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Reputational Risk in Banking: Important to Whom?

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6.1 Introduction

Protecting a financial institution's reputation is among the most significant challenges facing financial firms, and trust in the integrity of the financial sector is the cornerstone of its stability and growth. The financial crisis of 2007–2009 and the post-crisis restructuring period have brought an increased interest in the reputational risk, particularly in the banking and financial sector. Crisis and post-crisis restructuring always results in an increased interest in the issues of trust and corporate culture, as scandals and excesses of the pre-crisis period come to light, and the amounts spent to rescue banks raise public opposition (Walter 2013). Moreover, as the empirical research has indicated, the reputational risk increases with the scale and profitability of banks, making the subject even more relevant in a global system characterized by a highly

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concentrated banking markets (Fiordelisi et al. 2011). The crisis caused multibillion losses and revealed problems with strategic priorities and the failure of risk management systems in large global banks. Consequently, there has been a renewed interest in the creation of stable and functional risk culture in global banks. Thus, the aim of this chapter is to analyze why reputational risk is important for banks, and what are the incentives to manage it.

Reputational risk is often analyzed within an operational risk framework. The Basel Committee (BCBS 2001) described the latter as one of the three main categories of banking risks and defined it as a possibility of direct or indirect loss resulting from inadequate or failed internal processes, actions of people or systems, or losses related to the impact of external events. Although the definition was quite broad, the reputational risk, as well as the strategic one, has not been included. The methodology to manage and measure operational risk has been advancing rapidly in recent years, fueled by a number of well-publicized scandals (the bankruptcy of Barings, problems of Société Générale due to rogue traders and the Allied Irish Bank, and UBS due to unauthorized trading), and also, huge sums paid by banks and insurance companies after 2008 crisis to settle allegations of sales abuses illustrate the point. However, as it took over a decade to develop an acceptable infrastructure for operational risk management, the reputational risk is only at the beginning of a similar process.

Reputational risk is not a new concept, but the efforts to manage it as a self-standing type of risk and not within an operational risk framework are quite recent. However, it is more difficult to manage reputational risk than other risk categories, as it is difficult to define and quantify, or separate it from the impact of other events (ACE 2013). Consequently, in the empirical part, this chapter proposes a methodology to measure reputational risk, based on the bank stakeholders' perspective. The reputational risk is approximated by an integrated indicator: Stakeholder Reputation Score (SRS). Then, panel regression models are used to examine its impact on bank performance, for listed banks in Central and Eastern Europe (CEE-11). The aim of the empirical part is to analyze whether there is a reputational premium, i.e., what are the incentives to manage the reputational risk in banks.

The chapter is organized as follows: Sects. 2–3 review the approaches to define the reputational risk, Sect. 4 analyzes the literature on factors causing reputational risk, Sect. 5 reviews the approaches to measure reputational risk, Sect. 6 describes the empirical methodology and summarizes the results of the panel data models aiming at measuring the reputational performance premium for CEE banks, approximating reputational risk by Shareholder Reputational Score, and the last section concludes the chapter.

6.2 Reputational Risk from a Regulatory Perspective

Risk appears with every banking product and operation, and managing risk constitutes an everyday bank activity. Risk can be defined as uncertainty concerning the return or outcome of an investment or an action. Risk management is a process by which managers identify, assess, monitor, and control risks associated with financial institutions' activities (Koch and MacDonald 2015). Its objective is to minimize negative effects on the financial result and capital of a bank. However, in financial institutions, risk can be treated both as a threat and also as an opportunity (Marcinkowska 2014). Banks manage risk at many levels, taking account of both macro- and micro-factors, in many cases external to the decisions taken by bank. In many cases, risk is interconnected, both within a bank and in the whole system. Risk management encompasses the process of identifying risks to the bank, measuring exposures, ensuring that an effective capital monitoring program is in place, monitoring risk exposures and corresponding capital needs on an ongoing basis, taking steps to control or mitigate risk exposures, and reporting to senior management and the board on the bank's risk exposures and capital positions (BCBS 2011). In the future, the new challenges will be coming from expanding regulations, raising customers' expectations due to technological progress and the emergence of new types of risks (McKinsey 2015).

