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Benefits of a better image

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The key role of the financial system in an economy is to allow capital to flow from investors to its productive use in business. The smooth working of capital markets is, however, impaired by the investor's inferior knowledge of the true profitability of the companies in which he/she invests. Usually, insiders know much more about the future prospects of a company than potential external investors.

In such a world of imperfect or "asymmetric" information, reputable intermediaries play a key role in facilitating capital acquisition by companies. Ultimately, they derive their ability to win new business and charge high fees by their perceived talents, capabilities and trustworthiness – in other words, by their reputation.

Consider investment banks, for example. They facilitate the capital acquisition process by producing information about the quality of businesses trying to raise capital. This information typically consists of: analyses of company investment projects; valuations of business plans and market opportunities; and assessment of management teams. The high costs incurred by investment banks reflect the need to recruit and retain people with sufficient expertise to acquire and interpret such information.

Nevertheless, reputation is the primary motivating factor in the banks' efforts to produce high-quality information. They know that a good reputation can create a virtuous circle in which potential clients recognise them for recommending good investments and, therefore, give them the resources to compound their competitive advantage. The greater the reputation the investment bank has at stake, the more diligent it is likely to be in producing information, and the more conservative it is likely to be in recommending investments.

This first effect can be thought of as the "incentive effect" of reputation.

Why reputation management leads to self-regulation among intermediaries

In research published in the Journal of Finance, we showed that reputation acts as a disciplining mechanism on financial intermediaries such as investment banks by inducing them to place their long-term relationship with investors above the short-term benefits of opportunistic behaviour.

For example, a financial intermediary may be tempted to take advantage of the good relationships it has built with clients. This is particularly true in the case of investment banks, who underwrite securities (essentially buying them from the issuing company and reselling them to their client base of investors). As Professors Lily Fang and Ayako Yasuda discussed in the first issue of Mastering Financial Management, they face the temptation to "hype" the securities of companies they underwrite, regardless of their true worth to investors.

A conscious effort to manage reputation is the best way to dissuade such opportunistic behaviour. This second effect of reputation can be described as the "credibility enhancement effect". Technically, the reputation of an investment bank or other intermediary can be thought of as the belief of investors that the intermediary has good information, and that it maintains high standards of veracity. Thus, reputation has two components. First, it reflects the belief of investors that the intermediary works diligently and invests sufficient resources in producing good information about, say, a company selling securities (in the case of an investment bank underwriting a security issue). Second, it reflects their belief that the intermediary will place its long-term relationship with clients over the short-term benefits of opportunistic behaviour. In this way, reputation is built over time, and is the result of the investment bank's good performance in terms of past transactions with investors in the capital markets – as reflected, for example, in the performance of the equity issues of companies that they have underwritten in the past.

This implies that an investment bank's reputation cannot be replicated by a potential competitor in a short period of time. It also implies that, in the short run, reputable investment banks are in short supply, a circumstance that allows them to command a premium from their clients for their services.

In fact, the most reputable investment banks can sell the securities of companies for which they act as an underwriter at a greater price than their rivals. This superior placing capability is valuable enough to issuers that they are willing to pay larger underwriting fees for the services of more reputable investment banks. Thus, the reputation of an investment bank becomes a disproportionately valuable asset that reflects the bank's market power, and whose value evolves continuously over time depending on the bank's performance.

Reputation in commercial banking

Why do some companies prefer bank loans to publicly traded bonds, in spite of the higher interest rates? Direct borrowing in the credit markets tends to be a cheaper form of financing, but empirical research indicates that certain types of companies are eager to obtain more expensive credit by borrowing from commercial banks, even when they have the ability to issue publicly traded debt.

In most cases, the reason is reputation. Banks are typically long-lived institutions and long-term players, with an incentive to build up and maintain a reputation for being good partners to companies in financial distress. By contrast, investors in the publicly traded debt market are anonymous players with shorter horizons, with little or no incentive to build a similar status.

As we show in our recent research published in the Review of Financial Studies, a commercial bank's concern for its reputation makes it likely to devote significantly more resources than public bondholders towards evaluating a borrowing company in financial distress. Thus, it is more likely to make better decisions over whether to renegotiate a loan or liquidate the business in question. By contrast, the primary concern of public bondholders is typically to recover as much of their loan as possible.

Consequently, riskier companies that, privately, believe they have a moderate to high chance of falling into financial distress are willing to borrow at a premium from a reputable bank (that is, to pay a greater interest rate on the loan they receive) in the expectation that the bank will make the "right" decision if they run into trouble. Less risky companies, whose private assessment is that they are unlikely to end up in financial distress, may prefer to issue publicly traded bonds, since, for them, saving on interest rates would be more important. In summary, the perceived advantages of borrowing from institutions such as commercial banks depend on their ability to develop and maintain a good reputation.

Reputation in stock exchanges

Reputation is equally important for institutions such as stock exchanges that facilitate trade among investors. In accomplishing their role as self-regulatory organisations, stock exchanges have significant leeway in choosing both the stringency of listing standards and enforcement policies.

One of the effects of a company listing on an exchange is to mitigate against the asymmetry of information between company insiders and outsiders, since the process of obtaining and continuing to maintain a listing on an exchange by meeting its listing requirements serves a certifying role to outside investors. Thus, listing gives investors some confidence that the information provided by the company in its various financial statements and other disclosures is credible.

