CHAPTER 6

Reputational Risk

INGO WALTER
Seymour Milstein Professor of Finance, Corporate Governance and Ethics,
Stern School of Business, New York University

INTRODUCTION

The global financial crisis of 2007–2009 was associated with an unprecedented degree of financial and economic damage. For investors and financial intermediaries, the estimates seem to have risen to over $4 trillion or so worldwide by the time things began to stabilize, according to the International Monetary Fund (2009). Along with the financial damage has come substantial reputational damage for the financial services industry, for financial intermediaries and asset managers, and for individuals.

At the industry level, for example, Josef Ackermann, CEO of Deutsche Bank and chairman of the International Institute of Finance, noted in April 2008 that the industry 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—with a growing perception by the public of "clever crooks and greedy fools." He concluded that the industry has a great deal of work to do to regain its reputation.[1] Crisis-driven reputational damage at the firm level can be inferred from remarks by Peter Kurer, former supervisory board chairman of UBS AG, who noted at the bank's annual general meeting in April 2008 that "We shouldn't fool ourselves. We can't pretend that there has been no reputational damage. Experience says it goes away after two or three years."[2]

Perhaps it does, perhaps not, but the hemorrhage of private client withdrawals at the height of the crisis suggests severe reputational damage to the world's largest private bank—to the point that it was surpassed in assets under management by Bank of America (after its acquisition of Merrill Lynch) in 2009. The number of financial firms—ranging from Santander in Spain to Citigroup in the United States and Union Bancaire Privée in Switzerland—that have reimbursed client losses from the sale of bankrupt Lehman bonds, collapsed auction-rate securities, and investments in Bernard Madoff's fraudulent scheme suggests the importance of reputational capital and the lengths to which financial firms must go to maintain

The author is grateful for helpful comments by John Boatright and Ed Hartman on earlier drafts of this article.

it. And at the individual level the world is full of disgraced bankers whose hard work, career ambitions, and future prospects lie in tatters.

Whether at the industry, firm, or individual level, the reputational costs of the financial crisis have been enormous. The first section of this chapter considers the special nature of financial services and traces the roots of the reputational risk that firms in the industry invariably encounter. The second section defines what reputational risk is and outlines the sources of reputational risk facing financial services firms. The third section considers the key sources of reputational risk in the presence of transactions costs and imperfect information.[3] The fourth section surveys available empirical research on the impact of reputational losses imposed on financial intermediaries, including the separation of reputational losses from accounting losses. The chapter concludes with some governance and managerial implications.

THE SPECIAL CHARACTER OF FINANCIAL SERVICES

Financial services comprise an array of *special* businesses. They are special because they deal mainly with other people's money, and because problems that arise in financial intermediation can trigger serious external costs. In recent years, the roles of various types of financial intermediaries have evolved dramatically. Capital markets and institutional asset managers have taken a greater portion of the intermediation function from banks. Insurance activities conducted in the capital markets—such as credit default swaps and weather derivatives—compete with classic reinsurance functions. Fiduciary activities for institutional and retail clients are conducted by banks, broker-dealers, life insurers, and independent fund management companies. Intermediaries in each cohort compete as vigorously with their traditional rivals as with players in other cohorts, and the competition has been intensified by deregulation and rapid innovation in financial products and processes. Market developments have periodically overtaken regulatory capabilities intended to promote stability and fairness as well as efficiency and innovation. The regulatory arbitrage that can result has a great deal to do with the dynamics of the financial crisis of 2007–2009, and is being addressed in many of the regulatory efforts that have been proposed.

It is unsurprising that these conditions would give rise to significant reputational risk exposure for all financial firms. For their part, investors in banks and other financial intermediaries are sensitive to the going-concern value of the firms they own, and hence to the governance processes that are supposed to work in their interests. Regulators, in turn, are sensitive to the safety, soundness, and integrity of the financial system and will, from time to time, recalibrate the rules of the game. Market discipline, operating through the governance process, interacts with the regulatory process in ways that involve both costs and benefits to market participants and are reflected in the value of their business franchises.

WHAT IS REPUTATIONAL RISK?

There are substantial difficulties in defining the value of a financial firm's reputation, the extent of damage to that reputation, the origins of that damage, and,

therefore, the sources of reputational risk. Reputation itself may be defined as the opinion (more technically, a social evaluation) of the public toward a person, a group of people, or an organization. It is an important factor in many fields, such as education, business, online communities, and social status. In a business context, reputation helps drive the excess value of a business firm and such metrics as the market-to-book ratio. However, both a precise definition and data are found to be lacking. Arguably many deficiencies in both definition and data can be attributed to the fact that theory development related to corporate reputation has itself been deficient. Such problems notwithstanding, common sense suggests some sources of gain/loss in reputational capital:

- The cumulative reputation of the firm, including its self-promoted ethical image.
- Economic performance—market share, profitability, and growth.
- Stakeholder interface—shareholders, employees, clients, and suppliers.
- Legal interface—civil and criminal litigation and enforcement actions.

Consequently, proximate symptoms of sources of loss in reputational capital include:

- Client flight and loss of market share.
- Investor flight and increase in the cost of capital.
- Talent flight.

Increase in contracting costs. For practical purposes, reputational risk in the financial services sector is therefore associated with the possibility of loss in the going-concern value of the financial intermediary, which is to say the risk-adjusted value of expected future earnings. Reputational losses may be reflected in reduced operating revenues as clients and trading counterparties shift to competitors; increased compliance and other costs required to deal with the reputational problem, including opportunity costs; and an increased firm-specific risk perceived by the market. Reputational risk is often linked to operational risk, although there are important distinctions between the two. According to Basel II, operational risks are associated with people (internal fraud, clients, products, business practices, employment practices, and workplace safety), internal processes and systems, and external events (external fraud, damage or loss of assets, and force majeure). Operational risk is specifically *not* considered to include strategic and business risk, credit risk, market risk or systemic risk, or reputational risk.[4]

If reputational risk is bracketed out of operational risk from a regulatory perspective, then what is it? A possible working definition is as follows: Reputational risk comprises the risk of loss in the value of a firm's business franchise that extends beyond event-related accounting losses and is reflected in a decline in its share performance metrics. Reputation-related losses reflect reduced expected revenues and/or higher financing and contracting costs. Reputational risk, in turn, is related to the strategic positioning and execution of the firm, conflicts of interest exploitation, individual professional conduct, compliance and incentive systems, leadership, and the prevailing corporate culture. Reputational risk can frequently be rooted in conflicts of interest—between the firm and its clients, between clients, or within the financial firm itself.[5] Reputational risk is usually the consequence

of management *processes* rather than discrete *events*, and, therefore, requires risk control approaches that differ materially from operational risk.

According to this definition, a reputation-sensitive event might trigger an identifiable monetary decline in the market value of the firm. After subtracting from this market capitalization loss the present value of direct and allocated costs, such as fines and penalties and settlements under civil litigation, the balance can be ascribed to the impact on the firm's reputation. Firms that promote themselves as reputational standard-setters will, accordingly, tend to suffer larger reputational losses than firms that have taken a lower profile—that is, reputational losses associated with identical events according to this definition may be highly idiosyncratic to the individual firm.

