tend to be more transparent than other banks. However, combining selectivity and transparency can result in excess liquidity. Overall, the empirical findings not only confirm our theoretical hypotheses, but also raise challenging issues on the management of social banks.

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1. Introduction

Social banks (SBs), sometimes called “ethical” or “alternative” banks, are hybrid financial intermediaries that fund community-oriented projects and social enterprises (Defourny 2001). They put the emphasis not only on financial returns, but also—and often as a priority—on social aims (Green 1989; Weber and Remer 2011). Even though SBs are still niche institutions, they have spread widely in recent years, especially in Europe, their stronghold (Benedikter, 2011). In fact, SBs manage to provide funding to social enterprises at below-market costs by relying on the financial sacrifices of investors and depositors who share their social values. This paper looks at the devices SBs use to signal their values to fund providers.

According to the theories developed by Cornée and Szafarz (2014) and Barigozzi and Tedeschi (2015), borrowers with social projects can match an SB on a competitive credit market when they share a social identity. From the empirical stance, Cornée et al. (2012) compare the behaviors of mainstream and social bankers toward their borrowers. They find that social lenders do not take advantage of their oligopolistic situation by increasing their interest rates, thereby avoiding the so-called “hold-up effect” typically associated with relationship banking (Boot 2000). As emphasized by Hudon (2007) in the context of microcredit, the level of interest rates is instrumental from an ethical viewpoint. By contrast, the attitude of SBs with respect to their investors/owners and their depositors is much less studied. This paper fills the gap by comparing the balance sheet data released by social and mainstream banks in Europe.

SBs are governed by principles deriving from their double bottom-line (Becchetti et al. 2011; San José et al. 2011). First, while profit maximization is not an objective per se, profit making is a means for achieving economic sustainability. Accordingly, profits should be

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1 SBs are a prime example of “caring finance” (van Staveren, 2013), which means that the lender takes a long-term perspective, and is willing to support the borrower.
fairly distributed among stakeholders through appropriate governance mechanisms. Second, SBs focus on financing the real economy—as opposed to speculating on financial markets.

More specifically, SBs support their communities through transparent, prudent, and simple intermediation principles. They reject speculative transactions. Third, SBs are meeting points for socially-minded investors and social enterprises. By matching these two sides of impact-based financial intermediation, they promote the underlying social values.

This paper exploits a rich European dataset consisting of around 5,000 European banks, including 30 SBs, over the 1998-2013 period. We use micro-level bank balance sheet data (at unconsolidated level) from the Bankscope database provided by Bureau van Dijk (Iannotta et al. 2007; Ferri et al. 2014). Our results reveal that SBs signal their social commitment through two channels. First, they are selective in loan granting. Funding projects with a social content is a key aspect of their business model, and perhaps the most visible outcome they can provide to their stakeholders. Second, SBs operate more transparently than other banks. They make far fewer opaque transactions than their mainstream counterparts; and they favor direct intermediation over speculative transactions. At some point, however, the objectives of selectivity and transparency can lead to a trade-off. In particular, our results suggest that SBs face an excess liquidity issue, possibly due to the combination of a strict commitment to serve sustainable social enterprises (selectivity) and refrain from extending credit to other borrowers (transparency with respect to social mission). Dealing with excess liquidity is likely to be the most challenging issue for SB managers.

The paper is organized as follows. Section 2 introduces the dataset and methods. Section 3 presents and interprets the empirical results. Section 4 concludes.
2. Data and Methods

Identifying SBs is challenging (Karl, 2015). Previous studies, such as that of San Jose et al. (2011), select SBs based on the observable characteristics that we aim to test (transparency, traditional intermediation, etc.). In this paper, we take a different approach and identify SBs as banks with a substantial portion of assets originating from social enterprises.

Using annual data from 1998 to 2013, we consider banks from Western Europe that report financial information to Bankscope. Western Europe is a group of 20 countries including the pre-2004 15 European Union countries, together with Cyprus, Iceland, Malta, Norway, and Switzerland. Our selection procedure delivered a set of 30 SBs from 11 countries (list available upon request), including Triodos, GLS Bank, and Banca Etica. To match this group with the sample of other banks, we restricted the data on mainstream banks to those located in the same 11 countries. We use unconsolidated data, because very few SBs release consolidated data.

The literature suggests that social banking is based, on the one hand, on donations that materialize as sacrifices on owners’ and savers’ remunerations, and on the other, on the social mission of providing affordable credit to social enterprises (Becchetti 2012). Anecdotal evidence suggests that shareholders and savers of SBs exhibiting social preferences are ready to forgo a significant part of their financial returns as long as the financial funds motivate borrowers (Starr 2008). Becchetti et al. (2011) indicate that the financial sacrifice made by the investors in Banca Etica, an Italian SB, is around 15 basis points. San José et al. (2011) report that profit distribution in SBs is limited.

