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Greed or good deeds: An examination of the relation between corporate social responsibility and the financial performance of U.S. commercial banks around the financial crisis

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ABSTRACT

We examine the relation between banks' corporate social responsibility (CSR) and financial performance in a context of the recent financial crisis. We find that banks, in general, appear to be rewarded for being socially responsible as financial performance is positively and significantly related to CSR scores. We find that the biggest banks pursue socially responsible activities to a significantly greater extent than smaller banks. Further, the largest banks see a steep increase in CSR strengths and a steep drop in CSR concerns after 2009.

"Any modern economy needs a financial system, not only to process payments, but also to transform savings in one part of the economy into productive investment in another part of the economy. However, the Obama administration had decided, like the George W. Bush and Bill Clinton administrations before it, that it needed this financial system — a system dominated by the thirteen bankers who came to the White House in March. Their banks used huge balance sheets to place bets in brand-new financial markets, stirring together complex derivatives with exotic mortgages in a toxic brew that ultimately poisoned the global economy. In the process, they grew so large that their potential failure threatened the stability of the entire system, giving them a unique degree of leverage over the government."

[(13 Bankers: Wall Street Takeover and the Next Financial Meltdown by Simon Johnson and James Kwak, Randomhouse, 2010.)]

1. Introduction

The global economy continues its recovery from the worst recession since the 1930s. While there are a number of positive signs that the economy is slowly improving, the role the financial industry played in this crisis is widely discussed and recognized. As the above passage alludes, banks' obsession with profitability has been noted as a major reason for the advancement of financial innovations and risky speculations, the expansion of high risk loans and subprime mortgages, the increase in asset prices without economic basis, and eventually, the sudden and unexpected decrease in financial asset prices prior to the financial crisis. During and after the crisis, banks (particularly big banks) were heavily criticized for their failure to account for the impact of management decisions on society, e.g., for their failure to be socially responsible. However, large banks are more likely to be too-big-to-fail. Thus, they would not care about being socially responsible and its performance implications. In contrast, when small banks face difficulties they can mobilize the support of stakeholders if they have a history of being socially responsible. Depositors, the community, regulators, governments may step into help small, socially responsible banks emerge from difficult situations. Thus, social responsibility

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may matter more for small banks rather than large banks. Given the devastating effects of bank decisions on the financial system, as financial institutions work to restore growth and build goodwill, the issue of banks' pursuit of corporate social responsibility (CSR) and its relation to financial performance is more relevant than ever.

The aftereffects of the financial crisis and the slow economic recovery have resulted in increased skepticism and scrutiny of commercial banks' motives and actions. While not specifically stating that banks should improve their social responsibility, the Wall Street Reform and Consumer Protection Act of 2010 put big banks under close scrutiny. A way to reduce scrutiny would be to improve their engagement in socially responsible activities. The emergence of social media has resulted in consumers increasingly taking their frustrations to Facebook, Twitter, and petition sites such as www.change.org.[1] Nationwide campaigns, such Bank Transfer Day on November 5, 2011, encouraged consumers to leave their "big" banks for credit unions and community banks.[2] In addition, communities and local governments (e.g., New York City, Los Angeles, and Boston) are pressuring and requiring banks to offer better services in poor neighborhoods and to submit community reinvestment plans regularly in order to do business with them (New York Times, May 14, 2012).

There is some anecdotal evidence that banks are taking CSR more seriously and are working to enhance their CSR records after the financial crisis. For example, in August 2012, Bank of America released its second annual CSR report. The report highlights a number of initiatives such as the bank's ten-year, $1.5 trillion community development lending and investing goal; ten-year, $2 billion philanthropic investment goal; and ten-year, $50 billion environmental business goal. In September 2012, J.P. Morgan Chase released a full set of CSR reports, highlighting the firm's global efforts to help grow the economy, strengthen the communities in which it operates, expand educational opportunities, and promote environmental sustainability. Despite this anecdotal evidence, there has been no academic research on banks' CSR activities around the financial crisis.

In this paper, we investigate whether commercial banks in aggregate are taking substantive steps at being socially responsible, if their engagement in socially responsible activities have changed since the financial crisis, and whether there is a relationship between their CSR and financial performance. Using Environmental, Social, and Governance (ESG) ratings data from MSCI ESG STATS database (formerly KLD), we find that the largest banks (which were most heavily criticized for their obsession with profits and the resulting conduct of activities that led to the crisis) consistently have higher CSR strengths and CSR concerns throughout the sample period. Further, this group sees a steep increase in CSR strengths and a steep drop in CSR concerns after 2009, as the worst of the financial crisis passed. We find that, in both pre-crisis and post-crisis periods, larger banks with more females and minorities on the board of directors and with shorter-tenured directors have significantly higher overall CSR scores[3] and CSR strengths. In contrast, small banks' overall CSR scores and CSR strengths are not impacted by these governance variables. Similarly, large banks operating in Democratic leaning states have significantly higher CSR strengths, while small banks do not.