In terms of the overall hierarchy of risks faced by financial intermediaries, reputational risk is perhaps the most intractable. In terms of Exhibit 6.1, market risk is usually considered the most tractable, with adequate time-series and cross-sectional data availability, appropriate metrics to assess volatility and correlations, and the ability to apply techniques such as value at risk (VaR) and risk-adjusted return on capital (RAROC). Credit risk is arguably less tractable, given that many credits are on the books of financial intermediaries at historical values. The analysis of credit events in a portfolio context is less tractable than market risk in terms of the available metrics, although many types of credits have over the years become *marketized* through securitization structures such as asset-backed securities (ABSs) and collateralized loan obligations (CLOs), as well as derivatives such as credit default swaps (CDSs). These financial instruments are priced in both primary and secondary markets, and transfer some of the granularity and tractability found in market risk to the credit domain. Liquidity risk, by contrast, has both pluses and minuses in terms of tractability. In continuous markets, liquidity risk can be calibrated in terms of bid-offer spreads, although in times of severe market stress and flights to quality, liquidity can disappear.

If the top three risk domains in Exhibit 6.1 show a relatively high degree of manageability, the bottom three are frequently less manageable. Operational risk is a composite of highly manageable risks with a robust basis for suitable risk metrics

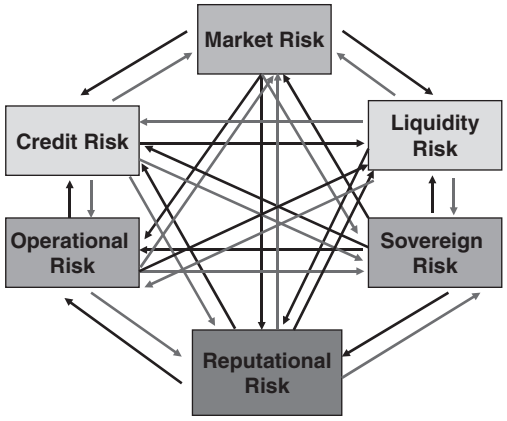


Exhibit 6.1 A Hierarchy of Risks Confronting Financial Intermediaries

together with risks that represent catastrophes and extreme values—tail events that are difficult to model and, in some cases, have never actually been observed. Here management is forced to rely on either simulations or external data to try to assess the probabilities and potential losses. Meanwhile, sovereign risk assessment basically involves applied political economy and relies on imprecise techniques, such as stylized facts analysis, so that the track record of even the most sophisticated analytical approaches is not particularly strong—especially under conditions of macro-stress and contagion. As in the case of credit risk, sovereign risk can be calibrated when sovereign foreign-currency bonds and sovereign default swaps (stripped of nonsovereign attributes like external guarantees and collateral) are traded in the market. This leaves reputational risk as perhaps the least tractable of all—with poor data, limited usable metrics, and strong fat-tail characteristics.

The other point brought out in Exhibit 6.1 relates to the linkages between the various risk domains. Even the most straightforward of these—such as the linkage between market risk and credit risk—are not easy to model or to value, particularly in a bidirectional form. There are 36 such linkages, exhibiting a broad range of tractability. It can be argued that the linkages that relate to reputational risk are among the most difficult to assess and to manage.

SOURCES OF REPUTATIONAL RISK

Where does reputational risk in financial intermediation originate? It may emanate in large part from the intersection between the financial firm and the competitive environment, on the one hand, and from the direct and indirect network of controls and behavioral expectations within which the firm operates, on the other hand, as depicted generically in Exhibit 6.2.[6] The franchise value of a financial institution as a going concern is calibrated against these two sets of benchmarks. One of them, market performance, tends to be relatively transparent and easy to reward

Exhibit 6.2 Reputational Risk and the External Control Web

or punish. The other, performance against corporate conduct benchmarks, is far more opaque but potentially more critical as a source of risk to shareholders.

Management must work to optimize with respect to both sets of benchmarks. If it strays too far in the direction of meeting the demands of social and regulatory controls, it runs the risks of poor performance in the market, punishment by shareholders, and possibly a change in corporate control. If it strays toward unrestrained market performance and sails too close to the wind in terms of questionable market conduct, its behavior may have disastrous results for the firm, its managers, and its shareholders. Such are the rules of the game, and financial intermediaries have to live with them.

But the rules are not immutable. There is constant tension between firms and regulators about appropriate constraints on corporate conduct. Sometimes financial intermediaries win battles (and even wars) leading to periods of deregulation. Sometimes it is possible to convince the public that self-regulation and market discipline are powerful enough to obviate the need for external control. Sometimes the regulators can be convinced, one way or another, to go easy. Then along comes another major transgression, and the constraint system reacts and creates a spate of new regulations. A wide array of interests get into this constant battle to define the rules under which financial business gets done—managers, politicians, the media, activists, investors, lawyers, and accountants—and eventually a new equilibrium gets established which will define the rules of engagement for the period ahead. There are some more fundamental factors at work as well. Laws and regulations governing the market conduct of firms are not created in a vacuum. They are rooted in social expectations as to what is appropriate and inappropriate, which in turn are driven by values imbedded in society. These values are rather basic. They deal with lying, cheating, and stealing, with trust and honor, with what is right and wrong. These are the *ultimate* benchmarks against which conduct is measured and which may be the origins of key reputational losses. But fundamental values in society may or may not be reflected in people's *expectations* as to how a firm's conduct is assessed. There may be a good deal of slippage between social values and how these are reflected in the public expectations of business conduct. Build-up of adverse opinion in the media, the formation of special-interest lobbies and pressure groups, and the general tide of public opinion with respect to one or another aspect of market conduct, can be reputationally debilitating. Moreover, neither values nor expectations are static in time. Both change. But values seem to change much more gradually than expectations. Indeed, fundamental values such as those previously noted are probably as close as one comes to constants in assessing business conduct. But even in this domain, things do change. As society becomes more diverse and mobile, for example, values tend to evolve. They also differ across cultures. And they are sometimes difficult to interpret. Is lying to clients or to trading counterparties wrong? What is the difference between lying and bluffing? Is the *context* necessary to determine how particular behavior is assessed? The same conduct may be interpreted differently under different circumstances, so that interpretations may change significantly over time and differ widely across cultures, giving rise to unique contours of reputational risk. There is additional slippage between society's expectations and the formation of public policy on the one hand, and the activities of public interest groups on the other. Things may go on as usual for a while despite occasional media commentary about

inappropriate behavior of a firm or an industry in the marketplace. Then, at some point, some sort of social tolerance limit is reached. A firm goes too far. A consensus emerges among various groups concerned with the issue. The system reacts through the political process, and a new set of constraints on firm behavior develops, possibly anchored in legislation, regulation, and bureaucracy. Or the firm is subject to class action litigation.[7] Or its reputation is so seriously compromised that its share price drops sharply. As managers review the reputational experiences of their competitors, they cannot escape an important message. Most financial firms can endure a credit loss or the cost of an unsuccessful trade or a broken deal, however large, and still survive. These are business risks that firms have learned to detect and limit their exposure to before the damage becomes serious. Reputational losses may be imposed by external reactions that may appear to professionals as unfocused or ambiguous, even unfair. They may also be new—a new reading of the rules, a new finding of culpability, something different from the way things were done before. Although regulators and litigants, analysts, and the media are accepted by financial professionals as facts of life, such outsiders can be influenced by public uproar and political pressure, during which times it is difficult to defend an offending financial firm.[8] In the United States, for example, tighter regulation and closer surveillance, aggressive prosecution and plaintiff litigation, unsympathetic media and juries, and stricter guidelines for penalties and sentencing make it easier to get into trouble and harder to avoid serious penalties. Global brokerage and trading operations, for example, involve hundreds of different, complex, and constantly changing products that are difficult to monitor carefully under the best of circumstances. Doing this in a highly competitive market, where profit margins are under constant challenge and there is considerable temptation to break the rules, is even more challenging. Performance-driven managers, through compensation and promotion practices, have sometimes unwittingly encouraged behavior that has inflicted major reputational damage on their firms and destroyed some of them.