We seek to identify the tangible proofs that SBs provide to convince investors and depositors that their financial sacrifices are worth it. We hypothesize that the two main signaling devices are selectivity and transparency. First, project selectivity stems from
screening borrowers using social criteria in addition to conventional financial criteria. Second, SBs combine accountability and transparency to gain corporate legitimacy while preventing allegations of green washing (San José et al. 2011).

The purpose of social screening is to align the values and motivations of borrowers with those of investors and depositors. Since mainstream banks are mostly indifferent to borrowers’ social characteristics, we theorize that adding social screening to financial screening leads SBs to employ relationship lending more intensively and rely more heavily on soft information than their counterparts do, for at least two reasons. First, SBs’ lending target is mainly composed of social enterprises. These atypical borrowers prove to be more informationally opaque than conventional small and medium sized enterprises (SMEs). Thus, from a strictly financial stance, SBs need to rely to a greater extent on soft information to predict credit defaults accurately (Cornée 2015). Second, the relational approach is critical for SBs when evaluating the social aspects of projects. More specifically, evaluating social aspects of an investment project also encapsulates a hard component, which includes all the public information available on the project (e.g. activity sector), but first and foremost a soft component that involves judgmental appreciations on intangibles such as borrowers’ social orientation and ethicality, the environment-friendliness of the business, and corporate responsibility to stakeholders (Cornée 2014).

Measuring the intensity of relationship lending from a bank’s financial statements is challenging. Here we follow the recommendation of Berlin and Mester (1999) to use the funding side of the balance sheet as an indication of intensity.\(^2\) The authors argue that deposits constitute a “channel linking bank liabilities to relationship lending” and that “[…]
access to deposits with inelastic rates (core deposits) permits a bank to make contractual agreements with borrowers that are infeasible if the bank must pay market rates for funds” (Berlin and Mester 1999, p. 579). Hence, to sustain their selective lending policy SBs have a greater need than other institutions for a funding-side structure based on deposit collection. We build the first part of our empirical design on this testable consequence of extra selectivity:

\[ DTA \text{ (social banks)} > DTA \text{ (mainstream banks)} \]  \hspace{1cm} (1)

where \( DTA \) denotes the deposit-to-asset ratio, which is expected to be higher for SBs.

Transparency includes the disclosure of information on borrowers. Most SBs publish exhaustive lists of the projects they fund in order to provide investors with solid proof that borrowers’ social values are aligned with their own. The other pillar of transparency—perhaps the most relevant one—is the principle of simple intermediation. By banning complex financial operations, SBs show how they allocate assets, manage risks, and substantiate their “internal interest rate channel”. Empirically, simple intermediation can be detected by limited use of non-interest income generating activities (Mercieca et al. 2007). As a result, SBs would resort to income diversification less than other banks. Income diversification is inversely captured by the interest share in total income, also known as the interest-income-share ratio, denoted IIS (see Table 1). We thus expect that:

\[ IIS \text{ (social banks)} > IIS \text{ (mainstream banks)} \] \hspace{1cm} (2)

meaning that SBs have a larger ratio than their conventional counterparts.

From the depositors’ standpoint, IIS captures only one aspect of transparency, namely simple intermediation. This aspect is important since it enables depositors to easily scrutinize the use of their funds. However, depositors are also keen to ensure that their deposits are
actually and directly transformed into loans to social borrowers. This second aspect of transparency is measurable with the help of the loan-minus-deposit (LMD) ratio (see Table 1):

\[
LMD(\text{social banks}) > LMD (\text{mainstream banks})
\]  (3)

Eq. (3) means that SBs reduce the loan-to-deposit gap more than other banks do.

To test the theoretical predictions in Eqs. (1), (2), and (3), we regress DTA, IIS, and LMD on the dummy for SBs and we control for year, country, and size (proxied by the log of total assets). We also control for the legal status (by having a dummy for cooperative and savings banks), as the literature increasingly stresses differences between stakeholder- and shareholder-oriented banks in terms of performance, balance sheet structure, lending behavior, and contribution to financial stability (Angelini et al. 1998; Hesse and Cihac 2007; Ferri et al. 2015).