Historically, the efforts in managing risk by banks tend to focus on credit and market risk. However, risk management in banking has been transformed over the past decade, largely in response to regulations that emerged from the global financial crisis. Reputation risk was not included in the recommendations of the Basel Committee on the modeling of risk in the banking sector. Basel II (2004) and Basel III (2010) kept reputational risk out of pillar one capital requirement, and reputational risk is currently not subject to any specific capital requirements in the EU. Capital Requirements Directives applicable to EU countries require only that the competent authorities evaluate reputational risks arising from securitization transactions and that financial institutions develop methodologies to assess the possible impact of reputational risk on funding positions (Dey 2016). In the USA, reputational risk is one of the Federal Reserve System's categories of safety and soundness and fiduciary risk (credit, market, liquidity, operational, legal, and reputational) and one of the three categories of compliance risk (Business Insurance 2016).

Reputational risk—damage to an organization through loss of its reputation—can arise as a consequence of operational failures, as well as from other events. Both operational and reputational risks belong to a similar area, as operational problems can have negative consequences for bank reputation, affecting client satisfaction and shareholder value. However, those risks can also include a broader set of incidents, such as fraud, privacy protection, legal risks, and physical (e.g., infrastructure shutdown) or environmental risks. In light of the significant number of recent operational risk-related losses incurred by banks, in June 2011, the Basel Committee published the "Principles for the Sound Management of Operational Risk," which incorporated the lessons from the financial crisis. The eleven principles cover governance, risk management environment and the role of disclosure, and address the three lines of defense: business line management, an independent operational risk management function, and an independent review. In 2014, the Committee conducted the review in the form of a questionnaire, involving 60 systemically important banks in 20 countries, in which the banks self-assessed their implementation of the principles. A key finding of the review was that banks have made insufficient progress in implementing the principles (BCBS 2014). Hence, in 2014, the Basel Committee proposed a

revision to its operational risk framework that set out a new approach for calculating operational risk capital. In addition, the Financial Stability Board stressed the importance of operational risk in the post-crisis environment, defining it as a synthetic one, including people risk, outsourcing risk, internal and external fraud, money laundering, and technology risk (FSB 2012).

In 2009, the Basel Committee passed the document addressing the need to strengthen risk management by banks, in which the reputational risk was defined as a multidimensional process, based on the perception of other market participants (BCBS 2009). Reputational risk was explained as the actual or potential risk related to earnings or capital, arising from negative perception of financial institutions by the current and potential stakeholders (customers, counterparties, shareholders, employees, investors, debt-holders, market analysts, other relevant parties, or regulators) that can adversely affect a bank's ability to maintain existing, or establish new, business relationships and its continued access to sources of funding, including the interbank market or the securitization processes. In this document, the Basel Committee stressed the need to manage reputation risk, identifying its sources and taking it into account when testing the resilience of a bank business model to external shocks (BCBS 2009). The Fed's *Commercial Bank Examination Manual* defines reputational risk as "the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation or revenue reductions" (Business Insurance 2016).

6.3 Reputational Risk as Internal and External Factor

Risk management is result oriented, with different priorities given to avoidance of operational and reputational problems and a different time horizon for maximizing the value of the company. The reputational risk is associated with faulty strategy, poor management and leadership, or a wrong system of incentives, inadequate supervision, and problematic

corporate culture. Reputational risk can be defined as the risk of economic losses associated with a negative image of the bank by the clients, supervisors, regulators, and the public. This and similar definitions stressed that reputational risk is multidimensional and reflects the perception of other market participants.

It can also be defined as the risk to bank goodwill, which is not associated with deterioration of book value and is typically reflected in a falling stock price (Walter 2013). There is also a problem of time frame. In most cases, the effects of a scandal or unexpected loss are immediate. The loss is seen as a signal that the company has a weak control environment. Shareholders may also sell shares if they believe that future losses are inevitable. However, there are also cases of more prolonged problems with corporate culture, which gradually erode customers' and business partners' trust. In some cases, reputational problems have a negative impact on the financial results, but there are also the opposite cases (Marcinkowska 2013).

