Ethics, Culture, and Higher Purpose in Banking: Post-Crisis Governance Developments*

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This paper examines the roles of ethics, culture, and higher purpose in banking, defining these concepts and discussing how they are related. Developments in these areas since the financial crisis are discussed in the context of governance in banking. The theoretical and empirical research on ethics, culture, and purpose is reviewed, including a discussion of a framework for diagnosing bank culture. The paper closes with a discussion of the regulatory policy implications of the review.

JEL Codes: G20, G21, G2.

1. Introduction

Ever since the end of the 2007–09 financial crisis, regulators in the United States and Europe have shown increasing interest in examining the potential of the "softer" aspects of corporate governance in banking as a way to enhance banking stability without sacrificing economic growth. A key component of these softer aspects is corporate culture in banking (e.g., Dudley 2014, Financial Stability Board 2014, and Lo 2016). The reason is that failures of corporate culture and weaknesses in corporate governance were blamed for unethical behavior that contributed to the crisis (e.g., Dahlgren 2016;

*I would like to thank an anonymous referee and the editor, Luc Laeven, for helpful comments. This paper is a substantially expanded version of a monograph I prepared for the Office of Financial Research (OFR) to be used as input for their annual report to Congress on the state of the financial system. Helpful comments received from the OFR are also gratefully acknowledged. The views expressed here do not represent the views of the OFR or anybody who provided comments. I alone am responsible for any errors or misstatements.

Kirkpatrick 2009; Thakor 2016a, 2019; and Winter 2011). There were consequently considerable efforts by bank regulators and industry groups to highlight culture as deserving of more attention to prevent a recurrence of some of the failures that preceded the 2007–09 crisis.[1] So the question is: what has to change?

In addressing this question, I comment on ethics, culture, and higher purpose.[2] These are all related ideas, of course, but they are also distinct enough to deserve being discussed separately. Each of these terms is defined, and I discuss the state of affairs in banking with respect to these issues. The view taken in this paper is that the firm's business strategy and higher purpose shape its culture, and the behavior of its employees—both ethical and unethical—is then influenced by this culture. The goals of the paper are primarily twofold. The first is to review post-crisis developments in the areas of ethics and corporate culture in banking. To this, I add higher purpose—a new topic on which research is still at a very early stage—and discuss what banks are doing on this front. The second goal is to connect these post-crisis developments to the related literature in banking to provide a regulatory perspective that is related to the research that preceded the crisis.

The key findings are as follows. First, unethical behavior in banking is a major regulatory concern, but ethics cannot be improved sufficiently by relying solely on contractual resolutions, regulatory monitoring, or explicit regulation of executive compensation in banking. This is because organizational culture exerts a powerful mediating influence, and it must be better understood.

Second, banks—many of which were fined heavily for legal ethical transgression prior to and during the 2007–09 crisis—have increasingly begun to emphasize corporate culture, and researchers have begun to develop theoretical models of bank culture. There is also empirical evidence emerging that bank culture matters for economic outcomes. However, large-scale empirical evidence on the magnitude

[1]See, for example, Dudley (2014).

[2]This focus distinguishes this paper from my earlier papers in which I focused more on regulatory and related issues and the design of a financial system that is healthy (and not crisis prone); see Thakor (2014, 2015b, 2018). Theories of financial crises include Brunnermeier and Oehmke (2013) and Thakor (2012), and empirical evidence on the role of capital and cash injections appears in Berger and Bouwman (2013) and Bergman, Iyer, and Thakor (2020).

and nature of culture change in banking and its effect on bank behavior is still lacking. This presents an opportunity for future research. This opportunity is particularly germane to post-crisis regulatory developments. For example, the Dutch Corporate Governance Code, adopted in December 2016, emphasizes culture and stipulates that banks report their values and a code of conduct.

Third, organizational higher purpose is a relatively new concept in banking, but there are signs that banks are beginning to realize its potential. I review the small body of research on organizational higher purpose and provide some anecdotal evidence on its adoption in banking. I also review some empirical evidence from outside banking. I conclude this discussion by pointing out the potential dark side of banks publicly embracing a higher purpose.

Finally, I offer some tentative thoughts on how regulators may wish to treat ethics, culture, and higher purpose in an integrated manner to engage banks in a dialogue, and how the existing tools of prudential regulation may be useful in influencing these choices by banks. I also discuss how some regulatory developments are already moving in this direction.

This paper is related to many different strands of the literature, and the relevant papers will be discussed in the sections that follow in the context of the specific topics. This paper builds on Thakor (2020) where I briefly sketched post-crisis developments in ethics, culture, and corporate governance in banking. This paper substantially expands the discussion in that predecessor, taking a deeper dive and providing a more thorough analysis that connects the issues here to a broader literature.

The rest of this paper is organized as follows. In section 2, I provide an overview of the literature on ethics, culture, and higher purpose, highlighting the relationship between these concepts. Section 3 specifically discusses ethics and culture in banking. In section 4, I discuss higher purpose. Section 5 concludes with a discussion of regulatory policy implications.

2. A Framework for Ethics, Culture, and Higher Purpose

Before examining each of these ideas, it is useful to define them and explain how they differ and how they are related.

Ethics. In economics, ethical behavior is typically viewed as behavior that is not only legal but is also not socially "censured behavior" (e.g., Shleifer 2004). Examples of unethical behavior provided by Shleifer (2004) include child labor, corruption, excessive executive compensation, corporate earnings manipulation, and involvement of universities in commercial activities. Unethical behavior is often described as "misconduct" of some sort in the firm's behavior with respect to its customers or competitors. For example, in Thanassoulis (2020), it is firms cutting corners on product quality by underinvesting in the variable cost of production. In Song and Thakor (2020), it is a bank "mis-selling" a financial product, i.e., selling a product to a customer when the bank knows that there is a high probability (less than 1) that the product is not suitable for that customer. An example they provide is an adjustable-rate mortgage given to a customer whose income makes it likely that the mortgage payments will be unaffordable when the initial teaser rate goes up in the future. While all illegal behavior is clearly unethical, there can be unethical behavior that is legal (e.g., an employee shirking in effort supply relative to what the employer expects). One can think of unethical behavior as violation of an implicit contract when formal contracting is incomplete, as in the Grossman and Hart (1986) framework.

