Preventing a Run on the Bank

A healthy balance sheet can't keep a bank safe from massive customer withdrawals; preventing panic is the real challenge.

There have been very few pictures of people lining up outside of banks waiting to withdraw their money during recent financial crises. Deposit insurance and interventions by authorities to shore up bank balance sheets have bailed out the banks and calmed customers' nerves. Many banks who eagerly accepted a government stake in return for solvency have managed to buy back those shares as their financial health improved. But bank runs are by no means extinct or even out of the question today.

A new working paper by INSEAD Professor of Entrepreneurship, **Henrich Greve**, and Assistant Professor of Entrepreneurship and Family Enterprise, **Jay Kim**, opines that the financial health of a bank has little impact on its probability of experiencing a bank run.

In ***Running for the Exit: Community Cohesion and Bank Panics,*** Greve and Kim examined bank panics as far back as 1893 and found that the characteristics of the community that the bank belongs to and especially the diffusion of information within that community are a more important factor in bank runs than the balance sheet.

Community cohesion spreads fear

They postulate that three mechanisms can cause a panic to spread to other economic institutions and cause runs; one is the contagion through the system (interbank lending); the second is economic conditions, for example, exposure to a troubled sector such as housing, and the third is rumours and bad news. "All three mechanisms are present in any banking panic, but I would say that the third mechanism, the contagion through rumours, is probably the most important," said Kim.

In many cases, this is exacerbated by homogenous communities, which tend to think alike. "If a community can agree that the bank is going poorly, if many, many people panic at the same time, then you have a real panic and the bank is in real danger," said Greve.

"Now, if they can't agree, that probably means they're not talking to each other very much or they don't totally trust each other," he added.

Community diversity

Basing their conclusions on their study of the great bank panic of 1893 in the United States, Greve said, "What saved some of the banks was the diversity of their communities. So, in a community, people can be different on various dimensions and the important ones in those days were the nation of origin because they were mostly immigrants, wealth, of course, and also religion. And we found that communities with a high diversity on any of those lines were less likely to have a bank run."

"Diversity in a customer base or just in a community around the bank, or in fact any business, is probably going to be a type of protection for the bad effects or reputation, anything that happens like a bank run somewhere else and it's a pretty important thing to happen because those banks are actually innocent in general," Greve added.

Greve and Kim point out that community diversity actually accentuates differences in beliefs and that individuals continue to digest content that confirms their own beliefs in a mixed environment.

"As a bank you want - and you rely on - the mechanism of people believing in themselves," said Greve. "Even if somebody says 'I told you so, that bank wasn't worth trusting,' maybe I will still keep my deposit in the bank if I'm a very committed customer."

Protecting the bank

But for banks in homogenous communities, how can bosses avoid unified negative community perceptions during systemic financial upheaval? According to Greve and Kim, there are ways to foster a diversity of views to protect reputation against potential panic.

"One thing they can do is actually to stop being so selective in choosing their customers. Niche selection and niche marketing is important in most kinds of business, and it's true in banking as well, but the better you are at selecting a niche, the more homogenous your customers will be which is probably fine in a non-crisis condition, but once a financial panic is on its way, that's exactly the position you don't want to have," said Greve.

But fostering mixed opinions is not the only way banks in homogenous environments can protect themselves. Paradoxically, homogeneity can also give rise to positive opinions across the customer base, but this depends on how the bank establishes strong relationships with influential groups within the community.

Homogenous benefits

"We believe it is also a two-edged sword," said Kim. "If you're in a homogenous society and you can create goodwill and good word-of-mouth marketing, that could actually transfer throughout the community quite well and we have seen this a lot in the homogenous communities of Korea and Japan."

Kim points out that the bigger national banks in Korea have built up a perception that they are too big to fail. Strong government and national interests prevail over the populace from a historic focus on nation building. "The non-failure of large banks is due to the fact that people perceive them to be safe, which is partly true."

However, the likes of the smaller community banks in homogenous communities, somewhat disconnected from the national standing of the bigger institutions, are still vulnerable per Greve and Kim's theory. "On the other hand, small institutions, especially savings banks…are more prone to bank runs than similar institutions in the U.S. due to homogeneity," Kim added.

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