Reputational risk is not regulation or compliance driven, but determined by stakeholder expectations. Steinhoff and Sprengel (2014) observed that risk awareness is probably the most important factor for risk reduction, so it should be placed inside the corporate governance framework, particularly in "who is responsible for what" approach. However, corporate culture is also a very broad concept and can be defined in many ways (Guiso et al. 2006). The development of corporate culture is a continuous process, where the results are visible in the long term. Its definitions emphasize that it rests on a set of values shared by a community, which affects its organization and motivates behavior within the organization (Carretta and Sargiacomo 2016). The period of crisis often results in an increased interest in corporate governance; however, changes in prudential regulations correcting errors in risk management are usually easier than the long-term changes in the corporate culture of market participants (Walter 2013). However, there are some mechanisms which can be used in enhancing trust, such as codes of ethics, internal anti-fraud systems, independent ethics audits, and reputational indices. Indirect measures involve membership of professional associations or self-regulatory organizations, which protect the reputation and discipline among its members, setting standards in codes of conduct and

developing mechanisms of better risk assessment processes (Morris and Vines 2014; Marcinkowska 2013).

Reputational risk is usually due not to incidental events, but is the result of long-term poor decision-making processes. The causes are often linked to the pressures on results, the asymmetry of the profit-to-risk ratio, conflict of interest related to the complexity of bank business models, and compensations based on bonuses (Walter 2013). Financial services differ significantly from the industrial sector. Key stakeholders of banks are depositors, creditors, and the government (insurance). As banks are financed largely through debt, shareholders have a lesser importance than in corporations. However, bank governance prioritizes shareholder interests, particularly when ownership is concentrated in institutional investors with a large risk tolerance. Consequently, governance of financial institutions may accept excessive operational risk, which may erode shareholder wealth and may fail to meet the expectation of other stakeholders (Dow 2014).

Inside the banking sector, reputation is often treated in the same way as a "brand," i.e., an intangible asset that can be impaired by operational mistakes or inappropriate behavior. In this approach, reputational risk is a derivative risk, arising as a result of damaging action (Steinhoff and Sprengel 2014). Reputation may also serve as a cushion against losses, i.e., companies with a better reputation suffered less severe declines in market value during the crisis periods although the empirical evidence varies in this respect—in some cases good reputation softens the impact of failures; in others, it may be dangerous, as other objective indicators of strength, such as capital or liquidity, may seem irrelevant. The third way is not to treat it as an asset, nor as a kind of equity capital, but as a set of obligations toward stakeholders, which have to be fulfilled (Steinhoff and Sprengel 2014). Thus, reputation can be summed up as having three main manifestations:

- reputation as asset (stakeholders' goodwill),
- reputation as liability (stakeholders' expectations), and
- reputation as capital (buffer against failure, helping to maintain goodwill when failing to meet expectations).

The impact of reputation on performance is a direct consequence of the interaction of those domains (Steinhoff and Sprengel 2014).

6.4 Reputational Risk in Global Surveys

The strategy of the largest global banks has evolved from simple, commercial institutions, providing selected services for a specific customer segment, to complex conglomerates, serving millions of customers in many countries. Traditionally, the financial services industry worked according to easily understandable principles, with clearly defined risk profiles, but in the last 20 years those divisions were blurred, and new players, such as hedge and equity funds, were offering para-banking services (Rajan 2005). However, the strategy of a "financial supermarket" and a "too big to fail" scale turned out to be very risky. Although among the top causes of the global financial crisis was a systemic risk associated with the activities of large global banks, after the crisis, their role has been further strengthened. In many countries, post-crisis restructuring took a form of mergers and acquisitions, particularly of investment banks by the universal ones in the USA or merging the nationalized banks to control losses (the Netherlands and the UK). So the question of managing the reputation risk in the process of acquisition is another important challenge (Schoenmaker 2011; Dermine 2006).

