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# The relation between religiosity and private bank outcomes☆

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We examine the effect of headquarters' local religiosity on private bank outcomes. Religiosity is associated with lower risk-taking for public banks, but the unique features of private banks may result in a different effect for private banks. We find religiosity is associated with greater asset risk-taking. At the same time, however, religiosity, is negatively associated with solvency risk and return on asset (ROA) volatility and is associated with higher ROAs and fewer failures. We reconcile these results by finding banks in areas with higher religiosity recognize larger fees from providing additional banking services, likely due to relationships formed from more risky lending. As a result, these banks are more (less) likely to realize extreme positive (negative) performance. We also find religiosity is associated with lower earnings management and increased conservatism. Collectively, our results confirm private banks are unique and religiosity can have a significant, and nuanced, effect on bank outcomes.

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## 1. Introduction

In the aftermath of the crisis, policy makers, regulators and academics have questioned what went wrong and how to prevent it from happening again (e.g., Fahlenbrach and Stulz, 2011; FCIC, 2011). While regulators have since updated rules (e.g., BIS, 2010), there is general agreement that regulation cannot mitigate the effect of a negative culture (Baxter, 2015). As stated by Warren Buffett (2011), "Culture, more than rule books, determines how an organization behaves." While there are multiple facets of culture, we examine one particular aspect: religiosity.

Religiosity refers to outward displays of religious beliefs that may affect a given culture. Prior literature documents two unique traits associated with religiosity: morality (e.g., Vitell, 2009) and risk aversion (e.g., Miller, 2000). Importantly, it can affect not only religious adherents but also non-religious individuals because social norm theory shows that individuals conform to the dominant set of behaviors and values of their peers (Cialdini and Trost, 1998; Kohlberg, 1984).

While religiosity directly influences individual behavior, it can also affect firm behavior because corporations are comprised of individuals. In this study, we examine the effect of religiosity on a large sample of privately-held (hereafter, private) U.S. banks from 1991–2010 because they are an important group on which to examine the effect of religiosity.

While smaller than public banks, private banks have a significant effect in the aggregate at facilitating capital for the economy, as shown in the crisis. In particular, private banks are more likely than public banks to provide loans to small businesses (Berger and Udell, 2002; Petersen and Rajan, 1994), who then use that money for local economic development and job creation (Korsching and Allen, 2004; Morrison et al., 2003). Private banks have also failed more frequently over the past two decades (FDIC, 2012a), making them an important public policy consideration due to taxpayer losses from governmentally-insured deposits and bailouts.[1]

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[1] In untabulated analysis, we find that 71% of all bank failures over our sample period are private banks. Furthermore, 63% of the banks that received TARP bailout disbursements are private banks the government has lost over $300 million on these disbursements, despite earning a profit on those to public banks (ProPublica, 2016).

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While the effect of religiosity has been well explored for non-banks (e.g., Hilary and Hui, 2009; McGuire et al., 2012), few papers examine its effect on banks (e.g., Adhikari and Agrawal, 2016; Kanagaretnam et al., 2015b). Of these, only one examines U.S. banks (Adhikari and Agrawal, 2016), and none examine private banks. Most related to our study, Adhikari and Agrawal (2016) and Kanagaretnam et al. (2015b) find religiosity is associated with lower public bank risk.

Examining the relation between religiosity and private bank risk and performance is important for at least two reasons which may make the effect of religiosity both more important, and potentially different, than it is for public banks. First, the extent of scrutiny and regulation is significantly lower for private banks, so any impact of religiosity should be more pronounced. Second, private banks more frequently engage in community banking, whereby they interact with their communities and use that information in banking decisions (FDIC, 2012a; Cole, 1998). However, increased investment in their local communities can result in increased risk (Kang et al., 2013). Potential increases in risk from community banking may be even more pronounced for banks in high religiosity areas due to an emphasis on morality and helping others. That is, banks in high religiosity areas that have strong customer relationships may originate risky loans that are deemed in the best interest of the community or may continue providing capital when they should be cutting their losses. Thus, contrary to public banks, religiosity may increase private bank risk.