Culture. While unethical behavior can be reduced through intrusive and direct monitoring, regulation, and penalties for detected violations of ethical norms (see Song and Thakor 2020), these mechanisms are costly and do not account for the powerful effect of organizational culture on individual behavior. An organization's culture is a set of explicit and implicit contracts and (often unwritten) rules of conduct that determine how people in the organization behave. The study of corporate culture was pioneered by Crémer (1993), Hodgson (1996), Kreps (1990), and Lazear (1995). As Hermalin (2000) points out, Kreps's (1990) theory of corporate culture depends on the following features: (i) formal contracts to cover all foreseen contingencies are too costly; (ii) firms and their employees are repeat players; (iii) inducing cooperation through repeated play is cheaper than inducing it contractually; (iv) many repeated games have multiple equilibriums; and (v) not all contingencies can be foreseen, which adds to the need for incomplete contracts. While elements (i)–(iii) play a role in culture, we

need either (iv) or (v) to make culture a compelling determinant of behavior beyond explicit contracts (see Hermalin 2000). Thus, in Kreps's (1990) model, culture is what generates a "focal point" effect and guarantees a specific (desired) equilibrium when multiple equilibriums exist. Likewise, culture is what helps determine behavior in the face of unforeseen contingencies being encountered. That is, unforeseen contingencies can make it infeasible to obtain the desired unique equilibrium via explicit contracting.

The observation that changing organization culture can potentially influence more ethical behavior in a way that explicit contracting or regulation cannot is what attracts the attention of bank regulators when they ponder approaches to improving ethical behavior in financial services.

Higher Purpose. An interesting question that often arises has to do with the factors that shape organizational culture. Corporate strategy is an important factor, as emphasized by Song and Thakor (2019). Bartlett and Ghoshal (1994) view purpose as an essential precursor of effective strategic management, and many papers have provided evidence on the economic effects of higher purpose (e.g., Gartenberg and Serafeim 2019, and Grant et al. 2007). Quinn and Thakor (2018) discuss the ways in which organizational higher purpose affects culture.

What is higher purpose? There is not a consensus definition in the literature, but there are common elements in the way higher purpose is defined by various papers. Bartlett and Ghoshal (1994) define it as "the statement of a company's moral response to its broadly defined responsibilities, not an amoral plan for exploiting commercial opportunity." Quinn and Thakor (2019) define it as a prosocial contribution goal that transcends the usual business goals like profit maximization but is intrinsically a part of the business of the organization. Gartenberg, Prat, and Serafeim (2019) argue that purpose need not be explicitly prosocial but should be viewed more broadly as the company's "reason for being." Similarly, Henderson and Van den Steen (2015) define purpose as "a concrete goal or objective for the firm that reaches beyond profit maximization." These differences notwithstanding, what is common in these definitions is that higher purpose represents a contribution goal of the company that goes beyond the usual business goals like shareholder value maximization, and most of this literature emphasizes the importance of

the authenticity of purpose and its consequent influence on business decisions. For example, Gartenberg, Prat, and Serafeim (2019) state that a company's primary purpose is not necessarily that which is stated in written documents or plaques on the wall. They state: "It is precisely this implicit aspect of purpose—that purpose is only effective insofar as it is actually adopted by employees within the firm—that creates the challenge for academics to study it meaningfully, across firms and over time." The idea is that employees will not "actually adopt" an organizational higher purpose in their decision-making unless they view it as authentic, rather than merely window dressing (see also Quinn and Thakor 2019).

While we would expect an organization's embrace of higher purpose—especially one that is prosocial—to shape its culture to generate more ethical behavior, this need *not* be so. This is because society's definition of ethical behavior evolves over time and not always in ways that are consistent with the way an organization might choose its purpose. Shleifer (2004) points out that "behavior that is ethical in some idealized society might make matters worse in the real world. For example, the ethical norm against debt or interest, which might have been justifiable a millennium ago, is clearly no longer efficient." This means that, in the context of banking, regulators cannot simply talk about strengthening bank culture and improving ethical behavior. Rather, they also need to engage banks in discussion of their higher-purpose statements and the influence on culture and behavior.

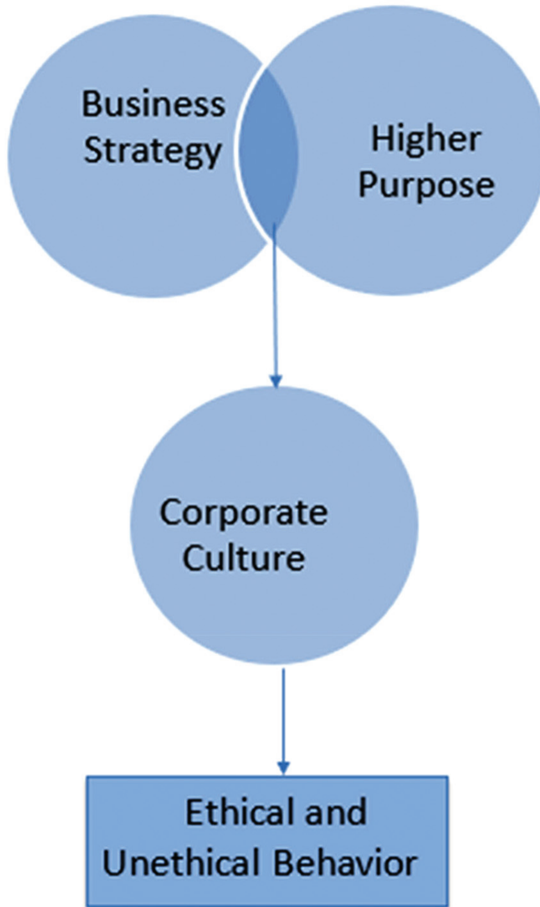
Figure 1 provides a pictorial depiction of the link between strategy, purpose, culture, and ethics. It illustrates that the firm makes decisions at the intersection of its business strategy and higher purpose (e.g., Quinn and Thakor 2019), so its culture is shaped to support these decisions and this, in turn, affects behavior, both ethical and unethical.