The 2008 financial crisis had a significant effect on bank reputation and trust, and only recently can we observe a gradual rebound of trust: Financial services have recorded an 8-point increase from 43% in 2012 to 51% in 2016 on a global basis. Financial services, however, are still the least trusted industry among those surveyed by the Edelman Trust Barometer (2016). Inside the industry, employees are more trusted than senior executives and CEOs to communicate about topics like financial earnings, crises, and the treatment of customers. In the USA, the Reputation Institute compared the financial industry problems with past reputation of tobacco firms. In the post-crisis period, the financial sector has been obliged to pay an incredible amount of litigation expenses, with the most notable being JP Morgan paying a 13 billion dollar settlement

to the US government over behavior leading to the crisis in 2014, Deutsche Bank investigated for tax evasion and money laundering, in addition to Libor fixing in 2012, or large banks fined for the Libor scandal in 2015. However, in 2016 for the first time, the large banks have risen in the US ranking—of the 33 banks evaluated, ten banks had an "excellent" reputation among their customers, compared to eight in 2015 (American Banker 2016). Other surveys have also shown that inside the banking industry, the best reputation has divisions related to new technologies, e.g., Internet banking and ATM, though not telephone banking (Ernst and Young 2014).

As early as in 2005, the Economist Intelligence Unit Report observed that protecting a firm's reputation is the most important and difficult task facing a firm's managers and reported that in a survey of 269 senior executives, responsible for managing risk, reputational risk emerged as the most significant threat to business out of a choice of 13 categories of risk. Reputational risk was defined as an event that undermined public trust in bank products or brand (The Economist 2005). Reputation is based on aggregate past experience; however, it is directed toward the future and reflects the expectations concerning the firm (Edelman Trust Barometer 2014). Customers satisfied with the services of the bank have a greater loyalty which helps to improve the bank image and its competitive position (Fiordelisi and Molyneux 2009). In contrast, problems with bank reputation can lead to (Eccles et al. 2007):

- loss of current or prospective customers,
- loss of employees or managers in the organization,
- departure of current or future business partners, and
- an increase in the cost of financing through a loan or capital markets.

The growing awareness of reputational risk is reflected in an annual survey conducted by the European Banking Authority and reported in "*Risk Assessment of the European Banks.*" This document includes a section on reputational risk, particularly assessing its impact on consumer confidence (EBA 2014, 2015, 2016). The reports showed a growing awareness of the reputational risk in the European banking sector, as indicated by 33% of responding banks in 2013, 44% in 2014, and 68%

in 2015. Numerous case studies and empirical studies showed that reputational risk is particularly important for large global banks and those with relatively low capitalization, so it should be an important subject of supervisory concern. According to EBA reports, particularly a detrimental impact on consumers had failures with regard to rate benchmark-setting processes, the misselling of banking products, and more recently misconduct related to foreign exchange rates, violations of trade sanctions and redress for payment protection insurance, and floors for mortgage loans at variable interest rates. The scope of identified detrimental business practices remains wide and misconduct costs remain high. The share of banks indicating that they have paid out more than one billion euros in compensation, litigation, and similar payments increased in 2015 to 32% of participating banks (16% in 2014 and only 8% in 2013) (EBA 2014, 2015, 2016). Efforts to adjust culture and risk governance are the most widely considered approach to address reputational and legal risks (85% in 2016), an increase from less than 50% of respondents in previous surveys. However, in the 2016 Report, only about 10% of surveyed banks indicated their intention to adjust products and business models in an effort to address reputational and legal risks.

Kaiser (2014) analyzes two surveys conducted by KPMG among the G-SIBs (the Global Systemically Important Banks) in 2013 and 2014 and responded to by ten banks and a survey of the German banks, responded to by 18 institutions, 13 of which belong to the 20 biggest German banks in 2012. In the surveys, 60% of both global and German banks asserted that reputational risk stands on its own, rather than being a consequential risk, or triggers to other risks; however, most banks did not include it in their risk inventory and admitted that it is not explicitly addressed in their risk strategy. Another question showed that only 55% of the G-SIBs and 60% of the German banks prioritized their stakeholders, in order to manage reputational risk more efficiently. German banks gave the highest priority to customers, while global banks gave top priorities to customers, employees, and regulators. The surveys demonstrated that banks put the main emphasis on the self-assessment of reputational risk, only supplementary emphasis on expert opinions, interviews with senior management, and analysis of press and social

media, and that they register and report losses due to reputational risk mainly as a part of an operational risk database, so although banks were aware of the need to include reputational risk in their overall risk mapping, in everyday life, they dealt with it in an operational risk management framework.