The reality is that the value of financial intermediaries suffers from such uncertain reputation-sensitive conditions. Since maximizing the value of the firm is supposed to be the ultimate role of management, its job to learn how to run the firm so that it optimizes the long-term trade-offs between profits and external control. It does no good to plead unfair treatment—the task is for management to learn to live with it, and to make the most of the variables it can control.

The overall process can be depicted in the diagram in Exhibit 6.3, which represents the firm and its internal governance processes in the center and various layers of external controls affecting both the firm's conduct and the reputational consequences of misconduct—ranging from hard compliance components near the center to soft but potentially vital issues of appropriate conduct on the periphery. Clearly, serious reputational losses can impact a financial firm even if it is fully in compliance with regulatory constraints and its actions are entirely legal. The risk of reputational damage incurred in these outer fringes of the web of social control are among the most difficult to assess and manage. Nor is the constraint system necessarily consistent. There are important differences in regulatory regimes (as well as expectations regarding responsible conduct) across markets in which a firm is active, so that conduct which is considered acceptable in one environment may give rise to significant reputational risk in another.

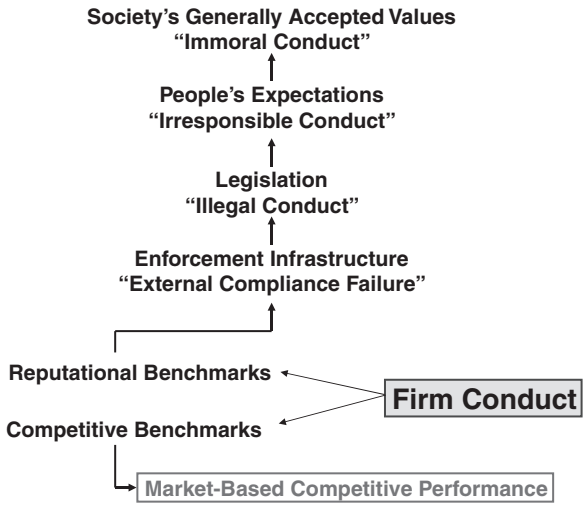


Exhibit 6.3 Performance Gaps, Competition, and Conflict

VALUING REPUTATIONAL RISK

Recent research has attempted to quantify the impact of reputational risk on share prices during the 1980s and 1990s.[9] Given the nature of the problem, most of the evidence has been anecdotal, although a number of event studies have been undertaken in cases where the reputation-sensitive event was clean in terms of the release of the relevant information to the market.

Exhibit 6.4 summarizes shareholder value losses in a reputation-sensitive situation involving the aforementioned sources of loss: (1) client defections and revenue erosion; (2) increases in monetary costs comprising accounting write-offs associated with the event, increased compliance costs, regulatory fines, and legal settlements, as well as indirect costs related to loss of reputation, such as higher financing costs, contracting costs, and opportunity costs; and (3) increases in firm-specific (unsystematic) risk assigned by the market as a result of the reputational

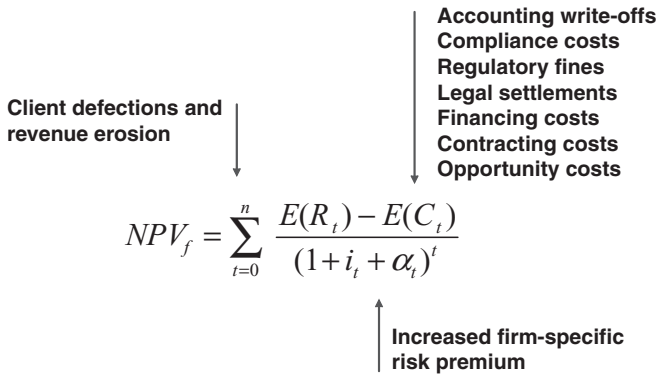


Exhibit 6.4 Reputation-Sensitive Events in a Simple Going-~~concern~~ Valuation Framework

event in question. In order to value the pure reputational losses, it is necessary to estimate the overall market value loss of the firm to a reputation-sensitive event, and then deduct the monetary losses identified in Exhibit 6.4. Consider the following example.[10] On December 28, 1993, the Bank of Spain took control of the country's fourth largest bank, Banco Español de Crédito (Banesto). Subsequently, shares of J.P. Morgan, a U.S. bank holding company closely involved with Banesto, declined dramatically. Such a reaction appeared inconsistent with market rationality, given that the impact of the event on Morgan's bottom line was trivial inasmuch as the accounting loss to Morgan was unlikely to exceed $10 million after taxes. Perhaps something more than the underlying book value of J.P. Morgan was moving the price of the stock. In particular, the central bank takeover of Banesto may have affected the value of Morgan's corporate franchise in some of the firm's core business areas, notably securities underwriting, funds management, client advisory work, and its ability to manage conflicts of interest that can accompany such activities in nontransparent environments. J.P. Morgan was involved in Banesto in four ways, in addition to normal interbank transactions relationships:[11]

1. In May 1992, it began raising funds for the Corsair Partnership, LP, aimed at making noncontrolling investments in financial institutions. By February 1993, Morgan had raised over $1 billion from 46 investors, including pension funds and private individuals. Morgan served as general partner and fund manager, with an investment of $100 million. The Corsair Partnership's objective was to identify troubled financial institutions and, by improving their performance, earn a significant return to shareholders in the fund. The Corsair Partnership's first investment, undertaken in February 1993, was a share purchase of $162 million in Banesto, thereby giving Morgan a $16.2 million equity stake in the Spanish bank.
2. A vice-chairman of JP Morgan served on the Spanish bank's board of directors.
3. Morgan was directly advising Banesto on its financial and business affairs.
4. As part of an effort to recapitalize Banesto, Morgan was lead underwriter during 1993 of two stock offerings that totaled $710 million. The Corsair Partnership was intended to search for troubled financial institutions in the United States and abroad. The objective was to restructure such institutions by applying Morgan's extensive expertise and contacts. Morgan indicated that Corsair investors could expect a 30 percent annual return over 10 years. Although Morgan had a separate investment banking subsidiary (J.P. Morgan Securities, Inc.), Corsair was believed to be the first equity fund organized and managed by Morgan since the Glass-Steagall Act separated banking and securities activities in 1933, a separation which ended in 1999. The business concept of searching for troubled financial institutions emerged from a time of turmoil in the United States and foreign banking sectors. When the U.S. banking industry started to improve as a result of a favorable interest rate environment, Corsair ventured abroad. Corsair's first stake in Banesto was taken in February 1993. By August 1993, it had invested $162 million (23 percent of the funds raised) in the Spanish bank. The overall J. P. Morgan–Banesto relationship is depicted in Exhibit 6.5.

