Introductory Statement

Ingo Walter[*]

THOUGHTS ON REPUTATIONAL RISK AND ADVERSE SELECTION IN BANKING

The epic financial crisis of a few years ago left behind massive damage to the process of financial intermediation, the fabric of the real economy, and the reputation of banks and bankers. Even today, some five years later, little has happened to restore financial firms to their former glory near the top of the reputational food-chain in most countries. For reasons of their own, many boards and managers in the banking industry have little good to say about the taxpayer bailouts and inevitable regulatory tightening. In the words for former Barclays CEO Bob Diamond, "There was a period of remorse and apology for banks. I think that period is over. Frankly, the biggest issue is how do we put some of the blame game behind us? There's been apologies and remorse, now we need to build some confidence."[1]

There have been some notable exceptions. In the middle of the crisis Josef Ackermann, former CEO of Deutsche Bank and Chairman of the International Institute of Finance (the preeminent lobbying organization for the world's largest banks), noted in 2008 that the industry as a whole was guilty of poor risk management, with serious overreliance on flawed models, inadequate stress-testing of portfolios, recurring conflicts of interest, and lack of common sense, as well as irrational compensation practices not linked to long-term profitability. Whether at the industry, firm or personal level, the reputational cost of the financial crisis five years ago was enormous.

* Ingo Walter is a Professor at New York University, Stern School of Business, USA.

1 Appearing before the Treasury Select Committee, UK Parliament, 11 January 2011. www.cbsnews.com/2100-500395_162-7234896.html

Still, memories are short. Redirection of financial flows through the shadow banking system, creation of new products, persistent regulatory fault-lines, and renewed erosion of due diligence in some markets show the persistent need for vigilance. Meantime, banks have been called on the carpet for an amazing variety of transgressions that encompass fixing Libor and foreign exchange benchmarks, aiding and abetting money laundering and tax evasion, rigging metals and energy markets, and an assortment of fiduciary and consumer protection abuses. Most of these allegations are independent of the crisis legacy, and have surfaced despite what were thought to be adequate legal and regulatory safeguards. All of them first came to light at individual banks. But most of them later turned out to be "industry practice."

Andrew Haldane of the Bank of England, among others, has suggested we look to "cultural" factors in modern banking for at least part of the answer. Banking culture is a product of individuals who act collectively in a firm that operates under a combination of market discipline and regulatory constraints. In turn, banks comprise multiple subcultures that range from transactions processing and retail banking to corporate finance and interprofessional trading – subcultures that are distinctive in terms of the professionals they attract and the performance pressure to which they are exposed. Financial markets can sometimes be so efficient that overstepping the rules offers one of the few routes to serious profit – as they say, "no conflict, no interest". Banks and bankers, some would argue, have somehow lost their way in carrying out their key role as efficient allocators of capital and creators of better social welfare. They seem more like wealth-redistributors, from their clients to bank employees and shareholders, all the while privatizing returns and socializing risks on the back of taxpayers when things go badly wrong. Fair assessment or not, it's no wonder the industry as a whole and individual banks have seen their reputational capital erode. What might explain this?

It could be the changed competitive market structure in global banking, in which more intense competitive pressure and heavily commoditized markets have made it increasingly difficult to deliver ambitious promised returns to shareholders and attractive bonus pools to employees. This creates incentives to migrate banking activities to less open and less transparent markets, where transaction costs and profit margins are higher. These are markets that have become increasingly problematic as a result of greater product complexity and erosion of transparency, with efforts to reform them often resisted furiously by banks and their advocates. It could also be that, in such an environment, the definition of "fiduciary obligation" – the duty of care and loyalty that has traditionally been the benchmark of trust between banker and client – has morphed into redefining the client as a "trading counterparty," to whom the bank owes nothing more than acceptable disclosure of price, quantity and product. A deal is a deal, and what happens later is only of limited concern in a world where the "long term" is after lunch.