6.5 Problems with Measurement of the Reputational Risk

Efforts to manage operational risk have been successfully quantified in the last decade, but for reputational risk, the typical approach is still to monitor it inside the broadly defined "risk culture." What gets measured gets managed (Diermeier 2008), but quantification of reputation risk is extremely difficult as there is no universally accepted methodology and the concept is broad. If we define reputational risk as unexpected losses due to the reaction of stakeholders to an altered perception of an institution (Kaiser 2014), there are many possible ways of approximating this risk. Moreover, reputational risk does not act in isolation and, on the contrary, is interrelated to many other types of risks. Some sources of gain/loss in the reputational capital include economic performance, stakeholder interface, and legal interface, which can be reflected in client flight, loss of market share, investor flight and increase of cost of capital, and talent flight and increase of contracting costs (Walter 2016). Assuming that reputational risk is managed through strong corporate governance, another approach is to create indexes which measure the quality of firms' corporate governance structure and link it to stock price-based performance of the company, assuming that the change in corporate governance index is a signal of quality of firm management (Fox et al. 2016).

Empirical studies typically focus on various surveys, case studies, or media coverage of detrimental events. There is also a lack of tools to link reputational risk with financial performance, and it is unclear how reputation risk can impact capital (Diermeier 2008). In many companies, reputational problems are still considered rather as a problem of public

relations than a strategic one, and the response is frequently inadequate to the scale of the damage. The problem of reputational risk measurement is still aggravated for CEE banks, as the stock markets are not efficient in discounting information, so the panel data models using stock market information may be misleading.

Assessing reputational risk is most often not an objective process, but rather it is a subjective assessment that could reflect a number of different factors. Reputation could be perceived as an intangible asset, synonymous with goodwill, which is difficult to measure and quantify. Consistently strong earnings, a trustworthy board of directors and senior management, loyal and content branch employees, and a strong customer base are just a few examples of positive factors that contribute to a bank's good reputation (Business Insurance 2016).

Establishing a strong reputation provides a competitive advantage. A good reputation strengthens a company's market position and increases shareholder value. It can even help attract top talent. Communication between a bank and its stakeholders can be the foundation for a strong reputation. Bank examiners may consider whether an institution responds to customer concerns; whether the stock analyst recommends buying or selling and why; and what the shareholders, employees, or general public are saying about the institution. They also consider whether the institution is expanding outside its normal geographical area and is supportive of the community. On-site, examiners will talk to both bank employees and management to get a sense of corporate ethics. Examiners will assess whether an institution's expertise is adequate and controls are in place to oversee growth if the institution should engage in riskier products or enter into new business lines (Brown 2016).

Also, the agencies, such as Standard & Poor's, Moody's, and Fitch, have significantly increased their emphasis on reputational risks related to corporate governance. The rating agency's primary focus is the ability and willingness of an entity to make full and timely payment of debt service on its financial obligations. However, a damaged reputation can significantly affect the performance and, ultimately, the ability to borrow capital. For example, S&P issued a statement saying that costs associated with the Costa Concordia disaster had negatively affected the firm's operating performance in 2012. Another example of the importance of

reputation in obtaining the rating score is public universities in the USA, which rely heavily on their reputation and brand as a strategic asset (Business Insurance 2016).

A measure that is sometimes used is the difference between the immediate costs of a crisis and damage to a firm's market capitalization in the period following a crisis event (ACE 2013). Another frequent approach in modeling reputational risk is to analyze it within an operational risk framework, assuming that operational loss events can lead to significant reputational losses, and to check the impact of bank reputational problems on bank market capitalization (Perry and De Fontnouvelle 2005). The reputational loss is defined as market value loss that exceeds announced operational loss (Eckert and Gatzer 2015). Another frequent approach is to conduct an event study analysis of the impact of operational loss events on the market values of financial institutions by examining a firm's stock price reaction to the announcement of particular operational loss events such as internal frauds, estimating the Reputational Value at Risk at a given confidence level, which represents the economic capital needed to cover reputational losses over a specified period (Micocci et al. 2009).