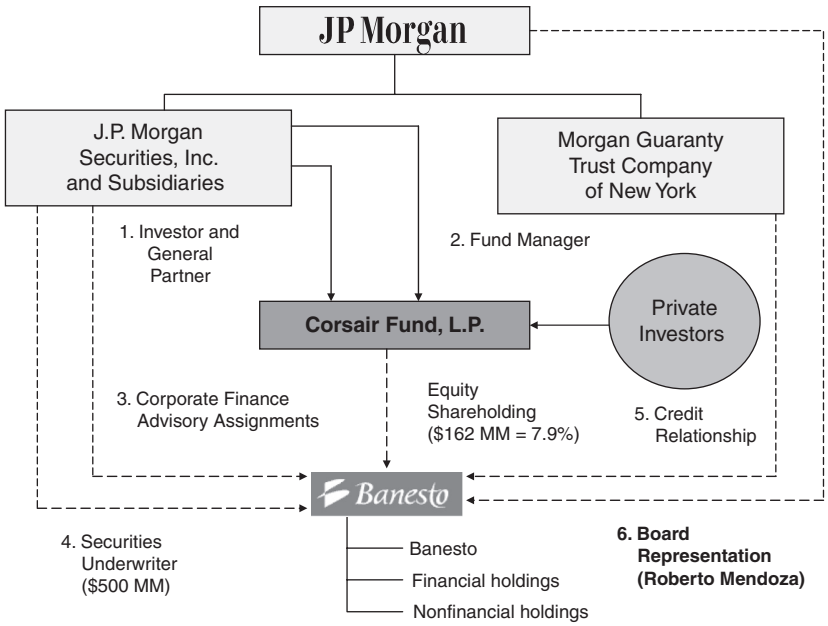


Exhibit 6.5 Reputational Risk Exposure: J.P. Morgan and Banco Español de Crédito, 1993

Banesto's problems stemmed from rapid growth and a convoluted structure of industrial holdings, followed by a serious downturn in the Spanish economy. The bank's lending book decreased from 4 trillion pesetas in 1988 to Pta. 2.3 trillion in 1991, a period when its competitors were growing at a quarter of that rate. Banesto bid aggressively for deposits, increasing interest rates by 51 percent while competitors increased theirs by 40 percent. When the Spanish economy weakened, the bank was stuck with an array of bad loans and losses on its industrial holdings. In October 1992, after a partial audit, the Bank of Spain was forced to lend the troubled institution a substantial amount. A full audit released at the end of December 1993 revealed that Banesto assets of Pta. 5.5 trillion ($385 billion) were overvalued in excess of Pta. 50 billion ($3.5 billion). In April 1994, Banesto was bought for $2.05 billion by Banco Santander, leaving costs of $3.7 billion to be borne by the Spanish banks and by taxpayers. Morgan had been advising Banesto on various deals since 1987. In July 1992, Morgan's involvement became more extensive when it began advising Banesto on how to raise capital. By August 1993, Morgan had assisted Banesto in two rights issues to raise $710 million. During the period of these rights issues, Corsair invested $162 million in Banesto. In a letter dated December 27, 1993, Morgan wrote to the Bank of Spain's governor, outlining how Banesto could continue to raise capital, including a bond issue that Morgan was planning to launch in the first quarter of 1993. Instead, the Bank of Spain took control of Banesto on the following day, December 28, 1993. Citing mismanagement and reckless lending, the governor justified the action as being necessary to avoid a run on the deposits of the bank, whose share prices were falling sharply on the Madrid Exchange. Given Morgan's multifaceted involvement in Banesto and potential conflicts imbedded in that relationship, the announcement of the takeover

could have had a large effect on the value of Morgan's reputation and business franchise and hence its stock price. In order to test the impact of the Banesto case on the J.P. Morgan share price, the authors of a study of this case use conventional event study methodology.[12] They create a sample prediction of returns on Morgan stock and compare the predicted returns with actual returns on Morgan shares after the Banesto event announcement.[13] The difference is considered the excess return attributable to the event, which is to say the difference between what shareholders would have received had they sold their shares in the market 50 days prior to the announcement and what they would have received if they had sold them on subsequent days. If the reputation effect hypothesis is correct, the market response to the Bank of Spain's announcement on December 28, 1993, should have significantly exceeded the firm's book exposure to Banesto.[14] Prior to the announcement, Morgan stock behaved as predicted based on its behavior during the 250 days before the event period. A few days before announcement, the stock price began to decline. Thereafter, an essentially steady decline occurred. A cumulative loss of 10 percent of shareholder equity value is apparent 50 days after the announcement translates into a loss in J.P. Morgan market capitalization of approximately $1.5 billion versus a maximum direct loss of only $10 million from the Banesto failure. This analysis suggests that the loss of an institution's franchise value can far outweigh an accounting loss when its reputation is called into question, a finding similar to that of Smith (1992) in the case of Salomon Brothers, Inc. Reasons for the adverse market reaction can only be conjectured. The takeover of Banesto could have been seen as compromising Morgan's reputation in precisely those areas key to its future. Inability to turn Banesto around may have called into question Morgan's ability to successfully advise clients. Banesto, as the dominant participant in the Corsair portfolio, may have suggested flaws in Morgan's ability to organize and manage certain equity funds. Difficulties with underwriting stock issues and placing shares with important investor-clients raises questions about its ability to judge risks in underwriting securities. Service on Banesto's board suggests problems with monitoring, and the configuration of Morgan's various involvements with Banesto suggests the potential for conflicts of interest or lack of objectivity. Whatever the linkages, here was a case of a financial services firm of exceedingly high standing, which in no way violated legal or regulatory constraints but whose shares nevertheless appeared to have been adversely affected by the market reaction to the way a high-profile piece of business was handled. In recent years, event studies such as this have yielded a growing body of evidence about share price sensitivity to reputational risk. For example, Cummins, Lewis, and Wei (2006) undertook a large sample study of operational and reputational events contained in the Fitch OpVar database. Exhibit 6.6 shows the results in terms of the magnitude of the losses using three-factor estimation models in terms of cumulative abnormal returns (CARs) and number of trading days before and after the announcement. The authors, however, do not distinguish between operational losses and reputational losses, as defined earlier.

