Sarah Bloom Raskin: Reflections on reputation and its consequences

Speech by Ms Sarah Bloom Raskin, Member of the Board of Governors of the Federal Reserve System, at the 2013 Banking Outlook Conference, Federal Reserve Bank of Atlanta, Atlanta, Georgia, 28 February 2013.

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Good afternoon. I want to thank the Federal Reserve Bank of Atlanta for inviting me to join you for today's 2013 banking outlook discussion. There are a number of interesting and very relevant topics on your agenda, most of which are rightly focused on the financial and regulatory environment. I would like to share some thoughts this afternoon on a broader topic, however, that may be due for a refreshed look: the relevance of a bank's reputation.

Let's start in an elementary way in constructing a concept of reputation: We know that reputation is not entirely a moral trait. We understand that there is a distinction between character and reputation. When we say that someone shows good character, we are usually referring to something at the core of their being or personality. On the other hand, when we refer to a person's reputation, we recognize that reputation is our perception of the person, that it is externally derived and not necessarily intrinsic to that individual. In other words, we understand that a person may not have complete control over the perception that has been created. Reputation, through no fault of one's own, can be tarnished. In the same way, one's reputation can be golden, even though nothing was done to earn it. But like the notion of character, reputation can be earned and it can be a type of stored value for when challenges to one's own reputation come later.

Now let's bring this distinction into the context of banks: Many bankers have a sterling character, and they operate financial institutions with sterling reputations that reflect that basic character. At the same time, there are bankers who, regardless of their personal character, manage financial institutions with reputations that have been tarnished. Their banks' reputations could have been tarnished by almost anything, but likely most tarnish is attributable to the subprime mortgage meltdown and the ensuing financial crisis that cost the economy trillions of dollars; left millions of Americans bankrupted, jobless, underemployed, or homeless; triggered massive litigation; and shook the confidence of our nation to the core.

Many of the darkest manifestations of the financial crisis have finally begun to diminish: the boarded-up homes with overgrown lawns, the half-built skyscrapers, the "We Buy Houses Cheap" signs planted at exit ramps, the eviction notices nailed to front doors. But even as the economy comes back to life, our memory of these events is still sharp and the reputational damage suffered by U.S. financial institutions during the crisis endures. To be blunt, a lot of people have negative feelings about banks, which they distrust and blame for the huge infusions of taxpayer money into the financial system that were deemed necessary during the crisis.

These reputational consequences – whether justified or not – are to be expected. Sociologists and economists have long remarked upon the central role that social trust plays in healthy markets. Market transactions depend on a whole series of assumptions that people must be able to rely on, including the soundness of money, the enforceability of contracts, the good will of their partners, the integrity of the legal system, and the common meanings of language. Social trust is the glue that holds markets and societies together. In the context of banking, social trust and reputation are related concepts.

Banks themselves – in crisis or not – are particularly vulnerable to reputational consequences because of their public role. The principal social value of financial institutions is their ability to facilitate the efficient deployment of funds held by investors (and entities that

pool these funds) to productive uses.[1] This value is maximized when the cost to the entity putting capital to work is close to the price demanded by the entity that seeks a return on its investment. In traditional banking, this means that financial intermediation occurs most effectively when the interest rate charged for use of funds in lending is close to the interest rate paid for deposits. As the difference between the two grows (which would be attributable to amounts extracted by intermediaries as compensation for essential intermediation), the costs of borrowing for the purposes of creating productive projects become higher than they should be, with arguably negative reputational consequences.

Given these particular reputational dimensions associated with financial institutions, might financial regulators have an interest in considering reputational harms analytically? Could there be benefits to understanding the ways that an individual financial institution's reputation – or that of the financial industry as a whole – might have particular effects on, for example, safety and soundness, financial inclusion, or financial innovation?

In my remarks today, I want to consider various aspects of how reputational harm manifests itself in banks and begin a dialogue with you about how we might refresh our thinking about this category of risk. I will start with a description of some factors that can affect a bank's reputation, especially in the wake of the financial crisis. Next, I will talk about ways in which reputation matters, including how supervisors can use their unique ability to see inside the institutions that they examine to uncover some early indicators of reputational problems. I will then turn to other reasons why policymakers may want to think about reputation. One reason involves possible consequences regarding financial inclusion; that is, a customer's ability to have a relationship with his or her bank that puts them in the position to save, access credit in a sustainable way, and understand the nature of the financial transactions in which they participate. Reputation also may help or hinder a bank's ability to innovate, so I will introduce this topic next. Finally, I want to frame a discussion around the recent cybersecurity threats that banks are facing and place them in the context of reputational risk so that they too can be discussed constructively.