3. Ethics and Culture in Banking

3.1 Ethics

In this section, I begin by providing some examples of what major banks are doing on the issues of ethics and culture and link these practices to the literature. The definition of ethical behavior for

Figure 1. A Framework for Ethical Behavior, Culture, and Higher Purpose



the bank is that the bank behaves in a manner that complies not only with the law but also with the spirit of regulation. This means not selling products to customers that may be unsuitable for them, avoiding cheating customers and counterparties in other ways, and not taking actions—including excessively risky lending—that abuse the taxpayer-funded safety net that protects banks. When institutions that operate in the financial market behave ethically and

Table 1. Fines Paid Since Financial Crisis by U.S. Banks

Bank of America	$76.1 billion
JP Morgan Chase	$43.7 billion
Citigroup	$19.0 billion
Deutsche Bank	$14.0 billion
Wells Fargo	$11.8 billion
RBS	$10.0 billion
BNP Paribas	$9.3 billion
Credit Suisse	$9.1 billion
Morgan Stanley	$8.6 billion
Goldman Sachs	$7.7 billion
UBS	$6.5 billion

avoid misconduct in their dealings with customers (e.g., Thanassoulis 2020), market participants develop trust in them, as shown by Guiso, Sapienza, and Zingales (2008) and Thakor and Merton (2019).[3] Nonetheless, the substantial fines paid by banks since the financial crisis paint a somewhat troublesome picture about ethics in banking. By early 2018, U.S. banks had paid $243 billion in fines since the financial crisis,[4] and it is expected that globally, banks will pay $400 billion in fines by end-2020. Table 1 provides a list of the top banks in terms of fines paid.

One has to be careful in interpreting what these fines convey. As far as I know, none of these cases went to trial, so the fines do not necessarily reflect violations of ethics or laws in every case. But these fines damage the reputation of the industry. A few bad apples can create a negative reputational externality for the whole industry, even if most institutions are behaving ethically. There is empirical evidence of some ethical violations leading up to the 2007–09 crisis. See, for example, Piskorski, Seru, and Witkin (2015), who document information misrepresentation in sales of mortgages. This misrepresentation involved false information about the true quality of assets in contractual disclosures made by selling intermediaries in the interagency market.

[3]Sapienza and Zingales (2011) review the literature.

[4]See Goldstein (2018).

The good news, however, is that many of the big banks are now emphasizing ethical behavior and culture much more. For example, I picked the top two banks in table 1 and looked at their 2018 annual reports. Here are some excerpts:

Bank of America:

- "Our *culture* of careful expense management . . . " (emphasis mine).
- "100 Best Companies to Work for."
- "We were recognized for our employment practices and commitment to being a good place to work, our customer service . . . ".
- "Our ability to deepen customer and client relationships is driven in part by the investment we are making to provide the best client care in the industry."

JP Morgan Chase:

- "First and foremost, we look at our business from the point of view of the customer."
- "We take care of our employees."
- "We need to continue to restore trust in the strength of the U.S. banking system . . . ".

The public recognition by banks of the importance of ethics is an encouraging sign. However, there is a word of caution. The values espoused by banks on their websites and in posters on the walls inside their buildings must be *authentic*; see earlier discussion of Gartenberg, Prat, and Serafeim (2019) on this issue. Otherwise, it will breed cynicism among employees and other stakeholders. Every organization I know likes to put up posters listing the "values" of the organization that are supposedly embedded in its culture. But are the values practiced? It is often hard for an outside observer to know, but later in the paper I discuss recent research that addresses this question.

Having said this, it is important to note that ethical behavior can be influenced, but it is much more difficult to legislate it. And, even if it can be legislated, better ethics is not a free lunch. Song and Thakor (2020) develop a model which shows that when incentive

contracts are designed to raise the level of ethical behavior, there is less innovation in financial products, and banks with higher ethical standards tend to attract less talented managers than those with lower ethical standards. The intuition is that incentivizing the provision of privately costly unobservable effort by the bank employee requires a bonus for selling a successful innovation, and the likelihood of a sale declines as the bank raises its ethical standard, where the ethical standard determines the "acceptable" probability of mis-selling an innovation to a customer, for example. This creates tension between the goal of promoting innovation and the desire for better ethics, thereby posing a dilemma for regulators. Song and Thakor (2020) show that higher capital requirements in *both* depository and shadow induce banks to provide a better way to raise ethical standards[5] than imposing penalties for unethical behavior or directly regulating executive compensation. The crux of their reasoning is that ethical standards are difficult to legislate, but they *can* be influenced through the traditional tools of prudential regulation.

3.2 Bank Culture

The focus of the analysis in Song and Thakor (2020) is on how compensation contracts of bank managers can be designed to elicit the desired ethical standards. In view of the limitations of optimal contracting to improve ethics that Song and Thakor (2020) have highlighted, the literature on corporate culture discussed in section 2 suggests that one possible way to improve ethics while minimizing these adverse consequences is to strengthen bank culture. The concept of culture is admittedly somewhat nebulous—as William Dudley, former president of the Federal Reserve Bank of New York, said: "Culture is like a gentle breeze. You cannot see it, but you can feel it."[6] However, there has been a surge of recent research interest in this topic. Corporate culture in a nonbanking context has been examined recently in numerous papers. See, for example, Gorton and Zentefis (2019), Guiso, Sapienza, and Zingales (2015), and Van den

[5]Higher capital can also improve ethics in banking through other channels like reputation (e.g., Boot, Greenbaum, and Thakor 1993) and enhanced pledgeability in the bank's promises to depositors (e.g., Donaldson, Piacentino, and Thakor 2018).