De Fontnouvelle et al. (2006) use loss data from the Fitch OpVar and SAS OpRisk databases to model operational risk for banks that are internationally active. In a series of robust statistical estimates, they find a high degree of regularity in operational losses that can be quantified. This would justify maintaining significant capital reserves against operational risk—see Exhibits 6.7 and 6.8. The paper

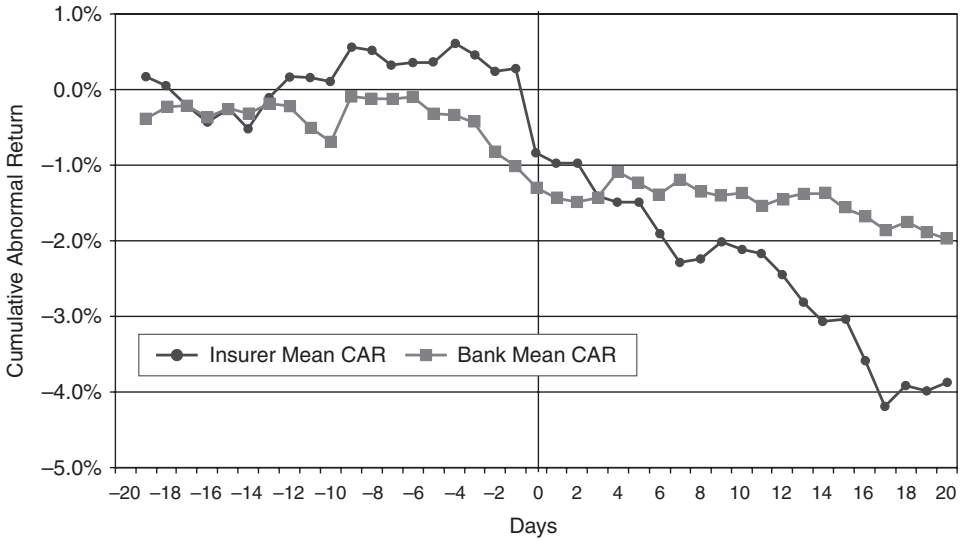


Exhibit 6.6 Cumulative Abnormal Returns for Banks and Insurers in a Large-sample Study of Operational and Reputational Events (Three-factor Models)

Source: J. David Cummins, Christopher M. Lewis and Ran Wei, "The Market Impact of Operational Risk Events for U.S. Banks and Insurers," *Journal of Banking and Finance* 30, no. 10 (October 2006): 2605–2634.

also segments the losses by event type and by activity line, as well as whether the operational losses occurred in the United States. The largest losses involved retail and commercial and retail/private banking activities in terms of type of event. As in the case of other studies, the authors do not distinguish the associated accounting losses due to legal settlements, fines, penalties, and other explicit operational risk–related costs from reputational losses. As such, these estimates are relevant from a regulatory perspective but probably materially understate the losses to shareholders.

In a pilot study of 49 reputation-sensitive events, using the aforementioned definition and excluding operational events, we find negative mean CARs of up to 7 percent and $3.5 billion, depending on the event windows used.[15] Exhibit 6.9 shows the results graphically, and the tables in Exhibits 6.10 and 6.11 show the numerical results. The results do not, however, distinguish between the associated monetary losses and the pure reputational losses.[16]

The only study to date that attempts to identify pure reputational losses is Karpoff, Lee, and Martin (2006). The authors attempt to distinguish book losses from reputational losses in the context of U.S. Securities and Exchange Commission enforcement actions related to earnings restatements or "cooking the books." The authors review 2,532 regulatory events in connection with all relevant SEC enforcement actions from 1978 to 2002 and the monetary costs of these actions in the ensuing period through 2005. These monetary costs are then compared with the cumulative abnormal returns estimated from event studies to separate them from the reputational costs. The results are depicted in Exhibit 6.12. Note that the reputational losses (66 percent) are far larger than the cost of fines (3 percent), class

Exhibit 6.7 Operational Losses by Event Type

	SAS OpRisk				Fitch OpVar				
		Percentiles ($M)				Percentiles ($M)			
Event Type	% of All Losses	50%	75%	95%	% of All Losses	50%	75%	95%	Wilcoxon Test
All Event Types	100.0%	6	17	88	100.0%	6	17	93	90.2%
Internal Fraud	23.0%	4	10	42	27.0%	6	16	110	1.2%
External Fraud	16.5%	5	17	93	16.6%	4	12	70	33.2%
EPWS	3.0%	4	14	–	3.3%	5	11	–	95.0%
CPBP	55.5%	7	20	95	48.1%	7	20	99	96.3%
Damage to Physical Assets	0.4%	18	–	–	0.3%	20	–	–	92.9%
BDSF	0.2%	36	–	–	0.4%	10	–	–	38.0%
EDPM	1.3%	9	27	–	4.2%	4	11	–	14.6%
Kruskal-Wallis Test	6.4E-06				9.1E-05				
Panel B, Losses that occurred outside the U.S.									
All Event Types	100.0%	10	36	221	100.0%	13	46	288	16.7%
Internal Fraud	48.5%	9	35	259	42.9%	15	62	381	1.5%
External Fraud	15.3%	7	27	–	21.6%	10	28	136	27.3%
EPWS	0.8%	7	–	–	1 .6%	2	7	–	75.3%
CPBP	32.6%	14	51	374	28.6%	13	51	359	99.6%
Damage to Physical Assets	0.0%	–	–	–	0.3%	163	–	–	–
BDSF	0.8%	7	–	–	0.5%	3	–	–	42.3%
EDPM	1 .9%	29	–	–	4.6%	5	19	–	8.1%
Kruskal-Wallis Test	11.8%				5.5E-05				

Source: Patrick de Fontnouvelle, Virginia DeJesus-Rueff, John S. Jordan, and Eric S. Rosengren, "Capital and Risk: New Evidence on Implications of Large Operational Losses," Federal Reserve Bank of Boston Working Paper, September 2006.

action settlements (6 percent), and accounting write-offs (25 percent) resulting from the events in question.

It is likely that the broader the range of a financial intermediary's activities, (1) the greater the likelihood that the firm will encounter exploitable conflicts of interest and reputational risk exposure; (2) the higher will be the potential agency costs facing its clients; and (3) the more difficult and costly will be the safeguards necessary to protect the value of the franchise. If this proposition is correct, costs associated with reputational risk mitigation can easily offset the realization of economies of scope in financial services firms—scope economies that are supposed to generate benefits on the demand side through cross-selling (revenue synergies) and on the supply side through more efficient use of the firm's

Exhibit 6.8 Operational Losses by Business Line

	SAS OpRisk				Fitch OpVar				
		Percentiles ($M)				Percentiles ($M)			
Business Line	% of All Losses	50%	75%	95%	% of All Losses	50%	75%	95%	Wilcoxon Test
All Business Lines	100%	6	17	88	100%	6	17	93	90.2%
Corporate Finance	6%	6	23	–	4%	8	23	–	55.8%
Trading and Sales	9%	10	44	334	9%	10	27	265	89.2%
Retail Banking	38%	5	11	52	39%	5	12	60	73.1%
Commercial Banking	21%	7	24	104	16%	8	28	123	13.3%
Payment and Settlement	1%	4	11	–	1%	4	11	–	65.8%
Agency Services	2%	22	110	–	3%	9	28	–	10.3%
Asset Management	5%	8	20	–	6%	3	22	165	80.8%
Retail Brokerage	17%	4	12	57	22%	4	13	67	98.0%
Kruskal-Wallis Test					1.0E–12				
Panel B. Losses that occurred outside the U.S.									
All Business Lines	100%	10	36	221	100%	13	46	288	16.7%
Corporate Finance	2%	13	–	–	3%	12	27		69.3%
Trading and Sales	9%	30	125	–	12%	25	66	–	35.3%
Retail Banking	41%	6	27	101	44%	9	29	272	10.4%
Commercial Banking	30%	15	42	437	21%	35	91	323	2.4%
Payment and Settlement	1%	5	–	–	1%	13	–	–	17.7%
Agency Services	2%	45	–	–	3%	20	77	–	49.6%
Asset Management	3%	5	47	–	5%	7	23	–	90.1%
Retail Brokerage	12%	10	42	–	11%	8	34	–	42.6%
Kruskal-Wallis Test	6.6E–04				1.1E–05				

Source: Patrick de Fontnouvelle, Virginia DeJesus-Rueff, John S. Jordan, and Eric S. Rosengren, "Capital and Risk: New Evidence on Implications of Large Operational Losses," Federal Reserve Bank of Boston Working Paper, September 2006.

business infrastructure (cost synergies). As a result of conflict exploitation, the firm may win and clients may lose in the first instance, but subsequent adverse reputational and regulatory consequences (along with efficiency factors such as the managerial and operational cost of complexity) can be considered diseconomies of scope.