6.6 Empirical Analysis of the Reputational Risk in the CEE Banking

Reputation can be perceived not only as a problem, but as an asset, contributing to a performance premium. The empirical part adopts this approach, examining the relationship between an indicator of the reputational risk (Shareholder Reputational Score) and bank performance. To test the role of reputational risk for bank performance in CEE-11 countries, the panel data model with fixed effects was used (with Hausman and Breusch-Pagana tests), based on individual bank data from Bankscope. In the sample, 42 banks listed at CEE stock exchanges were analyzed (15 from Poland, 12 from Croatia, 4 from Bulgaria and Slovakia, 3 from Romania, and 1 from the Czech Rep., Hungary, Lithuania, and Slovenia), for which the rating information from at least

one of the three major agencies: Standard & Poor's Rating Services, Moody's Investors Service Inc., or Fitch Ratings Ltd., was available.

The first step was to construct an index of reputational risk; the following one was to test its impact on bank performance. In the model, reputation risk was represented by a three-dimensional, synthetic index: Stakeholder Reputation Score (SRS). The index is based on the perspectives of three major bank stakeholders, according to the following formula:

SRS: (a) market participant perspective + (b) client perspective + (c) investor perspective.

Those three perspectives were approximated by:

SRS: (a) credit agencies' bank ratings + (b) deposit growth + (c) bank stock returns.

There is a long debate on the relevance of the rating information and rating agencies' credibility, particularly after the global crisis (Grothe 2013; Eckert and Gatzer 2015), but nevertheless credit rating encompasses a broach range of information. Credit ratings express credit rating agencies' forward-looking opinion about the creditworthiness of an obligor—the capacity and willingness to meet its financial obligations in full and on time (S&P 2016) and represent an evaluation of the qualitative and quantitative information on the prospective debtor. In the model, the ratings were employed both at a country level (CR) and at the bank level, included in the SRS index.

The three dimensions in SRS (a, b, and c) were calculated as follows:

a. ratings: scores from major credit agencies were used and the average score (arithmetic mean, in points) was established as in Table 6.2, on a scale of 1–16, adjusted by rating perspective of ±0.5% points; a stable outlook did not cause adjustments in the assessment;
b. deposits: the annual growth rate of current deposits from the non-financial sector was used (converted to points); and
c. stock return: the annual rate of return from bank stock was used, adjust by splits and dividends paid (in points) (Table 6.1).

Table 6.1 Scoring scale used in the model

Rating agency assessment			Model score
S&P	Fitch	Moody's	
AAA	AAA	Aaa	16
AA+	AA+	Aa1	15
AA	AA	Aa2	14
AA−	AA−	Aa3	13
A+	A+	A1	12
A	A	A2	11
A−	A−	A3	10
BBB+	BBB+	Baa1	9
BBB	BBB	Baa2	8
BBB−	BBB−	Baa3	7
BB+	BB+	Ba1	6
BB	BB	Ba2	5
BB−	BB−	Ba3	4
B+	B+	B1	3
B	B	B2	2
B−	B−	B3	1

Point values of the three dimensions (a, b, and c) of the SRS were calculated by assigning each year a numerical value to each decile for each indicator and for the whole group, in the following way:

- 0 points for the median for the entire group in a given year;
- from −5 to −1 respectively for deciles from 1 to 5; and
- from 1 to 5 respectively for deciles from 6 to 10.

Consequently, the SRS index ranges from −15 to +15 points for the three indicators and represents an approximation of the bank's reputational risk.

The next step was to run a panel data model, for the period 2009–2014. The dependent variables were the long-term, comprehensive indicator: Multi-Level Performance Score (MLPS) and the short-term, simple indicator: Return on Equity (ROE). MLPS was defined as the sum of points awarded in five key areas for long-term evaluation of bank performance: three performance indicators (ROE, cost-to-income ratio and loans-to-asset ratio) and two sustainability indicators (Z-score and NPL) (Miklaszewska and Kil 2015). Thus, MLPS = ROE + C/I + L/A + Z-score + NPL.