[6]See Dudley (2014).

Steen (2010). Morrison and Shapiro (2016) provide a review of bank culture.

Lo (2016) observes: "Culture is a potent force in shaping individual and group behavior, yet it has received scant attention in the context of financial risk management and the 2007–09 financial crisis." He presents an excellent overview of culture from multiple dimensions—psychology, sociology, and economics—and presents a framework for analyzing culture for financial institutions.

In Thakor (2016a), I discuss how one can use the Competing Values Framework (CVF) to make the seemingly nebulous concept of culture concrete and measurable. This is a framework developed in the organizational behavior literature (e.g., see Cameron and Quinn 1999). Like Lo (2016), in Thakor (2016a), I focus on what culture means, why it matters, and how it can be changed. I also discuss the lessons for regulators. The main point of that discussion is that regulators can deal with culture in a practically sensible way. Specifically, regulators do not necessarily need to tackle, head on, the thorny issue of how to measure culture and build a regulatory framework around it.[7] Rather, as Song and Thakor (2019) show, they can get banks to focus more on developing "safety-oriented" cultures by[8]

- increasing capital requirements,
- limiting interbank competition,
- reducing the probability of bailouts.

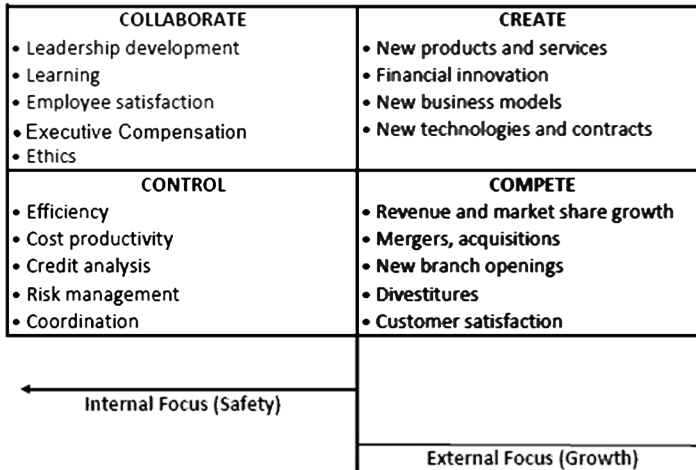
Moreover, culture choice is contagious, so if a few large banks orient their cultures in a certain way, others will follow.

In the CVF description of bank culture presented by Thakor (2016a), there are four dimensions of culture: Collaborate, Control,

[7] "Measuring" culture for regulation will likely tempt banks to manipulate their culture measures, apart from also suffering from the Goodhart critique.

[8] See also Thakor (2018). Song and Thakor (2019) distinguish between "growth-oriented" and "safety-oriented" cultures as follows. A growth-oriented culture is one that focuses on top-line (loan) growth, whereas a safety-oriented culture focuses on minimizing loan defaults by dedicating resources to credit analysis. Because of resource constraints, a greater allocation of resources to loan origination (to facilitate loan growth) implies a smaller allocation to credit analysis, so the bank's choice of culture also determines the optimal contracts to incent a specific kind of behavior, with the noncontractual aspects of culture exerting an additional influence.

Figure 2. The Competing Values Framework for Bank Culture



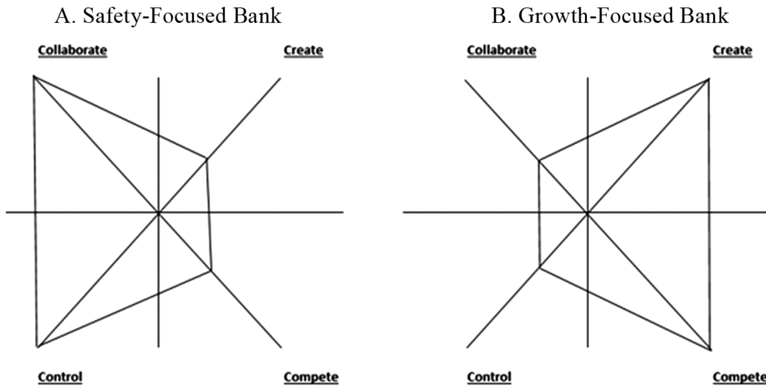
Compete, and Create. See figure 2, which provides examples of the bank's activities in the four dimensions. Each dimension represents a set of activities to which resources are allocated.

The activities in all four quadrants are intended to create value but in different ways, as described below. The emphasis the bank places on activities in any quadrant relative to the other quadrants reflects the bank's (resource allocation) strategy and its culture, because this emphasis will determine the kinds of explicit and implicit contracts the bank will use as well as noncontractual mechanisms it will deploy to produce the desired behaviors from its employees. Using the CVF culture diagnostic instrument that can be used to survey the bank's employees, one can pictorially depict any bank's culture, as shown in figure 3.

Collaborate refers to all the bank's activities directed at its own employees—their training, leadership development, learning, job satisfaction, work habits, and morale. The design of executive compensation and the development of ethical standards are also part of this quadrant.

Control refers to all of the bank's internal processes, including those designed to manage the bank's various risks, product and

Figure 3. Two Different Bank Culture Profiles



service quality, and costs. These are also activities to facilitate intra-bank coordination. The goals are efficiency and risk management.