Of course, I preface these remarks with the admonition that these views are my own and may not be representative of those of the Federal Reserve Board.

The financial crisis and the reputation of financial institutions

It has been more than five years since this country began experiencing a financial crisis that reverberated well beyond Wall Street. This crisis was unique, and many of its marks on individuals and communities remain. It was a crisis in which significant numbers of both subprime and prime mortgage defaults quickly spread across whole cities and regions until the impact was felt throughout the country. The devastation was magnified by waves of foreclosures, significant drops in house values, job losses, and, ultimately, significant reductions in household wealth, which have been responsible, in part, for the slow recovery we confront today.

The causes of the crisis and the subsequent devastation are myriad, but to large swaths of the American public who have experienced the devastation, the causes rest squarely on the shoulders of financial institutions, especially the largest institutions. Further, many Americans direct their anger at not only banks, but policymakers as well. Because the economy pulled back from the brink of depression only through a massive and unprecedented infusion of public dollars, American taxpayers feel that they were forced into a position of accepting that the government had to put a lot on the line to save the financial system from ruin. And many

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[1] See Sarah Bloom Raskin, Federal Reserve Board Governor (2012), "How Well is our Financial System Serving Us? Working Together to Find the High Road," speech delivered at the Graduate School of Banking at Colorado, Boulder, Colorado, July 23. See also Wallace C. Turbeville (2012), "Cracks in the Pipeline: Restoring Efficiency to Wall Street and Value to Main Street," Demos, Financial Pipeline Series, December 5.

of those taxpayers are still unhappy about such a massive government intervention that seemed to aid banks that were not held to account, while distressed households were left to pay the price.[2]

Unfortunately, in the public's view, little has happened to restore their trust and confidence in financial institutions. Since the crisis, the public's views of banks have been informed – for better or worse – by their experiences and those of their families and neighbors, who may have lost their homes, their jobs, or their household wealth. Many attempted unsuccessfully to modify their underwater mortgages, even when they were current on their payments. Against this backdrop, the public's lack of trust and confidence has been magnified by, among other things, the Occupy Wall Street movement, payday loans, overdraft fees, rate-rigging settlements in London Interbank Offered Rate (LIBOR) cases, executive compensation and bonuses that seem to bear no relationship to performance or risk, failures in the foreclosure process, and a drumbeat of civil litigation.

In the Internet age, the impact of consumer distrust is amplified: anyone can easily, cheaply, and anonymously create, organize, and participate in a protest. Participants do not have to gather physically to make their action felt. A recent survey found that

- 60 percent of American adults use social media, such as Facebook or Twitter, and
- 66 percent of those social media users (39 percent of all American adults) have used social media to engage on civic and political issues, including by encouraging other people to take action on a political or social issue.[3]

Take, for example, the impact of the consumer backlash that erupted in late 2011 when one of the nation's largest banks attempted to charge a $5 monthly fee for its debit card. A California woman, frustrated with the bank's decision to impose the fee, created a Facebook event, dubbed "Bank Transfer Day," and invited her friends to join her in transferring their money from large banks to credit unions on that day. In the five weeks leading up to Bank Transfer Day, this Facebook event received extensive press coverage and resulted in billions of dollars in deposits reportedly shifting out of large banks. The bank targeted by the Facebook protest ultimately reversed itself and declined to assess the monthly fee.

How reputational risk may be relevant

Financial institutions of all sizes have shared in the fall-out – fairly or unfairly – from a general decline in their industry's reputation among the public. Moreover, the steady stream of litigation against financial institutions since the crisis has further harmed the reputations of specific firms among their customers.

Consider that in today's financial institution sector, a substantial portion of a bank's enterprise value comes from intangible assets such as brand recognition and customer loyalty that may not appear on the balance sheet but are nevertheless critical to the bank's success. Also consider that at the end of 2012, deposits at commercial banks reached a record $10 trillion. At the same time, the share of each deposit dollar that banks lent out hit a post-financial crisis low in the third quarter, which means that banks' net interest margins

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[2] The public also remains angry at policymakers for actions taken since the crisis. The erosion of public trust extends beyond financial institutions to the government officials that oversee them. For example, an *American Banker* reader poll conducted from December 17–23, 2012, found that a mere 8 percent of readers who responded thought authorities took the right course in the case of enforcement against HSBC for money laundering violations. As many as 47 percent said the Justice Department should have prosecuted the bank, while another 45 percent said authorities should have gone after the individuals responsible for the violations.