Breadth of engagement with clients may create conflicts of interest that can be multidimensional and involve a number of different stakeholders at the same time. Several examples came to light during the corporate scandals in the early 2000s. Following the $103 billion bankruptcy of WorldCom in 2002, for example, it appeared that Citigroup, a multifunctional, global financial conglomerate, was serving as equity analyst, supplying assessments of WorldCom to institutional and (through the firm's brokers) retail clients, while simultaneously advising WorldCom management on strategic and financial matters. Citigroup's equity analyst at times participated in WorldCom's board meetings. As a major

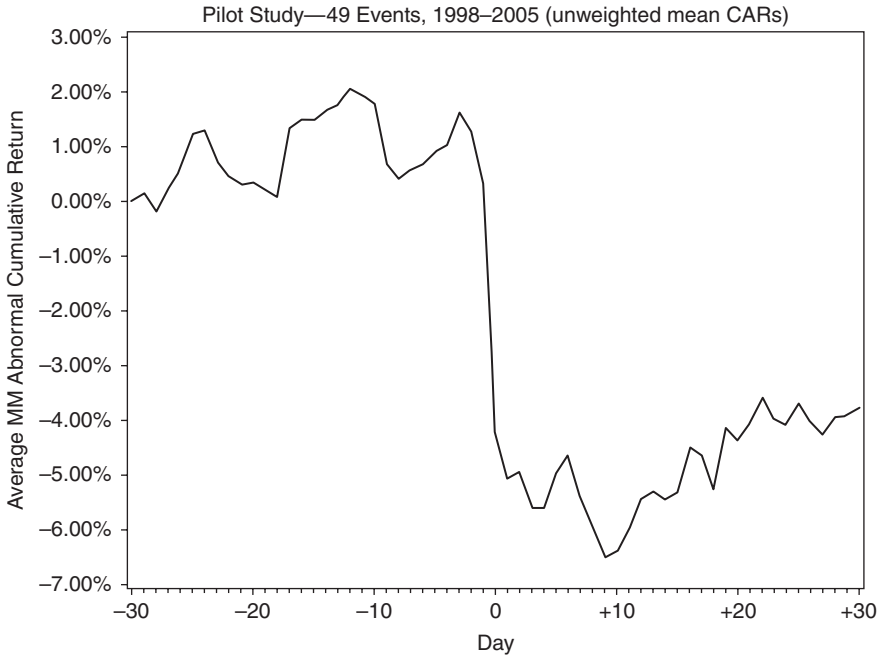


Exhibit 6.9 Reputational Impact and Share Prices
Source: Gayle De Long, Anthony Saunders, and Ingo Walter, "Pricing Reputation-Sensitive Events in Banking and Financial Services," New York University, Department of Finance Working Paper (in draft).

telecommunications-sector commercial and investment banking client, Citigroup maintained an active lending relationship with WorldCom and successfully competed for its securities underwriting business. At the same time, Citigroup served as the exclusive pension fund adviser to WorldCom and executed significant stock option trades for WorldCom executives, while at the same time conducting

Exhibit 6.10 Relative CARs—Reputational Loss Pilot Study

Cumulative Abnormal Returns—Statistical Summary				
Event window	(−5,3)	(−5,10)	(−1,3)	(−1,10)
Mean	−6.24%	−7.02%	−6.79%	−7.57%
Patell Z-score	−10.02	−7.63	−14.37	−9.41
Median	−4.59%	−4.92%	−4.55%	−4.96%
Bottom 95% loss	−38.17%	−44.97%	−35.88%	−44.37%
Bottom 99% loss	−62.57%	−47.52%	−63.78%	−48.73%
90% skew	−1.0907	0.1740	−1.2563	0.0538
90% kurtosis	0.0696	−4.6151	0.9144	−4.7431

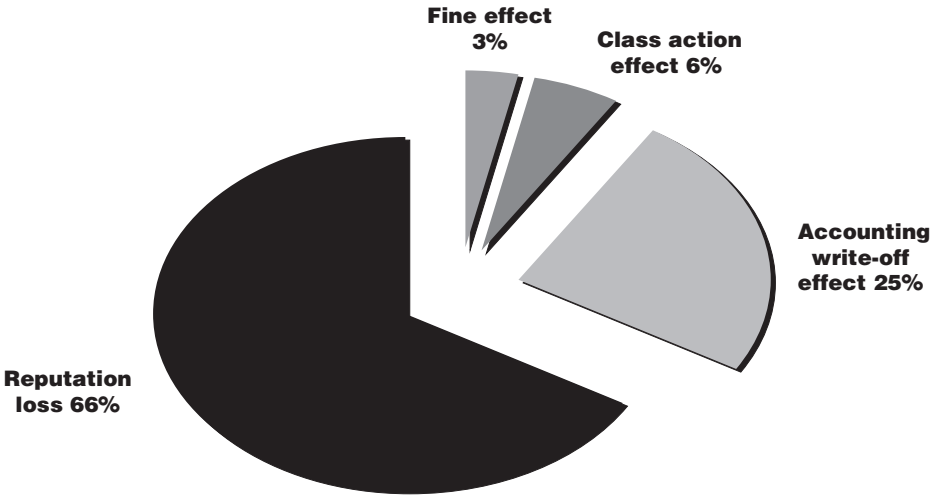
Source: Gayle De Long, Anthony Saunders, and Ingo Walter, "Pricing Reputation-Sensitive Events in Banking and Financial Services," New York University, Department of Finance Working Paper (in draft).

Exhibit 6.11 Absolute CARs—Reputational Loss Pilot Study

Reputational Losses in Market Capitalization—Statistical Summary				
Event window	(−5,3)	(−5,10)	(−1,3)	(−1,10)
Mean	−$3,300,009	−$3,485,131	−$1,765,038	−$1,950,161
p-value	0.0000	0.0013	0.0007	0.0049
Median	−$984,421	−$555,256	−$700,940	−$616,721
Bottom 95% loss	−$14,875,021	−$24,140,182	−$10,704,029	−$13,227,960
Bottom 99% loss	−$18,375,026	−$28,360,334	−$13,971,351	−$20,261,036
90% skew	−1.5269	0.2562	−0.5088	−1.3309
90% kurtosis	2.4720	−0.4915	0.1960	1.6990

proprietary trading in WorldCom stock and holding a significant position in the company's stock through its asset management unit. Additionally, Citigroup advised the WorldCom CEO, financed his margin purchases of company stock, and provided loans for one of his private businesses.