We find that banks that draw a larger percentage of deposits from low income communities have significantly higher overall CSR scores and CSR strengths scores after the crisis. The results are particularly true for bigger banks. As banks increase the level of deposits from low income communities from low to high, they become more entrenched in the communities. The result is a significant increase in CSR scores. Overall, we conclude that banks, and particularly larger banks that were at the center of criticism for their lack of social conscience prior to the financial crisis, did work to improve their CSR activities after the crisis. Despite the too-big-to-fail status of these banks, the crisis appears to have served as a wakeup call for the banks and their stakeholders to enhance their CSR records.

Many papers have examined the relation between firms' socially responsible behavior and their financial performance in a corporate context. Recent literature contends that firms pursue profit maximizing CSR (e.g., Fatemi et al., 2009; Bénabou and Tirole, 2010; Gillan et al., 2010; Garcia-Castro et al., 2010; Dimson et al., 2013; Servaes and Tamayo, 2013; Fatemi and Fooladi, 2013)[4] and get rewarded for their commitment to CSR in the form of higher values, lower cost of capital, and greater capital inflows (e.g., El Ghoul et al., 2011; Goss and Roberts, 2011; Jo and Harjoto, 2011).[5] Margolis et al. (2009) conduct a meta-analysis of 251 studies that examine the relation between corporate social performance and financial performance. Overall the relation is found to be positive but small: corporate social performance does not appear to penalize companies financially nor impair their economic functioning. They also find that doing bad, if discovered, as is the case for banks during the financial crisis, has a more pronounced effect on financial performance than doing good.

As for the banking industry, evidence on the relation between CSR and financial performance has been scarce. For example, Chih et al. (2010) investigate a total of 520 financial firms in 34 countries over 2003–2005 and conclude that CSR and financial performance are not related. However, only 162 of the sample 520 firms are U.S. financial institutions and only 8 of these have CSR scores. Wu and Shen (2013) analyze 162 banks in 22 countries over 2003–2009 and report that CSR is positively associated with financial performance in terms of return on assets, return on equity, net interest income, and noninterest income. Only 31 of the 162 sample firms are U.S. banks. Further, neither of these papers has a data set that allows for an examination of CSR in banks around the financial crisis. Given the actions of banks leading up to the financial crisis, the criticism of banks for causing the crisis, and the incentives for banks to improve their reputations after the financial crisis, an examination of bank CSR activities surrounding the crisis and their relation to bank performance would be of particular interest.

The relation between CSR and firm performance could be overstated if we do not control for an endogeneity problem.

[1] Molly Katchpole, a 22-year-old woman from Washington, collected more than 300,000 signatures on www.change.org website opposing the plan by Bank of America to charge $5 fee for using debit cards for purchases. Due to the outpouring of complaints, Bank of America abandoned its $5 fee plan on Nov 1, 2011. (The New York Times, Nov 1, 2011).

[2] This campaign ultimately cost big banks 2.2 million customers: http://www.huffingtonpost.com/bill-cheney/bank-transfer-day_b_2056292.html.

[3] As we describe below, our measure of overall CSR is total number of CSR strengths minus total number of CSR concerns in the MSCI ESG STATS database.

[4] Other papers look at issues other than profit and value maximization. For example, Bae et al. (2011) find a firm's incentive or ability to offer fair employee treatment is an important determinant of its financing policy. Edmans (2011) finds that firms' concerns for other stakeholders, such as employees, may ultimately benefit shareholders.

[5] Similarly, Hong and Kacperczyk (2009) find that stocks of companies involved in producing alcohol, tobacco, and gaming are less held by norm-constrained institutions such as pension plans as compared to mutual or hedge funds that are natural arbitrageurs, and they receive less coverage from analysts than do stocks of otherwise comparable characteristics. Deng et al. (2013) find that compared with low CSR acquirers, high CSR acquirers realize higher merger announcement returns, higher announcement returns on the value-weighted portfolio of the acquirer and the target, and larger increases in post-merger long-term operating performance. Finally, Hong and Kostovetsky (2012) find that mutual fund managers who make campaign donations to Democrats hold less of their portfolios (relative to nondonors or Republican donors) in companies that are deemed socially irresponsible (e.g., tobacco, guns).