[3] See Lee Rainie, Aaron Smith, Kay Lehman Schlozman, Henry Brady, and Sidney Verba (2012), "Social Media and Political Engagement (PDF)," Pew Internet & American Life Project (Washington, DC: Pew Research Center, October 19).

have fallen sharply. Across the industry, loan-to-deposit ratios are going down. In 2007, banks' aggregate loan-to-deposit ratio was 91 percent. This ratio currently stands at 70 percent. In such a context, achieving higher earnings is a challenge.

If bank profitability is going to improve in a context of low interest rates and higher compliance costs, lending income may remain low. Profits will need to come from elsewhere. One source of profits would be products that are not interest-rate dependent, but fee-dependent.

In other words, compressed net interest margins mean that many banks may look to new fee-generating products and trading activity to enhance profits. The pressure to generate enhanced profits through high fees is palpable, and banks may choose to move aggressively down these paths. But when a bank already suffers from a poor reputation – either deservedly or as a knock-on effect of broader discontent with the financial industry – it likely will face difficulties in introducing new fee-generating products or activities without inviting further criticism and damage to its reputation. So an evaluation of the effects of the new product or activity on the bank's reputation prior to launch is arguably necessary.

Reputational risk and supervision

The effects of the financial crisis, combined with the power of the Internet to broadly and quickly publicize information – whether factually accurate or not – should alert banks to how they are managing their reputations. And supervisors have a duty to see that all risks are fully understood, even those risks that, like reputational risk, are unquantifiable or have not fully emerged. I believe this is an area where supervision can add value. To the extent possible, supervision can unveil hidden loss exposures that may be building up through the accumulation of reputational risk elements. If we were better able to identify and monitor such free-floating risk, and in so doing, to push bank boards of directors and senior management to pay more attention to reputational risk, we could help reduce the underpricing of these risks.

Many have argued, and I think it's a compelling argument, that ineffective supervision and enforcement of existing laws and regulations contributed to the financial crisis. By tolerating reduced transparency of risk in balance sheets and in complex institutional portfolios, as well as arbitrage around capital requirements and other prudential measures, supervision may have encouraged the underpricing of risk. And the sudden correction of this underpricing of risk,[4] in turn, accelerated the crisis. The crisis punished investors who accepted more risk than they thought they had taken on, it punished consumers who overleveraged themselves, it punished Americans who lost their jobs and homes, and it contributed to the decline of once-vibrant neighborhoods and towns.

To mitigate the chances of such a crisis occurring again, supervisors need to redouble their efforts toward promoting greater transparency of risks and early confrontation of potential loss exposures. We should view these efforts as a set of responsibilities for both banks and regulators that are aligned to assure the public and markets that risks can be fully understood and accurately estimated and priced.

In some ways, this perspective is not new territory for bank regulators. The Federal Reserve, for example, issued supervisory guidance in 1995 that identified the six primary risks that remain the focus of its supervisory program, and reputational risk is among them.[5] Having

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[4] The reasons for ineffective supervision can be explored separately; they are beyond the scope of my remarks today. It is worth considering, however, whether the reputation of large banks would be enhanced by a belief that "regulatory capture" and other manifestations of ineffective supervision could be minimized.

[5] See Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (1995), "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies," Supervision and Regulation Letter 95-51 (SUP) (November 14).

said that, it is still a risk that both banks and supervisors should learn how to identify ex ante rather than ex post.[6]

So, while reputational risk is not a new concept by any means, it is an area that is ripe for additional work. For example, the enterprise risk management framework of the Committee of Sponsoring Organizations of the Treadway Commission – the so-called “COSO standard” – does not address reputational risk. Likewise, the Basel capital frameworks exclude reputational risks from regulatory capital requirements.[7]

Accordingly, the current approach to managing reputational risk is largely reactive rather than proactive. Banks and examiners tend to focus their energies on handling the threats to their reputations that have already surfaced. This is not risk management; it is crisis management – a reactive approach aimed at limiting the damage. Instead, we should think about a supervisory approach that incentivizes bank managers to sufficiently contemplate, quantify if necessary, and control the factors that affect the level of such risks before they fully emerge in an unmitigated form.