Compete refers to all the activities the bank engages in to increase its competitiveness in the markets in which it currently operates. The goals here are an increase in market share in the loan and deposit markets, revenue growth, and shareholder value creation. The focus is on improving effectiveness in the bank's interactions with its external stakeholders.

Create refers to the bank's innovation activities, designed to enhance organic growth. New business models and innovation in financial instruments and services all fall into this quadrant. Laeven, Levine, and Michalopolous (2015) develop a model which includes both real-sector technological innovation by entrepreneurs and financial innovation by banks. The paper shows that technological innovation and economic growth ultimately stop unless financiers like banks innovate in enhancing screening of entrepreneurs. Thakor (2012) provides a theory in which financial innovation can contribute to the innovating institutions experiencing funding dry-ups that could bankrupt them, and a crisis could ensue if sufficiently many institutions are affected.

The Collaborate and Control quadrants include activities that are focused on what is internal to the organization—its own people (Collaborate) and its own processes (Control). For a bank, a safety-focused culture is one that would involve substantial resource

allocation to activities in these quadrants. The Create and Complete quadrants include activities that are "external facing" and involve interactions with external stakeholders such as customers, shareholders, and competitors. A growth-oriented culture is one that would allocate substantial resources to activities in these quadrants. Thus, the culture dichotomy in Song and Thakor (2019) collapses Collaborate and Control into one choice of culture (safety oriented) and Create and Compete into another choice of culture (growth oriented).

In the CVF, the four quadrants represent four distinct approaches to value creation that have similarities and differences. Collaborate and Control are similar in their internal focus, whereas Create and Compete are similar in their external focus. Control and Compete are similar in their emphasis on tangible forms of value creation where outcomes are relatively easy to observe and base contracts on. So activities in these quadrants are more amenable to output measurement, explicit contracting, and well-specified rules of conduct. By contrast, the activities in Collaborate and Create emphasize less tangible forms of value creation over more ambiguous time horizons, and outcomes are harder to measure (at least over time horizons comparable for activities in Control and Compete). Relative to Control and Compete, there is greater reliance on implicit (and incomplete) contracting and less on explicit contracting. Consequently, "operating rules of conduct" are more flexible in order to deal with the greater likelihood of unforeseen contingencies.

As a result of these differences, any choice of culture involves tensions; e.g., at the margin, focusing more on innovation (Create) requires a greater tolerance for failure (i.e., less effective risk management in Control). Given constrained resources, focusing on activities in one quadrant comes at the expense of activities in another quadrant. The bank's choice of culture will depend both on its business strategy and its higher purpose.

Figure 3 shows two hypothetical examples of bank cultures.

The culture in 3A depicts a bank that is safety focused, whereas the culture in 3B depicts a bank that is growth focused. This is the dichotomy characterized in the theory of bank culture in Song and Thakor (2019). Which culture the bank chooses is a matter of strategy and its beliefs about the quality of the asset pool it is screening

from.[9] Song and Thakor (2019) show that if the belief is that the borrower pool is of high quality—so the marginal value of screening loan applicants is low—then the bank prefers a growth-oriented culture. If the borrower pool is believed to be of low quality, the bank prefers a safety-oriented culture.

While the Song and Thakor (2019) analysis solves for optimal incentive contracts to align the bank employee's actions with the bank's strategic goals (growth versus safety), it shows that the *non-contractual* aspects of culture can improve the alignment attainable with optimal contracts. This involves use of soft information signals that are not mutually verifiable and hence cannot be used for contracting but can be used for rewards and punishments. For example, these signals can be used for promotion and span-of-control decisions. All agents understand how these decisions will be made, and they represent aspects of the bank's culture, but they are "unwritten rules" of conduct and are not included in explicit contracts. Thus, the Song and Thakor (2019) analysis provides another perspective on how culture can act as a coordinating mechanism for obtaining the desired behavior in an incomplete contracting setting that Kreps (1990) highlighted as an important ingredient in models of corporate culture.

In the context of ethics, the Kreps (1990) approach would say that it is virtually impossible (or exorbitantly costly) to write down every future contingency in which an employee could choose between an ethical decision and a multitude of possible unethical decisions involving varying degrees of transgression. Given the inefficiency of explicit contracting in such a setting, the bank's culture can be an effective mechanism for achieving the desire behavior.

Song and Thakor (2019) also show that market forces influence the bank's choice of culture. Specifically, as interbank competition increases, banks are more inclined to choose growth-oriented cultures. A decrease in competition makes a safety-oriented culture more attractive ceteris paribus.

[9]As in Laeven, Levine, and Michalopoulos (2015), the raison d'etre for the existence of the bank in Song and Thakor (2019) is that it provides screening of borrowers, as in Coval and Thakor (2005) and Ramakrishnan and Thakor (1984). Screening is meant to resolve information reliability problems. Allen (1990) provides a theory of financial intermediation in which the reliability of information being sold is a central friction.

What is the empirical evidence on how culture affects banking outcomes? There is a growing empirical literature that uses the CVF as a culture identifier and examines its relationship to various outcomes. Fiordelisi, Raponi, and Rau (2015) document that banks with low capital ratios, poor performance, and high credit risk tend to attract regulatory enforcement actions.[10] Moreover, non-sanctioned banks with a high probability of being sanctioned tend to change their cultures to be more safety focused (Culture profile 3A). Barth and Mansouri (2020) provide evidence that banks that have stronger growth-focused cultures (more emphasis on Compete and Create) have higher stock returns. Song and Thakor (2019) predict that banks with stronger growth-oriented cultures will exhibit higher revenue growth, and the theories in Thakor (2015a, 2016b) show that during good economic times, banks will lower credit standards, lend more, have higher growth, and be valued more highly by investors. Thus, the Barth and Mansouri (2020) finding is consistent with these theories. Further, Barth and Mansouri (2020) also find that banks with stronger Create cultures will experience higher revenue growth but higher bankruptcy risk. This is consistent with the theory in Thakor (2012) which predicts higher bankruptcy risk for more innovative banks.

