The Teachable Moments of Financial Crisis

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Squint hard enough and you can find traces of long-ago crises in the way communities do business today.

For communities, financial crises are unforgiving mirrors. When money dries up in tightly-knit communities, trust emerges as a sort of substitute currency to bolster imperilled institutions. Mistrustful communities are less protected from external shocks. Therefore, one can pretty well measure the community cohesion that existed before a crisis by surveying the extent of the wreckage afterwards. In the same manner, community members – individuals and organisations – will learn approximately how much, or how little, they can trust one another in the future.

A community whose social bonds have been battle-tested will rebound from crisis differently from one that knows its bonds are fragile. Different mechanisms will be put in place to prepare for the next crisis. It seems likely, then, that the experience of financial crisis can influence the shape of affected communities for years, if not the foreseeable future.

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For a research paper forthcoming in *Organisation Science*, “Hereafter: How Crises Shape Communities Through Learning and Institutional Legacies” (co-authored with Lori Qingyuan Yue of USC Marshall School of Business), we analysed how communities in the *fin de siècle* United States responded to two major bank panics 14 years apart. We found community-level patterns linking outcomes from the second crisis to the aftermath of the first. In other words, lessons learned in the wake of the earlier crisis could still be discerned in community institutions 14 years later.

A pair of panics

The period between the end of the Civil War and the 1913 founding of the Federal Reserve is known as the National Banking Era in the U.S. The country suffered no less than five significant financial crises in this period, including the panics of 1893 and 1907 that are our chief concern here.

The two panics were very similar. Both began with a precipitous decline in the stock market, which put the big New York banks in hot water. Under the National Bank Act’s federal reserve requirements, banks in small towns and less populous cities stowed much of their deposits in New York. But beleaguered Big Apple banks prohibited their smaller siblings from withdrawing deposits, triggering a nationwide liquidity crisis. In 1893, the ensuing bank runs caused roughly 575 banks to suspend operations either permanently or temporarily.

The similarity of the two panics allowed us to draw apples-to-apples comparisons, and thus get a clearer view of community response in the intervening years.

“Worse than worthless”

Approximately two-thirds of banks in 1907 took collective action to contain the crisis. One common step was to issue small-denomination currency substitutes (otherwise known as ‘scrip’), essentially IOUs to be paid off when the crisis blew over. All told, banks issued more than US$250 million worth of currency substitutes in 1907.

Issuing currency substitutes was a calculated risk. Without the entire community – other banks as well as local employers, employees and merchants – agreeing to honour scrip as actual money, it would have been worse than worthless. Why worse? Resorting to currency substitutes

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amounted to an admission of serious vulnerability. If the community didn’t trust both the bank (to fulfil its obligations in the end) and one another (not to lapse into every-man-for-himself mode), a bank run would have been the inevitable result.

Despite the inherent risk, not one bank that issued currency substitutes in 1907 experienced a run. Moreover, banks that narrowly avoided a run in 1893 (because neighbouring banks were indeed run on that year) were especially likely to use currency substitutes in 1907. The memory of 1893 seemed a decisive factor in these banks’ correct decision to trust their local communities.

Mutual lending

In 1907, another self-protective measure banks employed was mutual lending arrangements, in which loan certificates issued by local clearinghouses were used as IOUs amongst member banks. Any bank requiring cash could thereby tap the collective coffers. In mutual lending, banks had only to trust their peers, not the wider community. The clearinghouse served as shelter in the storm for all members, though the risk was that fiscally responsible banks would sometimes have to bail out imprudent ones.

Here, too, the legacy of 1893 seemed salient. We found that in communities where several banks suffered runs in 1893, banks were far more likely to organise mutual lending in 1907. In other words, communities that exhibited distrust in the earlier crisis by wiping out their banks seemed to be judged on that basis even a half-generation later. The banks had learned not to rely on their communities, instead turning to their peers for support.

The immobile third

Recall that two-thirds of banks took collective action in 1907. Our research uncovered two factors that seemed to contribute to the remaining third’s inability to act: a) disorganisation, as reflected by the absence of a community clearinghouse; and b) institutional amnesia, as reflected by a lower-than-average number of banks in the community that survived the 1893 crisis and hence could remember what happened then.

The purpose of clearinghouses was to clear cheques, not to organise mutually supportive obligations between banks. Yet in practice,

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clearinghouses gave banks a meeting place and a procedure for coordinating collective response to crises. It is therefore likely that the high frequency of financial crises during the National Banking Era contributed to the formation of clearinghouses. However, there's no way to know for sure.

The Great Recession

Looking at the 1907 panic, we can understand more about the global financial crisis that erupted almost exactly a century later. We see that when organisations possess deep community ties and are strategically aligned, they are able to retain and learn from even long-past experience. Collective actions informed by historical experience often have an inherent wisdom that johnny-come-latelies rarely attain.

The late 20th century saw rapid centralisation across the U.S. services sector, and consequently an erosion of community ties. Centralisation fostered anonymity and demolished trust, such that banks declined to enter into mutual lending obligations for fear of betrayal. In 1907, by contrast, banks pre-obliged themselves to honour loan certificates issued by the clearinghouse, knowing full well the counterparty risks involved. For all their power, the big 21st century banks were thus like the minority of banks in 1907 that were unable to take concerted action due to disorganisation and a lack of information.

Organisations that are new to a community should study its history. Also, they should treat all crises as learning opportunities: not only the ones they face, but also those that hit close to home but don't affect them directly.

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