The way that the Federal Reserve supervises banking organizations may help identify risks sooner. For all banking organizations, the supervisory program here does not simply rely on an annual onsite examination. The Federal Reserve supplements its regular examination activities with a program of continuous monitoring between examinations. One of the key objectives of this program is to identify emerging risks and communicate with other regulators and the banks an updated risk assessment and supervisory strategy based on these risks.

When we contemplate a supervisory approach that illuminates reputational risk, we might be able to more fully uncover the interconnection of risks that certain activities could impose on investors, creditors, counterparties, and taxpayers. In this approach, we would first and foremost need to encourage banks to assess the potential riskiness of particular operations, investments, products, and decisions to their reputations and, ultimately, to their enterprise value. As supervisors, one objective as we work with financial institutions to extract such information would be to try to develop ways of measuring the value of the risks that banks shift onto the financial safety net.

Reputation and financial inclusion

There is also a relationship between reputation and financial inclusion, by which I mean the extent to which consumers can participate in a financial marketplace that consists of competitive providers of credit, savings vehicles, and sources of enabling financial information. As policymakers, we must address the perceived trustworthiness of those financial institutions that interact with the public and move the millions of Americans lingering in the margins of the financial marketplace into relationships that provide them with sustainable access to banking and credit, an understanding of how mortgages and credit work, and an understanding of how to create savings.

Data from the Federal Reserve’s Survey of Consumer Finances and the Federal Deposit Insurance Corporation’s survey of the unbanked and underbanked show that the percentage of families earning $15,000 per year or less who reported that they have no bank account

[6] Other regulators consider reputation risk as part of their supervisory programs. The Public Company Accounting Oversight Board (PCAOB) has integrated reputational risk into its guidance on how an auditor should evaluate a company’s internal controls and corporate governance environment. Other PCAOB standards include reputational risk as it relates to executive compensation structures.

[7] Pillar 2 of the Basel II capital framework, however, does note that internationally active banks are expected to hold sufficient capital to address all significant risks, including reputational risk, as part of their internal capital adequacy assessment processes.

has been increasing steadily for the past five years, resulting in more than 28 percent of these families being unbanked as of 2011.[8] Families slightly further up the income distribution scale, earning between $15,000 and $30,000 per year, are also financially marginalized: 12 percent reported being unbanked and almost 26 percent reported being underbanked in 2011.[9]

There are several potential reasons for these impediments to inclusion. When we examine barriers that individual consumers face in becoming financially included, we uncover trustworthiness and reputation. A Federal Reserve analysis of the most recent Survey of Consumer Finances suggests that the primary reason individuals do not have a transaction account is a simple dislike of dealing with financial institutions.[10] If that dislike emanates from the reputation of the particular bank, or the reputation of the banking industry as a whole, policymakers and financial institutions will not be able to enhance financial inclusion without addressing the reputational context.

Reputation and innovation

I'd like to imagine how the public's sense of well-being might be enhanced by their interactions with financial institutions. If we paid attention to the experiences of consumers as they interact with various segments of the financial marketplace, what could we learn? If we see rigidities or imperfections in that interactive experience, what innovation might we imagine that would not only reduce reputational risk but create something new and potentially advantageous?

Technological innovation was the subject of a recent award ceremony in San Francisco. The winners were companies with names like SoundCloud, GitHub, MakerBot, Techmeme, and Snapchat, all of which presumably do amazing things, although I don't understand exactly what.[11] But, evidently, the real buzz at the ceremony was over something much more mundane that I for one have no problem understanding. That buzz was around a pedestrian item – a new and improved coffee cup lid.[12] This lid, called FoamAroma, reportedly provides exactly the right set of openings to maximize aroma and recyclability, while minimizing the effects of coffee spurting out too fast. The point here is that the innovator noticed something simple that others had not: many coffee shop employees don't drink their coffee from cups with plastic lids like their customers do, so there was a market need that had not been recognized and then addressed.

Here I am not just talking about the mixed miracle of mobile banking and mobile payments or being able to take a picture of a check with a smart phone and it appearing in my checking account. That's a topic that is amazing in its own right and worthy of a separate speech. I am talking about encouraging banks to pay attention to the banking experiences of their customers and finding process improvements or service elements that may lead to something seemingly mundane but valuable nonetheless.