On the one hand, Citigroup was very successfully engaged in the pursuit of revenue economies of scope (cross-selling), simultaneously targeting both the asset and liability sides of its client's balance sheet, generating advisory fee income,



Data: All SEC enforcement actions 1978–2002 (2,532 regulatory events).
Actions and penalties tracked through November 15, 2005.
Mean CAR –38.06% = mean market value loss $397 million (24% higher for surviving firms).

Partitioned for sample:

Fines imposed on firms	**$5.01 million**
Class action payments	**$8 .59 million**
Accounting write-off	**$37 .4 billion**
Reputation loss	**$101 .5 billion**

Exhibit 6.12 Decomposing CARs Related to Earnings Restatement
Source: Jonathan M. Karpoff, D. Scott Lee, and Gerald S. Martin, "The Cost to Firms of Cooking the Books," Social Science Research Network, March 8, 2006. Available at http://ssrn.com/abstract=652121.

managing assets, and meeting the private banking needs of WorldCom's CEO. However, that same success caught the firm in simultaneous conflicts of interest relating to retail investors, institutional fund managers, WorldCom executives, and shareholders, as well as Citigroup's own positions in WorldCom credit exposure and stock trades. WorldCom's bankruptcy triggered a large market capitalization loss for Citigroup's own shareholders, only about a third of which can be explained by a $2.65 billion civil settlement the firm reached with investors in May 2004.[17]

It seems plausible that the broader the range of services that a financial firm provides to a given client in the market, and the greater the cross-selling pressure, the greater the potential likelihood that conflicts of interest and reputational risk exposure will be compounded in any given case, and, when these conflicts of interest are exploited, the more likely they are to damage the market value of the financial firm's business franchise once they come to light. Similarly, the more active a financial intermediary becomes in principal transactions such as affiliated private equity businesses and hedge funds, the more exposed it is likely to be to reputational risk related to conflicts of interest.

CONCLUSION

This article attempts to define reputational risk and to outline the sources of such risk facing financial services firms. It then considers the key drivers of reputational risk in the presence of transactions costs and imperfect information, and surveys available empirical research on the impact of reputational losses imposed on financial intermediaries. We conclude that market discipline, through the reputation effects on the franchise value of financial intermediaries, can be a powerful complement to regulation and civil litigation. Nevertheless, market discipline–based controls remain controversial. Financial firms continue to encounter serious instances of reputation loss due to misconduct despite its effects on the value of their franchises. This suggests material lapses in the governance and management process.[18]

Dealing with reputational risk can be an expensive business, with compliance systems that are costly to maintain and various types of walls between business units and functions that impose significant opportunity costs due to inefficient use of information within the organization. Moreover, management of certain kinds of reputational exposure in multifunctional financial firms may be sufficiently difficult to require structural remediation. However, reputation losses can cause serious damage, as demonstrated by reputation-sensitive, apparent accidents that seem to occur repeatedly in the financial services industry. Indeed, it can be argued that such issues contribute to market valuations among financial conglomerates that fall below valuations of more specialized financial services businesses (Laeven and Levine 2005; Schmid and Walter 2006).[19] The massive shrinkage of market values of financial firms in 2007–2009 depicted in Exhibit 6.13 certainly embodies reputational damage that will make it even more difficult to recover after the crisis ebbs.

Managements and boards of financial intermediaries must be convinced that a good defense is as important as a good offense in determining sustainable competitive performance. This is something that is extraordinarily difficult to put into practice in a highly competitive environment for both financial services firms and

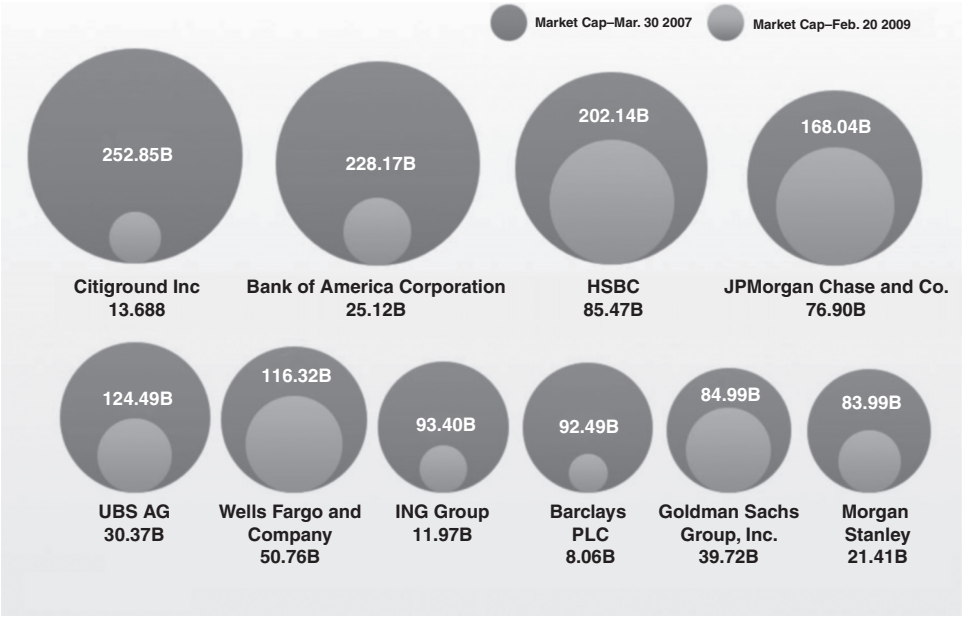


Exhibit 6.13 Declines in Market Capitalization of Major Banks, 2007–2009
Source: MyBankTracker.com.

for the highly skilled professionals that comprise the industry. A good defense requires an unusual degree of senior management leadership and commitment (Smith and Walter 1997). Internally, there have to be mechanisms that reinforce the loyalty and professional conduct of employees. Externally, there has to be careful and sustained attention to reputation and competition as disciplinary mechanisms. 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 comparative advantage.

NOTES

1. For the ensuing report, see http://www.iasplus.com/crunch/0804iifbestpractices.pdf.
2. See http://careers.hereisthecity.com/front_office/corporate_and_investment_banking/press_releases/124.cntns.
3. Earlier studies focusing on reputation include Chemmanur and Fulghieri (1994), Smith (1992), Walter and De Long (1995), and Smith and Walter (1997).
4. Basel II at http://www.bis.org/publ/bcbs107.htm.
5. See for example Attorney General (2003), Demsky (2003), Herman (1975), Krozner & Strahan (1999), Saunders (1985), Schotland (1980), and Walter (2004).
6. For an early discussion of external conduct benchmarks, see Galbraith (1973).
7. For a discussion, see Capiello (2006).
8. For a full examination of these issues, see Smith and Walter (1997).