The empirical papers that use the CVF to assess bank culture basically rely on the argument in Crémer (1993) and Hoberg and Phillips (2016)—there is a common language and vocabulary within the firm that is used in the management discussion and analysis (MD&A) section of the firm's 10-K reports and it reflects the firm's corporate culture. So these papers use the text of banks' MD&A section to extract words that correspond to the CVF quadrant descriptors and thereby infer culture.

One limitation of these studies is that one cannot assess how authentic the firm's commitment to a "stated" culture is, i.e., are the words in financial statements just part of "politically correct" communication to investors or do they represent a set of corporate values that are consistently practiced? There has not been much empirical work done on this, but recent research by Grennan (2019) is illuminating. That paper uses a simple but clever aspect of culture to

[10]This is consistent with the evidence in Berger and Bouwman (2013) that banks with higher capital have a higher probability of surviving a crisis.

examine its effect on bank performance—the consistency with which culture is communicated to different stakeholder groups. Using historical versions of websites from 2004 to 2017 for 300 U.S. banks, Grennan (2019) finds that a majority of banks communicate their values inconsistently across websites themes (i.e., tabs on websites labeled "about us," "career," "community," "culture," and "investor relations"). Her most important empirical finding is that banks that communicated their culture values consistently before the 2007–09 financial crisis experienced better operating and stock performance during the crisis.[11] Indeed, for each additional cultural value that is miscommunicated prior to the crisis, a bank lost an annualized 2.8 percent to 3.3 percent during the financial crisis from July 2007 to December 2008.

An important contribution that empirically examines the impact of bank culture using a plausible proxy for culture is Ellul and Yerramilli (2013). That paper does not rely on a direct measurement of culture, but rather constructs a "risk-management index" (RMI) to assess the strength and independence of the risk-management function at bank holding companies. One can view the RMI as proxying for the bank's risk-management culture. They show that a stronger risk-management culture leads to lower tail risk, lower nonperforming loans, and better operating and stock return performance.

Regulators have an expressed interest in promoting stronger safety-oriented cultures in banks. For example, the Dutch Corporate Governance Code of 2016 emphasizes the importance of the role of risk management and internal controls as important components of the bank's culture. The Code encourages banks to establish their risk appetite, codify it, and integrate it into the organization's work processes.[12]

There does not appear to be systemic evidence on *how* bank culture has changed since the financial crisis. Given the elevated regulatory focus on safety and soundness and the heavier reliance on stress tests and capital regulation, one suspects a shift toward more safety-oriented cultures. But this conjecture awaits empirical testing.

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[11]Grennan's (2019) hypothesis is that consistency, as measured by her, is a proxy for authenticity.

[12]See van Zijl, van der Bie, and Vorst (2017), for example.

However, the empirical evidence available to date indicates that bank culture has a potentially significant effect on bank behavior.

4. Higher Purpose

In this section, I discuss the relevance of organizational higher purpose to banking.

4.1 Organizational Higher Purpose and Banks

The notion of organizational higher purpose has gained theoretical traction in recent years. See, for example, Gartenberg, Prat, and Serafeim (2019), Hedblom, Hickman, and List (2019), and Henderson and Van den Steen (2015). Quinn and Thakor (2019) emphasize that organizational higher purpose is a contribution goal that transcends the usual business goals—profits or shareholder value—yet intersects these goals, so it is *connected* to the firm's business. It is *not* charity. These prosocial higher-purpose goals include taking a broader perspective on the stakeholders who should matter to the bank, including employees, customers, and society at large; many such examples are discussed in Quinn and Thakor (2019) and Thakor (2019).[13] In this sense, the notion of a higher purpose is consistent with the fundamental principle in the Dutch Corporate Governance Code of 2016 that banks should focus on *long-term stakeholder value creation*. While one typically thinks of a directive like that conflicting with shareholder value maximization, Thakor and Quinn (2019) provide a formal model in which an authentic higher purpose can, under some conditions, lead to higher profits and shareholder value in the long run, despite short-term profit sacrifices. This means that while long-term stakeholder value maximization may conflict with shareholder value, it need not, especially if the former is part of an authentic higher-purpose pursuit. What does this imply for banking?

As I discussed earlier, higher purpose influences the bank's culture, and this affects employee behavior, both ethical and unethical.

[13] A recent survey by Bunderson and Thakor (2020) reveals that an organizational higher purpose is actually more meaningful and impactful for employees when it is focused on stakeholders other than shareholders than when it is primarily focused on shareholders.

Thus, purpose can be a complement to the usual channels of executive compensation, capital requirements, and regulatory jawboning in changing bank behavior. We do not as yet have a formal theory of higher purpose in banking, but in Thakor (2019), I point out what higher purpose could mean in banking. Specifically, I argue that it could help to achieve the twin goals of financial stability *and* economic growth in the real sector through the actions of banks, goals that many believe conflict with each other. Moreover, visible pursuit of higher purpose will also contribute to a rebuilding of trust in banks. Shleifer (2004) argues that competition may encourage unethical behavior. However, recently Thakor and Merton (2019) provide a theory of the role of trust in bank lending in which depository institutions have an advantage over nondepositories in developing trust. Their theory highlights the role of trust in the competitive interactions between banks and nonbanks.

Banks have begun to think about higher purpose. I looked at the financial statements and websites of three of the banks in table 1 and found the following in their 2018 annual reports and/or on their websites:

Bank of America:

- “We did this by living our purpose, which is to help make our clients’ lives better through the power of every connection we can make.”

JP Morgan Chase:

- “We lift up our communities.”
- “[We started our] *Advancing Cities* initiative to support wage and job growth in communities most in need of capital.”