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[8] See Federal Deposit Insurance Corporation (2012), *2011 FDIC National Survey of Unbanked and Underbanked Households* (PDF). See also Brian K. Bucks, Arthur B. Kennickell, Traci L. Mach, and Kevin B. Moore (2009), "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances (PDF)," *Federal Reserve Bulletin*, v. 95 (February), pp. A1–A55.

[9] See Federal Deposit Insurance Corporation (2012).

[10] See Jesse Bricker, Arthur B. Kennickell, Kevin B. Moore, and John Sabelhaus (2012), "Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances (PDF)," *Federal Reserve Bulletin*, v. 98 (June), pp. 1–80.

[11] See http://techcrunch.com/events/crunchies-2012/winners/.

[12] See Holly Finn (2013), "Modest Miracles of Invention," *Wall Street Journal*, February 8.

Some innovators see reputation itself as not just something to be managed, but as a product in and of itself. With buyers and sellers repeatedly and constantly interacting on the Internet, there are "reputation trails" that are being created that, when compiled, give an alternative set of markers about how trustworthy a particular buyer or seller may be. These reputation trails – gathered when you evaluate a product you've bought online or when you deliver the product that you've promised – create a picture of trust that some have argued has value that can be shaped.[13]

Reputational risks and cybersecurity

Perhaps reputation will one day transform commerce. But in the meantime, I would like to mention one set of reputational issues that the banking industry is confronting as we speak. As is the case for reputation trails, it too involves the Internet, but this use of the Internet is not being done in the spirit of cooperation and enhancement of public trust. This set of reputational issues comes in response to the recent substantial increase in cyberattacks, all of which have the potential to undermine the fundamental trust that the public puts into financial institutions.

Cyberattacks on banks are occurring with increasing frequency, and concerted cooperative work between government and financial institutions is underway. Customers are increasingly being affected by the cybersecurity threats that banks face. Recently, distributed denial-of-service attacks have caused temporary disruptions of some web services. In September, the websites of several large banks were rendered inaccessible for several hours from attacks now attributed to possible foreign state-sponsored hackers. One of the greatest threats facing not just banks but many businesses and government agencies is hacking – and the possible theft of proprietary data and personal information about customers.

This cybersecurity threat is increasing at a time when more and more bank customers depend on electronic and mobile banking. Workers are using their own laptops and smart phones or working remotely from home computers, and this increases the entry points to the systems that need to be protected. In addition, customers and vendors are linking their systems, enhancing efficiency, but also creating more opportunities for potential intrusions.

But even beyond the potential theft of data and disruption of service, cyberattacks can represent significant reputational risk because they have the potential to create dissatisfaction among many customers or, even more chilling, total loss of consumer confidence.

Cooperative work between government and industry is underway. Through the Department of the Treasury, many of the affected institutions have requested and received technical assistance from the Department of Homeland Security, which has been helpful in mitigating the attacks. Some institutions are researching new technologies for defense against cyberattacks through their Internet service providers or security vendors, and others are reviewing their incident response processes to better manage recovery time and communications among information technology, employees, vendors, media, and customers.

The Financial and Banking Information Infrastructure Committee, the Financial Services Information Sharing and Analysis Center, and the Financial Services Sector Coordinating Council are serving as the forum through which the financial services sector shares important information and develops critical infrastructure protection policies. Through their coordination, affected institutions and law enforcement agencies can share threat information and mitigation techniques.

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[13] See Rachel Botsman (2012), "The currency of the new economy is trust," speech delivered at TEDGlobal 2012 in Edinburgh, Scotland, June.

In addition, a recent Executive Order issued by the President represents a continued commitment to enhancing the security and resiliency of the nation's critical infrastructure to meet future threats.[14]

Conclusion

In closing, these have been some of my reflections on reputation as it applies to the business of banks. The concept of trust is relevant to how bankers engage in a business that is of benefit to the public and provides meaningful innovation to the core function of financial intermediation, as well as to how we as supervisors can engage in a process of observation that is forward-looking and of benefit to both the public and the institutions that we regulate.

Thank you for your attention today. I look forward to taking your questions.

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[14] Executive Office of the President (2013), "Improving Critical Infrastructure Cybersecurity, Executive Order 13636," *Federal Register*, vol. 78 (February 19), pp.11737–44.