

A LENDER'S TAKE ON 'MORAL HAZARD'

Ethical challenges banking confronts, and five thoughts on how to do it

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Much of the public talk and vocal criticism of banks during the last two years or so has centered on the misbehaviors of bankers. The latest uproar, both public and political, is the result of apparent short-cuts and other deficiencies related to foreclosures on delinquent residential real estate customers. There is no question that the actions of some have brought strong criticism on our industry and greatly increased the existence of reputation risk from our various constituents.

But perhaps we should ask where our biggest business risks lie: In the behaviors of our own colleagues? Or in the behaviors of certain customers?

This is not a simple question.

A spreading blemish on our economy and society

The Ethics Resource Center, a not-for-profit organization headquartered in Alexandria, Va., publishes bi-annual surveys of ethics in the workplace. The latest was published in 2009 and represents the most comprehensive longitudinal study of business ethics in the U.S.

The results demonstrate a remarkably pervasive problem of employee behaviors across industries.

Approximately half of the 3,000 respondents from private sector businesses have reported observing personal misbehaviors. These misbehaviors include: company resource abuse (23%); abusive behavior (22%); email or internet abuse (18%); conflicts of interest (16%); falsifying time or expenses (10%); stealing (9%); and document alteration (6%). The study has 27 categories in all and for most categories, reflects comparable information to 2007. The results year-to-year show modest improvement in some of categories and deterioration in others.

Other studies in recent years by the Ethics Resource Center have focused on non-profits and governmental entities. A key finding: There appears to be little behavioral difference among the three large categories of employees-non-profits, government, and private enterprise.

In other words misbehaviors are everywhere and the problem is growing, not receding according to the data since 1994.

The implications of this "fact" are stunning. If the workforces across industry and professional lines have similar behaviors, we are not immune from significant problems in our own banks or in dealing with our customers.

"Moral hazard": Sometimes crisp, sometimes blurry

Moral hazard has several possible definitions and shades of meaning.

The most benign is the behavior of employees in responding to incentives without any serious reference to whether the incited behavior makes sense for the total enterprise or for the person or entity that is being solicited or "sold."

Behavioral scientists learned years ago that incentives modify behavior. But this is not necessarily unethical activity.

Moral hazard that is culpable and unethical includes those activities that deliberately violate the standards of a particular group, or its accepted norms, or the rights of individuals in that group.

The group could be your employer, your local community, the national community, or the local Rotary Club.

Moral hazard could also encompass such terms as "medical ethics" and "legal ethics." It is illegal and unethical to steal. It is illegal and unethical to misrepresent in a material way what is being sold or offered to customers.

Legal, yes. Ethical, hardly

But what of behaviors that while legal are certainly not ethical because of the harm they do to a segment of the group or the population?

The most vivid example for me of unethical behavior but activity not necessarily illegal is workplace bullying.

We have all observed bullying bosses, bullying directors, bullying loan committee chairmen, bullying owners, and bullying borrowers. In our own personal, non-working hours most of us have also observed bullying spouses and parents. We've certainly seen it among children while they are at play.

Personal misbehavior is all around us. It's in our own workplaces. Perhaps we've even become inured to some of what we see.

Fortunately, the better understood the problem of individual behaviors becomes and the more proactive that managements are within the cultures of their workplaces in responding and correcting it, the more transparent our work environments become. This tends to be self-correcting.

Ethics on the other side of the desk

However, we are still exposed to the possible misbehavior of customers.

One type of customer misbehavior that has become much more common recently is the tendency of some to simply walk away from their financial obligations. The term that has developed in a depressed real estate environment is "strategic default." Obligors are walking away from negative equity in their homes in startling numbers.

"Why be surprised?" you might ask.

My own view is that a contractual borrowing relationship defines the penalties and rewards to the borrower and the lender. The borrower gets the benefit of the loan, whatever that may be, while the lender gets a contractual rate of interest and repayment in full. A borrower signs a promissory note indicating an intent to repay.

But what if the deal goes sour for whatever reason? Is the note voidable at the borrower's discretion? How many lenders would willingly enter into a deal this way?

Credit risk has always been the main hazard in lending, and occasional customer dishonesty is not a new phenomenon.

Today, however, potential customer misbehaviors are probably reflected in the deteriorating level of ethical behavior embedded in the results of the latest National Business Ethics Survey.

How can you protect your bank?

Today's risks aren't new, but they appear to be growing. How are we to protect ourselves and our institutions against these risks?

Here's my short list of potential solutions:

1. Be fully trained as lenders to the requirements of the bank's business base.
2. Respect the essential and independent role of Loan Review and Internal and External Audit. We should consciously strive to take the confrontation out of these relationships.
3. Practice better due diligence on the borrower's business and the collateral that we accept as security.
4. Maintain a watchful eye on borrowers' activities. President Ronald Reagan said it very well: "Trust but verify."
5. Understand that ethical behavior is not a constant among customers or coworkers. We must be vigilant and "naturally" suspicious.

I wish today's world were otherwise but it's not. Transparency of individual behavior is the best antidote to unethical behavior, starting with each one of us. In future columns we'll explore some of the issues affecting lenders and banks more fully.

- About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear free audio interviews with Ed about workouts here. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.