

## Swissquote Conference 2016 on the Future of Banking

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**Title: Bank Culture**

**Abstract:** Bank culture has recently been in the regulatory spotlight in Europe and the US as a causally determining factor in influencing bank risk taking and incidents involving misrepresentation and fraud. There is, however, no economic theory of bank culture to provide a framework for this discussion. We attempt to fill this gap by developing a theory that is linked to concepts of organization culture developed in Organization Behavior. In our model, bank culture improves upon outcomes attainable with incentive contracting. The bank designs a second-best incentive contract to induce the desired managerial effort allocation across growth and safety, but this induces excessive growth relative to the first best, a distortion exacerbated by interbank competition. Bank culture can exert a mediating influence on this through two effects: it matches managers to banks with similar beliefs (assortative sorting), and a safety-oriented culture reduces the competition-induced excessive growth focus (competitive herding). Culture is also contagious--a safety-oriented culture in some banks causes others to follow suit. This effect strengthens with higher bank capital and weakens with stronger safety nets. We discuss the regulatory policy implications related to how these economic insights on bank culture can shape future bank regulatory policy and what regulators ought to be cautious about as they contemplate ways to integrate bank culture into prudential regulation.