We measure the religiosity of the county where a private bank is headquartered because most corporate decisions will be made or significantly influenced at this location (Hilary and Hui, 2009). We then examine the effect of religiosity on numerous measures of risk and performance with extensive controls for bank-level characteristics and county-level demographics and economic variables that may be correlated both with religiosity and bank behavior. Unlike the prior literature on public banks, we do not find religiosity is consistently related with lower bank risk. While we find that there is a negative relation between religiosity and a common measure of bank solvency risk and return on asset (ROA) volatility, we find insignificant relations with several measures of liability-based risk, and positive relations with several measures of asset-based risk, including risk-weighted assets, nonperforming loans, and charge-offs. However, despite these increased credit losses, we find religiosity is associated with higher ROAs and a lower occurrence of failure. We also find evidence that religiosity appears to be associated with taking more “good risks” than “bad risks,” as opposed to unambiguously increasing risk-taking, as it is associated with a greater (lower) occurrence of extreme positive (negative) ROA.

As with most empirical research, we acknowledge that asserting a causal relation of religiosity on bank outcomes is difficult. In particular, religiosity is likely correlated with many macroeconomic factors that may also effect bank outcomes and are difficult to control for, particularly due to the fact that most county-level control variables are only available periodically and must be linearly interpolated in intervening years. However, we perform an extensive set of robustness and alternative analyses including state*year fixed effects, additional control variables, propensity-score matching, and two-stage least squares specifications, and we find similar results.

In additional analyses, we find religiosity is associated with larger fees earned from additional banking services (e.g., advisory, underwriting, servicing and insurance), as well as lower exposure to real estate loans and slower asset growth. These finding help reconcile our results that religiosity is associated with higher loan losses and yet higher performance. In other words, banks in highly religious counties appear to more-than-offset loan losses with additional fee income, potentially due to stronger customer relationships resulting from the increased community lending, as well as more strategic growth. We also find religiosity is associated with less earnings management and higher conservatism. Finally, we find minimal evidence performance results are directly due to higher risks being associated with higher returns.

In sum, despite potentially increasing some measures of risk-taking, we find religiosity appears to be a beneficial component of private bank culture. We contribute to a growing literature examining the effect of culture on bank outcomes (e.g., Kanagaretnam et al., 2014; Adhikari and Agrawal, 2016). Specifically, we expand this literature by examining the relation between religiosity and private banks, showing a different and more nuanced effect of religiosity on private bank risk-taking relative to public banks, examining several measures of performance, and examining its effect on conservatism, a uniquely important measure of bank financial reporting quality. Our findings should be of interest to bank regulators, auditors and investors.

The paper proceeds as follows. Section 2 discusses the related literature and hypothesis development. Section 3 discusses the research design. Section 4 discusses the main results. Section 5 contains additional analyses, and Section 6 concludes.

## 2. Background and related literature

### *2.1. Religiosity and social norm theory*

Prior literature documents two unique traits exhibited by religious adherents that may have implications for firm behavior: morality and risk aversion. Vitell and Paolillo (2003) find religious individuals in consumer settings are linked to more morally inclined judgments of questionable behaviors. Numerous other studies also examine the relations between religion and morality, particularly in business settings (see Vitell, 2009). Miller and Hoffman (1995) show a relation between religiosity and risk preferences, and Diaz (2000) finds the religiosity of Las Vegas residents is negatively associated with their propensity to gamble.

Critically, religiosity can affect the behavior of non-religious individuals. Social norm theory suggests that a high level of religious adherents in an area will create cultural norms around morality and risk aversion that will affect the behavior of *all* individuals since both groups will conform to the normative behavior and values of the people around them (e.g., Cialdini and Trost, 1998; Kohlberg, 1984). Thus, regardless of the actual religiosity of bank managers, we would expect banks headquartered in areas with greater portions of religious adherents to be more subjected to cultural norms around morality and risk aversion. These norms also may increase the likelihood of displays of ethical reminders, such as codes of ethics, in public settings as well as individual displays of religious iconography, such as a cross, that further reinforce these norms.

### *2.2. Religiosity and bank culture*

It is important to understand the association between religiosity and bank behavior because bank complexity has made it difficult for bad behavior or excessive risk-taking to be monitored and constrained either internally by the Board, externally by market participants (Greenspan, 2008; Moody's, 2005), or even bank regulators (Bliss and Flannery, 2001).

As a result, regulators have recently began to consider how culture can positively affect banks (Deloitte, 2015). For example, Dudley (2014), President of the Federal Reserve Bank of New York, stated in a speech on how culture can enhance financial stability that “Culture relates to the implicit norms that guide behavior in the absence of regulations or compliance rules—and sometimes despite those explicit restraints.... Like a gentle breeze, culture may

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