Compounding the effects of market dynamics is the changing nature of the banks themselves, which might be considered both a cause and a consequence of crisis-related and subsequent reputational issues. If bank size, complexity, imbedded conflicts of interest, and the ability to manage and govern themselves were contributory factors leading to the recent crisis, then these issues are even more problematic today – if only as a result of still bigger and broader financial conglomerates emerging from governments' efforts to stabilize the system. In the restructuring process some important things can easily get lost, with thousands of people from competing institutions newly hired and others dropped from the team. Whatever affirmative culture once existed can get washed-away in the merger integration. Such factors are sometimes complemented by banks' underinvestment in risk management and compliance (the "defense") and its perennial disadvantage in questions of judgment and engagement against revenue- and earnings-generation (the "offense"). Usually this "tilt" is compounded by levels and systems of compensation designed to emphasize bonus against malus. Reputational capital is lost by people, acting individually and collectively. So what drives them is of critical importance.

Nor can boards of directors be let off the hook. They are supposed to set the tone that dominates everything a bank does, and how that is projected into the marketplace. In some cases factors like poor industry knowledge of directors, lack of technical background, dominant or "imperial" chairmen, and a boardroom sociology that puts a premium on "teamwork" can be at fault. And who is supposed to control boards? Presumably it's individual investors and fiduciaries, which control shareholder voting rights. Perhaps most important are institutional investors who fail to use the power of the proxy to challenge errant boardroom behavior – possibly because they themselves face conflicts of interest and do business with the same banks in which they hold voting shares. And not least, banking regulators have plenty of problems understanding and approving conventional risk indicators and management in large, complex banks and other financial firms. Understanding the specific reputation-sensitivity of practices in the banks they regulate at the business-line level just may be too much to ask.

One would like to believe that market discipline – triggered by stock price erosion that reflects the impact of reputation-effects on the franchise value of banks – can be a powerful deterrent. But this depends critically on the efficiency and effectiveness of corporate governance. Banks continue to encounter serious instances of reputation loss due to misconduct despite the effects on the value of their business. Alternatives include civil litigation and external regulation aimed at avoiding or remedying damage created by unacceptable financial practices. Yet civil litigation seems ineffective in changing bank behavior despite "deferred prosecution" agreements not to repeat offenses. This again suggests continued material lapses in the governance and management process. Even criminal fraud

convictions of banks seem to be relatively meaningless. In announcing Credit Suisse "guilty" plea to a criminal charge of aiding and abetting US tax evasion in May 2014, CEO Brady Dougan told a press conference he didn't think there would be any effects on the bank. There was the matter of $2.6 billion in fines and penalties, but he said that could be earned back by the end of the year and wouldn't affect the bank's regulatory capital. No serious changes in strategy. No senior management changes. No client defections. No investor flight. Just business as usual.

Dealing properly with reputational risk can be an expensive business, with compliance systems that are costly to set up and maintain, and various types of walls between business units and functions that impose opportunity costs on banks due to inefficient use of information and capital within the organization. And some kinds of reputational risk exposure in banks subject to conflicts of interest may defy sustainable control and possibly require structural remediation involving withdrawal from certain activities. These are not popular topics among bankers. Nonetheless, it can be argued that operational, compliance and reputational issues contribute to market valuations among the world's major financial conglomerates that fall well below valuations of simpler, more specialized financial services businesses.

In the end, it is probably leadership more than anything else that separates winners from losers over the long term – the notion that appropriate professional behavior reinforced by a sense of belonging to a quality franchise constitutes a decisive competitive advantage. Supply and demand for financial "talent" seem to meet in tight-knit banking subcultures that populate hypercompetitive markets, in which the temptation to trespass on off-limits regulatory or behavioral territory is palpable and self-reinforcing, both within banks and through chat-rooms and high job mobility between them. Adverse selection suggests that banking may be attracting more than its fair share of people who end up in the wrong business for the wrong reasons and create the wrong cultures. There is plenty of scope for problematic professional conduct that turns out to be "industry practice," but there also seems to be scope for firms that get in trouble and those that don't. What next? Here are some options: Tougher due diligence on who gets to do what in banking businesses that are prone to conflicts of interest and compliance issues. Zero-tolerance telegraphed by senior management and boards. Targeting civil and criminal enforcement actions on the specific individuals involved (those closest to the action) instead of those farthest away (shareholders). Compensation schemes that handcuff bankers to the future financial performance of their firm (already well advanced at most banks). Boards' willingness to leave on the table some incremental financial performance to achieve reduced regulatory and reputational risk, admittedly a tough balance to execute. None of this is easy, and there are no free lunches. Hard to prove, but the payoff could be handsome indeed.