Stock exchanges understand the certification value of listing standards, and may use the choice of standards competitively to attract companies and investors. This is particularly important in the light of the recent process of integration in international capital markets that has led a growing number of companies to seek listing outside their country of origin.

As it has become viable for companies to list in a variety of new venues worldwide, so competition among stock exchanges has increased dramatically. Both the New York Stock Exchange and the London Stock Exchange, for example, have been competing vigorously for listings from abroad, and especially from emerging economies.

The natural question to arise from this trend is: how will listing requirements change as a result? Some fear that exchanges will compete with each other for new listings by setting progressively lower requirements, thereby creating a “race to the bottom” in which every listing loses its value.

Reputation management by exchanges provides a way out of this problem. While it is true that, like investment banks, exchanges benefit in the short run by lowering their listing standards and thus attracting more listings, such opportunistic behaviour is likely to be costly in the long run. After all, the certification effect of a listing will be lower if the exchange is known to set lower listing standards. Such certification effects will clearly be almost non-existent if almost all companies applying to list can obtain a listing, and can continue to be listed, regardless of any irregularities.

In research to be published in the Journal of Financial Economics, we show that exchanges have an incentive to develop a reputation for maintaining stringency in listing standards, since investors will award greater valuations to the equity of companies listed in exchanges with better reputations for strictly enforcing high listing standards.

Furthermore, as exchanges become increasingly aware of the need to acquire a good reputation, the competition between them will result not in a race to the bottom in terms of listing standards, but in a segmented market for listings. Exchanges with a strong reputation will set high listing standards and become top-tier markets, while exchanges with poorer reputations will set lower listing standards and become lower-tier markets.

In this context, companies are likely to aim as high as possible, in terms of the reputation of an exchange, when choosing where to list. By doing so, they are likely to benefit from a higher valuation of their equity and a corresponding increase in shareholder wealth that exceeds the premium fees charged by the exchange in question.

Reputation among other intermediaries

There are many other intermediaries who benefit from conscious efforts to acquire higher reputations. Consider venture capitalists (VCs), for example. Similar to investment banks, VCs are long-term players in the financial markets, and clearly possess good information about the companies with which they are associated, since they usually get involved in financing these companies at an early stage.

However, VCs have an incentive to engage in opportunistic behaviour by giving a seal of approval to companies with poorer prospects and taking them public through an IPO, since a higher valuation would enable them to liquidate their equity position more profitably. Reputation management would mitigate such short-term incentives, since a VC who consistently backs companies with poor operating (accounting) performance would find that the IPOs of companies backed by them would only fetch much lower valuations in the future.

Another group of intermediaries in the financial market for whom reputation is crucial are auditors. Like an investment bank underwriting an equity issue, an auditor needs to expend substantial resources to produce information about the financial condition of a company. Just as analysts may be tempted to recommend shares owned by their institutions, so auditors have short-term incentives to give a good report to companies they audit, since their auditing fee is paid by the companies on which they are reporting. An auditor has credibility only to the extent that it has a high reputation for veracity: companies that lose their reputation generally lose their ability to do business. Consider Arthur Anderson, which lost much of its reputation as a result of being accused of malfeasance in the Enron case. Investors are utterly dependent on the ability of auditors to unearth accounting irregularities so, from their perspective, a clean bill of health from an auditor without a significant reputation means little.

Why good reputation management creates a virtuous circle

Empirical research regarding initial public offerings supports the above conclusions. In a recent working paper, Prof Chemmanur, in collaboration with Karthik Krishnan of Boston College, investigated the effect of the reputation of investment banks on the equity valuations of companies for whom they acted as the lead IPO underwriter. The research found that companies whose IPOs were underwritten by underwriters with a higher reputation received much higher valuations than those whose IPOs were underwritten by underwriters with lower reputations. Another recent working paper by Prof Chemmanur and Professor Elena Loutskina of the Darden School found that companies backed by higher-reputation venture capitalists were awarded higher valuations by the IPO market compared with those backed by lower-reputation venture capitalists.

What we have written so far should not be read as arguing that reputation management is a panacea to solve every short-term temptation faced by intermediaries. Rather, we are only suggesting that it acts as a strong countervailing effect to some of the short-term temptations faced by financial intermediaries.

Clearly, whether or not an intermediary's concern for reputation triumphs over its incentives to engage in opportunistic behaviour depends on how big its short-term benefits from engaging in opportunistic behaviour are, and how much damage this does to its reputation. For example, when an investment bank enjoys a very high level of reputation, it may find it profitable to take occasional advantage of its good standing.

This happens because outside investors are aware that, even with the best of intentions, an investment bank is likely to make "honest mistakes" once in a while. Therefore, when an investment bank's reputation is high, investors are likely to give it the benefit of the doubt in the event of failure, such as underwriting the IPO of a company that performs very poorly subsequently. After all, while many reputable investment banks sold shares in the IPOs of internet companies during the bubble period at inflated offer prices, their reputations do not seem to have been irreparably damaged.

Only when intermediaries are thought to have engaged in blatantly corrupt or criminal behaviour, as in the case of Arthur Andersen, is their reputation so greatly damaged that they may have to cease operating altogether. In most other cases, the damage to reputation is only temporary, and the intermediary is able to build up its reputation again by dismissing its failures as temporary and focusing on subsequent good performance.

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