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## WHAT REPUTATION RISK REALLY MEANS

Part 7 of a series: Community banks must work to rebuild reputation

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Blogger Ed O'Leary has been considering facets of the future of community banking, as seen through the lens of lending. This week he probes what independence means to community banks and why it is critical to them. You can start at the beginning of the series [here](#).

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There was an article on the editorial page of The Wall Street Journal this week on the subject of "sincerity." Since I've been conditioned to think of bankers as generally sincere people--professionals genuinely interested in helping customers achieve beneficial results for their businesses--I read the article with interest.

Notably, for the author's purposes, sincerity was defined as "the alignment between the inner and outer selves."

That definition struck me as a little "touchy-feely." But as I thought about it, it made good sense. It also reminded me of other applications of the term that bankers should spend more time thinking and talking about.

Rethinking sincerity as "alignment"

"Alignment" as a term describing one outcome of our actions gives us another way of understanding whether we are "walking the talk."

Financial analysts talk about the alignment of managements' interests and shareholders' interests. Bank managers responsible for the administration of incentive programs to stimulate the production of revenue have to balance the production of services for a fee with safety and soundness of the institution. How easy is it to load up the loan portfolio with credit exposures representing concentrations of credit or sell products that do not necessarily benefit the customer while generating income for the bank?

One might think of these as "soft" examples of conflicts of interest. For things to work harmoniously there should be an "alignment" of interests. This is perhaps another way of saying that the interests of the principal constituents of any business should exist in a balanced and compatible way.

Do stockholders' interests necessarily trump the interests of any and all other constituents? Too often we seem to act as if this is the only valid metric of how and what we're doing.

Alignment and reputation risk

There is one major indicator of serious alignment problems for the banking business today and that's the current level of reputation risk.

Reputation risk is best understood as the risk to income and capital of negative impressions and perceptions of a

particular bank by the banking public. A bank's public includes its customers but also the general public as well. In fact it incorporates the community in which a bank conducts its business and in a very broad sense would or should include all the constituents of the enterprise.

Years ago, reputation risk was generally confined to those institutions that were experiencing significant credit quality issues; had become enmeshed in litigation; or involved in some sort of negative publicity event.

Today, reputation risk engulfs much of our industry, often putting our basic credibility as an industry in jeopardy. There are a few examples with truly systemic industry implications: the well documented abuses in residential mortgage collection and servicing businesses of some of the major players in our industry; the very recent allegations of LIBOR rate manipulations among 18 of the world's largest and most prestigious banking companies; and the massive risk taking activities involved in the acquisition of Merrill Lynch by BofA and of Golden West by Wachovia as only two of many possible examples from the recent past.

One source of reputation risk is to do dumb things with adverse consequences, while the other is to operate with insufficient or callous attention to the overall consequences of one's actions. J.P. Morgan's huge derivative risk exposure is an example of the former, while deliberately processing incomplete or fraudulent mortgage documents in foreclosure proceedings are examples of the latter.

Either one exposes the institution to financial cost; increased regulation that is often of a punitive nature; and ultimately to the possibility of public ridicule.

What this means for community banks

During the last credit cycle, reputations, nurtured and protected over generations, have been shredded in a matter of months. The damage is not limited to the shareholders of the largest and most prominent of the banking industry's participants. The consequences and the pain of the current epidemic of reputation risk are infecting the entire industry. Nothing short of our collective credibility is on the line.

The shareholders of the largest banks have experienced the negative consequences of their institutions' tarnished reputations in the form of "hits" to the stock price. Market capitalizations of the big banks most severely impacted by reputation risk have lost billions of dollars of value. Perhaps that will cause shareholders to deal with those managements in traditional ways. We'll see.

What of the rest of the industry? What of those community and independent banks that largely avoided the credit excesses of the last business cycle and were not distinguished in the eyes of their constituents for having serious misalignments between their stated values and their operating values? How can the rest of the industry recapture the high ground and restore confidence in the integrity of their business models and behaviors?

I think that the current malaise highlights a major if not the principal difference between independent banks and those that are operated by impersonal factors dominated by profit and return on invested capital. Independent in this context to me means operating in conformance to local values and standards where service is not simply measured in terms of wait times in the teller line or at the drive up. It's where service translates into value added to the customer for dealing with a particular bank and its staff. It means service tailored to the needs of the individual customer and not conformance by the customer to the bank's generic sort of business model.

When an industry has lost its reputation, then the viability of the industry is threatened by market forces or the forces of

political retribution.

A eye on the future--destinies will be decided now

These are very dangerous times for our industry. What we collectively do during this next business cycle will set the parameters of the strategic discussion and its outcome for years to come.

We ultimately have to be mindful of one fundamental misalignment to which we are all exposed. We have got to make sure that our actions match our principles.

Do our actions reflect conformity to high standards of business ethics? Or do we seem to be like so many others just chasing a buck?

Unfortunately the latter is the way that many customers seem to view us. We can change that, but we have to be serious about the outcome and focused on the right things that may not always put maximum profitability at the top of the hill we're climbing.

This is not hard stuff to understand. In fact, we all deep down understand what we have to do. And the fact that it's so hard at times remind us about how dysfunctional some of our misalignments have been.

**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.

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