Morgan Stanley:

- “We believe capital can work to benefit all of society.”
- “We make this belief a reality by putting clients first, leading with exceptional ideas, doing the right thing, and giving back.”

The authenticity of these purpose statements is a matter for future research to determine, but the interesting empirical evidence provided by Gartenberg, Prat, and Serafeim (2019) is that an authentic higher purpose communicated with clarity improves operating and shareholder value performance in firms. I believe that in banking it will improve stability without sacrificing economic growth. As far as I know, regulators have not done anything explicitly on this front, although the Dutch Corporate Governance Code of 2016 has some elements of this embedded in it. To be clear, as mentioned earlier, I do *not* believe higher purpose can always be effectively legislated or regulated. Rather, I am proposing that bank regulators ought to understand its power and make it a part of their dialogue with banks, and think of regulatory directives that can encourage the adoption of authentic higher purpose in banking.

This dialogue can point to examples of how some banks are authentically pursuing higher purpose. An interesting example is the Bank of Bird-in-Hand in southern Pennsylvania. It is now a full-service bank whose purpose is to provide banking services to the underbanked Amish community. It seeks to foster local economic development and does so in part by supporting community projects like hay auctions (see Volz 2019).

4.2 Higher Purpose, Relationship Banking, and Bank Capital

Relationship banking is a key part of the business model of many depositories, and it helps to distinguish banks from shadow banks that compete aggressively in transaction lending. Rajan (1992) and Sharpe (1990) developed some of the early theories of relationship lending and focused on the economic effects of proprietary information generation during bank–borrower relationships. Boot and Thakor (2000) show that when faced with increased competition from other banks and the capital market, relationship lending optimally shrinks but banks deepen their relationship lending focus—and hence the value-added in each relationship loan—to increase their distinctiveness. Song and Thakor (2007) provide a model that links the bank's deposit funding choice (core deposits versus purchased money) to its lending choice (relationship versus transaction loans), thereby highlighting a new type of "balance sheet matching." Their main result is that relationship borrowers find bank loans more

valuable when the probability of interim loan termination due to the bank's funding drying up is lower, because the longevity of the bank–borrower relationship is especially important to relationship borrowers who experience increasing benefits of relationship banking as the duration of the relationship grows. Empirical evidence on the link between relationship-lending duration and the benefits of relationship borrowing is provided by Lopez-Espinosa, Mayordomo, and Moreno (2017), who document that the benefits of relationship borrowing begin to accrue to borrowers only after two years of the relationship. This is why in the Song and Thakor (2007) model relationship lenders rely more on core deposits, which are stickier than purchased funds.

A simple extension of this logic indicates that banks with higher capital ratios—which have higher continuation probabilities—will be more attractive to borrowers who seek relationship loans, because they will perceive higher total surplus from dealing with such banks.[14] Empirical evidence in support of this implication is provided by Schwert (2018), who documents that borrowers that are more bank dependent (i.e., those who value relationship loans more) are matched in equilibrium with banks that have higher capital ratios. That is, higher bank capital contributes to an increase in the surplus created by relationship lending.[15]

Relationship lending has numerous benefits for banks and their borrowers that combine to generate relationship-related surplus. On the theoretical front, Boot and Thakor (1994) develop an infinite-horizon credit contracting model in which relationship lending helps to reduce the use of costly collateral. Ferri, Minetti, and Murro (2019) provide empirical evidence that stronger bank relationships in which banks have greater access to soft information about borrowers make these borrowers have greater export resilience in the face

[14]How this surplus will be shared will depend on the competitive structure of the credit market. But if the bank as well as the borrower share in this surplus so that each gets a portion of it, then borrowers who value relationship loans more will gravitate to banks with higher capital, and those banks will prefer these borrowers.

[15]Borrower capital ratios may also play a role in influencing economic outcomes. Donaldson, Piacentino, and Thakor (2019) develop a model in which high consumer leverage leads to high unemployment in a general equilibrium.

of trade collapse, especially when these borrowers are firms that are at an early stage of internationalization.

Organizational higher purpose can facilitate relationship banking. If the bank's higher purpose is to further the interests of the communities in which it operates, it can do so by adding more value to its relationship borrowers. The example of the Bank of Bird-in-Hand illustrates this kind of higher purpose. Higher purpose is especially relevant in the context of relationship banking because the soft information that is an integral part of relationship banking necessitates reliance on incomplete contracts. As discussed earlier, it is precisely in these kinds of settings that purpose and culture have important roles to play in affecting bank behavior through noncontractual mechanisms. To the extent that higher bank capital generates greater surplus in relationship banking, an increase in bank capital can also elevate the value of higher purpose in banking.

The notion that the adoption of an authentic higher purpose can benefit the bank's customers and thus increase consumer welfare is in the spirit of the long-term stakeholder value creation prescription in the Dutch Corporate Governance Code of 2016. Quinn and Thakor (2019) discuss that there are three kinds of higher purposes that organizations adopt: customer-centric, employee-centric, and explicitly prosocial. So while not all higher-purpose statements are explicitly prosocial, they do address a broader set of stakeholders than shareholders, and attending to customer welfare is a frequently adopted higher purpose.

4.3 How Does Higher Purpose Affect Culture?

Because a firm that makes decisions at the intersection of its higher purpose and its business strategy inevitably allocates resources in a manner that is consistent with its articulated purpose, it is easy to see how purpose shapes culture, in context of the discussion in section 2. Explicit as well as implicit contracts end up being influenced by the higher purpose, and this affects the culture of the organization.