Table 6.2 Description of explanatory variables

Symbol	Description	Rationale/Data source
a. Macroeconomic variables		
Δ GDP	Real GDP growth rate (%)	Macroeconomic business cycle (World Bank: World Development Indicators)
HHI	Herfindahl-Hirschman index for credit institutions	Banking market concentration (BSCEE Review and ECB Database)
SB	Total bank assets (% of GDP)	Size of the banking sector (Raiffeisen Research 2015)
CR	Country LT credit rating	Country credit standing (Bankscope, rating agencies' internet sites)
b. Bank-level variables (data source: Bankscope)		
ln_TA	Logarithm of total assets (in USD)	Bank size
SRS	Reputational risk index	Approximation of reputational risk
L_D	Loans-to-Deposits ratio	Bank funding risk
NeII_NoIOI	Net interest income/ Total non-interest operating income	Income diversification (bank business model)
S_TA	Securities/Total Assets	Market risk
LA_DSTF	Liquid assets/Deposits and short-term funding	Liquidity risk

The score was calculated as follows: For each indicator, the whole group was divided into ten deciles, and the median value is 0 (neutral); each subsequent deciles above the median for the ROE, L/A, and Z-score ranged from 1 to 5, and each successive deciles below the median had negative value and ranged from −1 to −5. For C/I and NPLs, the signs were the opposite. This indicator has a simple interpretation: The higher the value of the MLP score, the better the assessment of the bank's results. The panel data model with fixed effects was used, which measured the impact of reputation risk (approximated by the SRS score) on bank performance, measured by the comprehensive index Multi-Level Performance Score (MLPS) and profitability indicator (ROE). For robustness, bank stock rate of return (RR) as dependent variable was also tested, but the SRS was insignificant for that model. The explanatory variables are defined in Table 6.2.

The results of estimations for the reputational effects on bank performance are summarized in Tables 6.3 (for the comprehensive MLPS) and 6.4 (for the ROE).

Table 6.3 Panel data estimations for MLPS, CEE-11, 2009–2014

Control variables		
const	−79,050	
	0.121	
Δ GDP	0.369	*
	0.068	
HHI	−249,297	*
	0.078	
SB	2351	
	0.827	
CR	−3789	***
	0.008	
ln_TA	7173	**
	0.030	
SRS	−0.265	**
	0.011	
L_D	0.218	***
	0.000	
NeII_NoIOI	−0.012	**
	0.017	
S_TA	−0.039	
	0.688	
LA_DSTF	0.178	**
	0.026	
R^2	0.856	
R^2 corrected	0.837	

Note ***, **, * correspond to 1%, 5%, and 10% significance level
Source Own calculation

The estimation results presented in Tables 6.3 and 6.4 indicate that analyzing bank performance, both approximated by short-term ROE and by a comprehensive MLP score, the index of bank reputation SCR (similarly like the country's rating CR on a macroeconomic level) not only has a positive impact, but on the contrary affects bank performance strongly negatively, similarly as the HHI concentration index. Factors with a positive impact on bank performance were the size of the bank, its financing strategy, the asset risks, and the high level of GDP growth. Thus, the empirical results are contrary to the expectations: For CEE-11 stock-listed banks, large risky banks with low reputational score were best placed for best results, both in a short-term (ROE) and in a long-term (MLPS) perspective.

Table 6.4 Panel data estimations for ROE, CEE 2009–2014

Control variables	2009–2014	
const	−187,278	*
	0.082	
Δ GDP	0.121	
	0.747	
HHI	−504,163	*
	0.076	
SB	21,042	
	0.288	
CR	−2037	
	0.424	
ln_TA	12,325	*
	0.072	
SRS	−0.357	*
	0.081	
L_D	0.168	**
	0.048	
NeII_NoIOI	−0.003	
	0.672	
S_TA	0.488	**
	0.012	
LA_DSTF	0.292	*
	0.067	
R^2	0.639	
R2 corrected	0.489	

Note ***, **, * correspond to 1%, 5%, and 10% significance level
Source Own calculation

6.7 Conclusion

The reputational risk literature and surveys, analyzed in this chapter, suggested that banks should treat reputational risk as a separate class of risk and analyze it beyond the framework of operational risk and corporate governance. It should not be narrowed down to "public relation" response to crisis events, but treated as a strategic type of risk, with a strong potential to harm the value of the company.

However, as the reputational literature and many case studies indicate, it is very difficult to categorize and quantify reputational risk, as it can arise as a consequence of other risks and many events. The panel data models for listed banks in CEE-11 countries, analyzed in this chapter,

have also indicated that proper management of reputational risk may not be important (and even harmful) for an assessment of bank performance, which may explain why many banks dealt with reputational risk mainly in the context of minimizing loss after a scandal. Consequently, there seem to be incentives to disregard reputational risk in an operational and strategic bank management and deal with it only with crisis events.

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