Table 2 presents summary statistics for SBs and other banks separately, together with the results of t-tests for equal means. The number of year-observations shows substantial variations as they oscillate from 250-300 for SBs to over 50,000 for other banks. The t-test for DTA and IIS are aligned with our predictions on selectivity and transparency as formalized in Eqs. (1) and (2). SBs exhibit a higher DTA than their conventional counterparts. IIS is also
much higher in SBs than in mainstream banks. In contrast, the fact that LMD is lower for SBs than for the other banks departs from our theoretical prediction in Eq. (3).³

3. Assessing Selectivity and Transparency

Table 3 displays the regressions assessing the selectivity and transparency of SBs. Columns (A) and (B) test Eq. (1), which states that SBs have higher DTA ratios than other banks, rationalized by maintaining credit relationships with their borrowers. The results support this prediction since the coefficients of the SB dummy are significantly positive in both specifications. Columns (C) and (D) assess transparency following the hypothesis in Eq. (2) that the share of interest income in total revenue (IIS) is higher for SBs than for other banks. The positive and significant coefficients of the SB dummy in both regressions suggest that Eq. (2) is supported empirically. The coefficient of bank size (proxied by the log of assets) indicates that, all else equal, small banks seem both more selective and more transparent than larger ones. In effect, as opposed to large banks, small ones benefit from a comparative advantage in relationship lending as well as in using locally-based simple intermediation. This advantage stems from more efficient use of soft information, inherent in the simplicity of organizational architecture (e.g. Cole et al. 2004; Scott 2004; Berger et al. 2005).

[Table 3 about here]

³ Using unconsolidated data, where observations are often legally autonomous local banks, means that the coefficients of control variables in Table 2 have counter-intuitive signs. First, the SBs and mainstream banks in our sample have similar average sizes. Second, SBs are less often cooperative or savings banks than their mainstream counterparts are. Both of these results are related to the fact that the share of cooperative and saving banks in the number of banks in Europe is larger than their market share in assets or loans, i.e. local cooperative and savings banks are smaller on average.
Columns (E) and (F) in Table 3 assess transparency following the hypothesis in Eq. (3) that the loan-minus-deposit ratio is higher for SBs than for other banks.\textsuperscript{4} The negative coefficient of SB refutes the prediction in Eq. (3). The estimations reveal that SBs have a liquidity surplus, meaning they transform deposits into credit to a lesser extent than mainstream banks.

There are several possible explanations for this unexpected outcome, stemming from both sides of the credit market. From the supply side, specifications (E) and (F) in Table 3 highlight the possible existence of a trade-off between transparency and selectivity. All else equal, a heavier screening process inevitably limits the volume of loans granted, and hence reduces the loan-to-asset ratio. In turn, this creates excess liquidity.

On the demand side of the credit market, while social enterprises increasingly seek outside capital to thrive, two factors limit their quantity of external finance. First, many social enterprises are not profitable enough to afford the (even below-market) interest rates charged by SBs. Second, and more importantly, social enterprises follow lower-pace growth strategies than traditional SMEs. Their value-creation process, sometimes regarded as \textit{social bricolage} (Di Domenico et al. 2010), implies a subtle equilibrium between commercial, philanthropic, and benevolent resources. From a managerial standpoint, this process is a double-edged sword: It makes social enterprises more flexible and adaptable, but it also prevents them from long-term formal planning. Typically, social enterprise managers opt for adaptive financial management and a cautious growth strategy, since rapid growth can jeopardize their hybrid resource model (Sunley and Pinch 2012). In the same vein, Philipps (2006) argues that growth can represent a paradox for social enterprises, especially when it is fostered through an orthodox view of further marketization.

\textsuperscript{4} Actually, SBs have a significantly higher deposit-to-asset ratio than their conventional counterparts but their loan-to-asset ratio is not significantly different from that of conventional banks (unreported results). As a result, their LMD appears significantly negative.
Finally, we cannot exclude the possibility that the credit granting process might become clogged. Social enterprise managers and bankers—even “social” ones—can have different business mindsets and practices. For example, the lack of business and financial skills among social enterprise managers may act as an impediment to formalizing credible business plans and gaining access to scarce financial resources. Field research attests that the majority of these managers are far more experienced in the public and voluntary sectors than in the private one (Sunley and Pinch 2012). Consequently, these managers could find it uncomfortable to deal with banks, even social ones.

In sum, this section shows that SBs apply higher social standards than mainstream banks in loan granting (selectivity), and rely on a business model of simple financial intermediation (transparency). Nonetheless, our results suggest that selectivity and transparency may come into conflict and lead to overliquidity.

4. Conclusion

According to the theory of social banking, owners and depositors of SBs are ready to relinquish part of their remunerations as long as the bank serves social enterprises and keeps funding community-oriented projects. As a result, it is key for SBs to signal their accomplishments to funders through selectivity and transparency. Our findings suggest, however, that the link between these two characteristics is complex. Up to a certain point, increasing selectivity makes social lending more transparent. But when selectivity is high, it can impede loan granting enough to undermine direct intermediation and transparency. Put differently, tough social screening can restrain a bank’s ability to transform deposits into loans. The subsequent excess liquidity might be the Achilles’ heel of the SB business model.
To solve the excess liquidity issue, SBs may scale up their lending volume by co-funding public infrastructures for ecological transition, developing sustainable personal finance, and promoting locally-managed, participative finance (e.g. La Nef 2012). Banca Etica, an Italian SB, which in our database achieves an above-SB-average LMD ratio, offers attractive credit conditions, such as low collateral requirements, by forging trust-based business relationships with its borrowers. The bank partly offsets information asymmetry and the risk of moral hazard by establishing close connections with umbrella organizations of social enterprises (Becchetti and Garcia 2011).