9. For one of the early studies, see Smith (1992).
10. Walter and DeLong (1995).
11. For a journalistic account, see various 1994 issues of the *Wall Street Journal* and *Euromoney*. These matters were discussed there in great detail.
12. De Long and Walter (1994). For event study methodology, see Brown and Warner (1985).
13. In order to create this prediction, we regressed the daily return of Morgan stock on the daily return on the market index as well as on an industry-group index. The industry-group index included 20 financial institutions with characteristics showing some degree of overlap with those of J.P. Morgan. This was the unweighted average of share prices for Banc One, BankAmerica, Bank of Boston, Bank of New York, Bankers Trust NY, Barnett Bank, Bear Stearns, Chase Manhattan, Chemical Bank, Citicorp, Continental Bank, First Chicago, First Fidelity Bancorp, First Virginia, Merrill Lynch, Morgan Stanley Group, NationsBank, Paine Webber Group, Salomon Inc., and Wells Fargo. We used data from 300 days to 50 days prior to the announcement date (December 28, 1993). The resulting coefficients were then multiplied by the returns on the market and industry indexes from 50 days prior to 50 days after the announcement, in order to obtain an estimation of the daily stock return during this period. Then the excess return was calculated at the predicted return minus the actual Morgan stock returns for the period, and the cumulative excess return was plotted. In order to translate these results into the monetary effect on J.P. Morgan stock, the cumulated excess return was multiplied by the total market value of equity (shares outstanding times price per share) 50 days before the announcement.
14. We regressed Morgan's stock returns against the value-weighted NYSE index and the industry group composed of 20 banking and securities firms. While autocorrelation can be a problem in using daily stock returns, J.P. Morgan stock was heavily traded, so that daily carryover is unlikely to be significant. Indeed, when we controlled the industry for this potential problem by including the lagged market index as a regression, the resulting coefficient was negative and statistically insignificant. We obtained the following model, estimated over days –300 to –50 prior to the announcement date:

$$R_{JPMt} = -0.00014 + 0.5766 \times R_{Mt} + 0.2714 \times R_{Gt} + u_t$$

where R_{JPMt} = return on J.P. Morgan stock
R_{Mt} = return on NYSE composite (value-weighted) index
R_{Gt} = return on group of companies in the same industry.

The excess return attributable to the event is the calculated residual (u_t) from 50 days prior to 50 days after the announcement.

15. Based on an ongoing empirical study of reputational risk being conducted at the Stern School of Business, New York University.
16. Based on ongoing empirical work on reputation-sensitive financial services events with Gayle De Long and Anthony Saunders.
17. Similar issues surfaced in the case of the 2001 Enron bankruptcy. See Batson (2003) and Healy and Palepu (2003).
18. These issues are explored in Daniel Hoechle, Markus Schmid, Ingo Walter, and David Yermack, "Corporate Governance and the Diversification Discount," available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1341006.
19. See also Kanatas and Qi (2003) and Saunders and Walter (1997).

REFERENCES

Attorney General of the State of New York. 2003. *Global settlement: Findings of fact*. Albany, NY: Office of the State Attorney General.

Batson, Neal. 2003. *Final report*, Chapter 11, Case no. 01-16034 (AJG), United States Bankruptcy Court, Southern District of New York, July 28.

Brown, Stephen J., and Jerold B. Warner. 1985. Using daily stock returns: The case of event studies. *Journal of Financial Economics* 14: 3–31.

Capiello, S. 2006. Public enforcement and class actions against conflicts of interest in universal banking: The U.S. experience vis-à-vis recent Italian initiatives. Working Paper, Bank of Italy, Law and Economics Research Department.

Chemmanur, Thomas J., and Paolo Fulghieri. 1994. Investment bank reputation, information production, and financial intermediation. *Journal of Finance* 49 (March): 57–86.

Cummins, J. David, Christopher M. Lewis, and Ran Wei. 2006. The market impact of operational risk events for U.S. banks and insurers. *Journal of Banking and Finance* 30, no. 10 (October 2006): 2605–2634.

De Fontnouvelle, Patrick, Virginia DeJesus-Rueff, John S. Jordan, and Eric S. Rosengren. 2006. Capital and risk: New evidence on implications of large operational losses. Working Paper, Federal Reserve Bank of Boston (September).

De Long, Gayle, and Ingo Walter. 1994. J.P. Morgan and Banesto: An event study. Working Paper, New York University Salomon Center (April).

Demsky, Joel S. 2003. Corporate conflicts of interest. *Journal of Economic Perspectives* 17, no. 2 (Spring): 51–72.

Galbraith, John Kenneth. 1973. *Economics and the public purpose*. New York: Macmillan.

Herman, Edward S. 1975. *Conflicts of interest: Commercial banks and trust companies*. New York: Twentieth Century Fund.

Healey, Paul M., and Krishna G. Palepu. 2003. The fall of Enron. *Journal of Economic Perspectives* 17, no. 2 (Spring): 3–26.

International Monetary, Fund. 2009. *Global financial stability report*. Washington, DC: IMF (April).

Kanatas, George, and Jianping Qi. 2003. Integration of lending and underwriting: Implications of scope economies. *Journal of Finance* 58, no. 3: 1167–1191.

Krozner, Randall S., and Philip E. Strahan. 1999. Bankers on boards, conflicts of interest, and lender liability. Working Paper no. W7319, National Bureau of Economic Research (August).

Laeven, Luc, and Ross, Levine. 2007. Is there a diversification discount in financial conglomerates? *Journal of Financial Economics* 85: 331–367.

Saunders, Anthony. 1985. Conflicts of interest: An economic view. In *Deregulating Wall Street*, ed. Ingo Walter. New York: John Wiley & Sons.

Saunders, Anthony, and Ingo Walter. 1997. *Universal banking in the United States: What could we gain? What could we lose?* New York: Oxford University Press.

Schmid, Markus M., and Ingo Walter. 2009. Do financial conglomerates create or destroy economic value? *Journal of Financial Intermediation* 14, no. 2 (May 2009): 78–94.

Schotland, R.A. 1980. Abuse on Wall Street: Conflicts of interest in the securities markets. Westport, CT: Quantum Books.

Smith, Clifford W. 1992. Economics and ethics: The case of Salomon Brothers. *Journal of Applied Corporate Finance* 5, no. 2 (Summer): 23–28.

Smith, Roy C., and Ingo Walter. 1997. *Street smarts: Linking professional conduct and shareholder value in the securities industry*. Boston: Harvard Business School Press.

Walter, Ingo. 2004. Conflicts of interest and market discipline in financial services firms. In *Market Discipline Across Countries and Industries*, ed. Claudio Borio, William Curt Hunter, George G. Kaufman, and Kostas Tsatsaronis. Cambridge: MIT Press.

Walter, Ingo, and Gayle DeLong. 1995. The reputation effect of international merchant banking accidents: Evidence from stock market data. Working Paper, New York University Salomon Center.

ABOUT THE AUTHOR

Ingo Walter is the Seymour Milstein Professor of Finance, Corporate Governance and Ethics at the Stern School of Business, New York University, and dean of faculty. He has taught at New York University since 1970, and served a number of terms as associate dean for academic affairs, chair of International Business, chair of Finance, and, from 1990 to 2003, as director of the New York University Salomon Center for the Study of Financial Institutions. Since 1985 he has also been affiliated with INSEAD in Fontainebleau, France, and serves as a consultant to various corporations, banks, government agencies, and international institutions, and has authored or co-authored numerous books and articles in the fields of international trade policy, international banking, environmental economics, and economics of multinational corporate operations. Among his recent publications are *Governing the Modern Corporation* (Oxford University Press, 2006) and "Can Microfinance Reduce Portfolio Volatility?" (Working Paper, Social Science Research Network, 2008).