Quinn and Thakor (2019) provide numerous examples of how organizational higher purpose influences organizational culture. I discuss one of them here as an illustration of how purpose shapes culture. Sandler, O'Neill, and Partners, a mid-sized investment bank,

lost a third of its workforce during the 9/11 terrorist attacks. Jimmy Dunne, the new CEO, articulated a higher purpose that involved viewing employees as part of the "Sandler family." This led to the company paying the families of dead employees the salaries and benefits of these employees for an extended time period. The impact of this purpose on the firm's culture is described in Quinn and Thakor (2019). Specifically, employee "back-biting" was discouraged by the emergent culture, so, for example, when an executive came to Jimmy Dunne to "confidentially" complain about another employee, Dunne began dialing the other employee's phone number so he could come over and listen to what was being said about him. The person who had come to complain was shocked and stopped his complaining. Dunne stated that this kind of openness improved teamwork and collaboration. This is an example of how noncontractual mechanisms are used to reinforce certain aspects of the organization's culture, thereby influencing how the organization works and the economic outcomes it achieves.

The Song and Thakor (2019) model predicts that culture will be "contagious" in the sense that the choice of a particular culture orientation by a few banks will influence other banks to adopt the same culture. This proclivity of culture suggests that higher purpose too will propagate across banks. From a regulatory policy standpoint, this implies that the adoption of authentic prosocial purpose in banking can begin with a few (highly visible) banks, and it will subsequently spread to other banks.

4.4 Is There a Dark Side to Higher Purpose?

Organizational higher purpose could be misused in at least three ways. First, it may be inauthentic, in which case it is likely to be recognized as such by employees and be ineffective at best and breed cynicism at worst (see Quinn and Thakor 2019). Second, it could be used by the bank's leadership as an excuse for poor performance—"we are not doing well financially because we are devoting resources to higher purpose." In this case, higher purpose can be used to obstruct effective corporate governance and it will have two adverse consequences: (i) it will alienate investors, possibly leading to CEO replacement (see Oehmke and Opp 2020 for a model in which social impact requires investors to internalize social costs), and (ii) it will

diminish the credibility of higher-purpose initiatives at both the bank in question and other banks, including those that may be pursuing authentic higher purpose. Third, the bank's leadership could invest in initiatives that yield them private benefits—including the pursuit of political agendas—and "package" these as higher-purpose initiatives.[16] It is precisely because of the last two possibilities that Milton Friedman proposed profit maximization as the only goal firms should have. Endorsing the pursuit of multiple objectives by the bank can be a license to have poor corporate governance and bad investments. In banking this is a particularly important problem because it can threaten the public safety net. So in that sense, paradoxically, the stated purpose of embracing a corporate higher purpose that benefits the community ends up hurting the public interest by weakening the taxpayer-funded safety net![17]

Thakor and Quinn (2019) explicitly account for these possibilities in their formal analysis. They show that these possibilities lead to reduced higher-purpose investments by firms and also possibly higher wage costs and external financing costs relative to the situation in which these incentive frictions are absent (first best). That is, the firms that misuse higher purpose create a negative externality for firms that pursue authentic higher purpose. This is why it is important for banks to have an authentic higher purpose and make decisions at the *intersection* of higher purpose and prudent business goals such as long-run shareholder value maximization. As pointed out earlier, this need not conflict with attending to the welfare of stakeholders besides shareholders, i.e., this intersection of higher purpose and shareholder value is not empty. Banks need to have long-term financial viability that does not undermine the interests of depositors and the public safety net if they are to pursue a sustainable and authentic higher purpose.

[16]It could also embolden special interest groups to put pressure on banks to make loans to their favored constituencies—loans that may be imprudent from the bank's perspective—to serve the bank's stated higher purpose. This could imperil the bank's financial health.

[17]Safety nets such as deposit insurance provide banks with a funding cost advantage over nonbanks, and this can have a potentially profound impact on how the credit market segments itself. See Donaldson, Piacentino, and Thakor (2020). Merton and Thakor (2019) show why deposit insurance can be welfare enhancing even when bank runs are not a problem.

5. Conclusion

This paper has provided an assessment of changes in ethics, corporate culture, and higher purpose in banking since the financial crisis and has highlighted organizational higher purpose as an area deserving of greater recognition and emphasis by banks. I end now with a brief discussion of the takeaways for bank regulations on these issues.[18] First, preaching the importance of ethics to banks or even imposing penalties on banks for ethical transgressions may not be as effective as higher capital requirements in generating more ethical behavior.[19] Thus, a familiar tool of prudential regulation—capital requirements—can be used to even improve ethical behavior. However, ethics is not a free good, and higher ethical standards may be associated with lower financial innovation. Second, the organizational culture in banks can exert a powerful influence on the behavior of bank employees and can determine not only how ethical banks are but also the effectiveness of the risk-management systems they develop, the default losses they experience (that is, the strength of their safety-oriented cultures), and the tail risks they take. Culture is now being explicitly addressed in regulatory directives. For example, the Dutch Corporate Governance Code of 2016 addresses culture both directly by requiring a report on the adopted code of conduct and indirectly through its emphasis on risk management and internal controls codification and integration into work processes. Third, organizational culture in banks is influenced by the higher purpose they choose to embrace and the business strategies they adopt. While purpose and culture may not always be effectively legislated via regulation, regulatory practices have already begun to integrate elements of culture and purpose into the overall framework for bank regulation, which is a good sign. Current research suggests that greater

[18]Bhattacharya, Boot, and Thakor (1998) provide a pre-crisis perspective on the economics of bank regulation and the regulatory challenges involved.

[19]The advantage of capital requirements, especially those that are enshrined in bank regulation and involve minimums that are not subject to regulatory discretion, is that they can generate the desired effects without being potentially distorted by regulatory career concerns. See Boot and Thakor (1993) for an example of how regulatory career concerns can lead to regulators delaying the closure of troubled banks, relative to the social optimum.

dialogue between banks and regulators on these issues seems worthwhile. Such a dialogue can illuminate some of the practical issues banks and regulators will need to confront in applying in a financial services context the lessons learned by nonfinancial firms in the adoption of higher purpose, as well as the lessons learned through research on this topic.

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