Alternatively, SBs might wish to finance social projects with low profitability in the short run. To do so, they would need to seek funds from motivated funders who require low to no return. In this respect, attracting donations is optimal. In any case, the future of SBs will depend on their capacity to address the new challenges associated with their post-crisis growth. Excess liquidity is clearly one of those challenges.
References


List of Tables

Table 1: Dependent and Control Variables

<table>
<thead>
<tr>
<th>Variables</th>
<th>Definition</th>
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<tbody>
<tr>
<td><strong>Dependent variables</strong></td>
<td></td>
</tr>
<tr>
<td>Deposit-to-asset ratio in % (DTA)</td>
<td>[Deposits] / [total assets]</td>
</tr>
<tr>
<td>Interest-income-share ratio in % (IIS)</td>
<td>[Interest income] / [total income]</td>
</tr>
<tr>
<td>Loan-minus-deposit ratio in % (LMD)</td>
<td>[Loans–deposits] / [total assets]</td>
</tr>
<tr>
<td><strong>Control variables</strong></td>
<td></td>
</tr>
<tr>
<td>Log of assets</td>
<td>Log (assets)</td>
</tr>
<tr>
<td>Stakeholder bank in %</td>
<td>Dummy=1 if it is a cooperative or a savings bank</td>
</tr>
</tbody>
</table>

Table 2: Summary Statistics: Comparison between social banks and other banks

<table>
<thead>
<tr>
<th>Variable</th>
<th>Social banks</th>
<th>Other banks</th>
<th>T-tests for equal means</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dependent variables</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deposit-to-asset ratio</td>
<td>68.92 (20.81) [N=251]</td>
<td>63.85 (19.54) [N=53,259]</td>
<td>-4.09***</td>
</tr>
<tr>
<td>Interest-income-share</td>
<td>82.60 (12.53) [N=267]</td>
<td>71.85 (16.43) [N=53,441]</td>
<td>-10.67***</td>
</tr>
<tr>
<td>Loan-minus-deposit ratio</td>
<td>-12.32 (1.44) [N=289]</td>
<td>-3.97 (0.11) [N=54,320]</td>
<td>5.01***</td>
</tr>
<tr>
<td><strong>Control variables</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Log of assets</td>
<td>6.27 (2.04) [N=310]</td>
<td>6.38 (1.78) [N=56,609]</td>
<td>1.03</td>
</tr>
<tr>
<td>Stakeholder bank</td>
<td>66.20 [N=432]</td>
<td>75.95 [N=85,712]</td>
<td>4.72***</td>
</tr>
</tbody>
</table>

Note: Means and standard deviations are in parentheses. Number N of point-observations is in brackets. ***: p < 0.01, **: p < 0.05, *: p < 0.1.
Table 3: Assessing Selectivity and Transparency

<table>
<thead>
<tr>
<th>VARIABLES</th>
<th>Selectivity</th>
<th>Transparency</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>(A)</td>
<td>(B)</td>
</tr>
<tr>
<td>Hypothesis tested</td>
<td>Eq. (1)</td>
<td>Eq. (1)</td>
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<tr>
<td>Social bank</td>
<td>8.98***</td>
<td>8.93**</td>
</tr>
<tr>
<td></td>
<td>(3.361)</td>
<td>(3.784)</td>
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<tr>
<td>Stakeholder bank</td>
<td>11.48***</td>
<td>19.11***</td>
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<tr>
<td></td>
<td>(0.958)</td>
<td>(0.940)</td>
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<tr>
<td>Log (assets)</td>
<td>-2.78***</td>
<td>-2.44***</td>
</tr>
<tr>
<td></td>
<td>(0.161)</td>
<td>(0.161)</td>
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<tr>
<td>Constant</td>
<td>71.89***</td>
<td>68.83***</td>
</tr>
<tr>
<td></td>
<td>(3.725)</td>
<td>(3.898)</td>
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<td>Yes</td>
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<tr>
<td>Year dummies</td>
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<td>Yes</td>
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<tr>
<td>Observations</td>
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<td>46,022</td>
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<tr>
<td>R-squared</td>
<td>0.30</td>
<td>0.35</td>
</tr>
<tr>
<td>Social bank</td>
<td>251</td>
<td>251</td>
</tr>
</tbody>
</table>

*** p<0.01, ** p<0.05, * p<0.1
Standard errors (in parenthesis) are heteroscedasticity and cluster robust.