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Reputational risks and large international banks

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Abstract The paper considers the causes, costs and consequences of reputational risk in large international financial institutions. A conceptual strategic positioning model focusing on clients, products and geographic arenas is superimposed on a flow of funds model based on the key financial intermediation functions. This nexus is used to identify important areas of reputational risk, which are then documented in an inventory of adverse events in recent banking history, and explained in terms of behavior failures in compliance, public expectations and behavioral norms. This framework is then used to position empirical studies of reputational risk in the literature, and a normative discussion of reputational risk governance and bank culture.

Keywords Reputational risk · International banking · Conflicts of interest · Bank regulation · Market discipline · Risk governance

JEL Classification G20 · G21 · G28

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1 Lessons from the past

Reputational risk in banking and finance is nothing new. It can be found in historical accounts dating at least to biblical times, cementing the "specialness" of banking in the public discourse and engaging thinkers as diverse as Machiavelli, Adam Smith, Walter Bagehot, Frederick the Great and Alexander Hamilton.

Damage associated with banking issues tends to spread beyond those immediately involved to the broader economy, and is reflected in episodic booms, busts and panics throughout financial history. In due course, regulation targeting individual firms and the financial system as a whole usually gained traction, ranging from honest dealing and "fitness and properness" reviews of banks and bankers to wholesale constraint-based approaches intended to match the ultimate financial backstop of the general public with the public's right to set the rules. Privatizing gains and socializing losses in the financial system have never been politically tenable for very long.

Fast forwarding to recent times, banking and finance have continued to be dogged by reputational issues. Issues were centered on conflicted equity research, insider trading, late trading in mutual funds, fee kickbacks to insurance brokers, mis-selling complex securities and worthless payment protection insurance, stock clearing for pump-and-dump brokerage scams erupted with alarming regularity—in each case eroding the vital trust attribute of the industry. Sometimes, prosecutorial zeal perhaps went too far, extracting settlements from firms in no position to argue their case in an open court. Too often, one eruption began to fade just as another was just over the horizon.

The global financial crisis of 2007–2009 inflicted enormous financial damage and arguably brought the financial industry and its professionals to a reputational nadir around the world. What has happened since that time to restore financial firms to their former glory near the top of the reputational food chain? Boards and managers in the banking industry have little good to say about the massive taxpayer bailouts that rescued the system and inevitable regulatory tightening that followed in their struggle to get back to business as usual. Almost a decade after the financial turbulence began to unfold, the industry's reputation has not yet recovered.

Why? Maybe people have longer memories than they used to, or the "made in finance" crisis hit them harder and lasted longer than they had imagined. Maybe it is the old and new reputational carnage that seems to pop up like clockwork, penetrating even corners of finance that had nothing to do with the crisis. Or maybe it is the finance industry itself, apparently not capable of learning past lessons, a no-holds-barred profile in politics, and an exaggerated sense of self-worth.

The blowback inevitably continues to damage the industry and its people, as layers of regulation are piled on, weighing on financial efficiency and passing the cost on to clients, employees and shareholders. Nobody knows how large these efficiency losses are or how they affect economic welfare and growth in the name of greater stability and robustness. But the legacy imbedded in people's memories that now passes to the next generation militates against taking chances on reversing excessive regulation, and the drumbeat of reputation-sensitive revelations keeps the flame alive.[1]

[1] Earlier studies focusing on reputation include Chemmanur and Fulghieri (1994), Smith (1992), Walter and DeLong (1995) and Smith and Walter (1997).

2 Specialness

Financial services comprise an array of what are arguably "special" businesses. They are "special" because they deal mainly with other people's money and because problems that arise in financial intermediation can trigger serious external costs. In recent years, the roles of various types of financial intermediaries have evolved dramatically, as summarized in Fig. 1.

Capital markets and institutional asset managers have taken a greater portion of the intermediation function from banks, who themselves have followed the money by creating "universal" banking firms. Insurance activities conducted in the capital markets such as credit default swaps compete with classic insurance and reinsurance functions. Fiduciary activities for institutional and retail clients are conducted by banks, broker-dealers, life insurers and independent fund management companies. Financial intermediaries in each cohort compete as vigorously with their traditional rivals and with players in other cohorts, catalyzed by deregulation and innovation in financial products and processes.

At the same time, the information infrastructure of financial intermediation has continues to evolve, driving down information costs and making available to market participants all kinds of interpretation of material developments. Equally, the system's "plumbing" (trading and payments, clearance and settlement, custody, etc.) has exploited economies of scale as well as technology to lower transactions costs. The impact of improved information- and transaction economies on financial efficiency

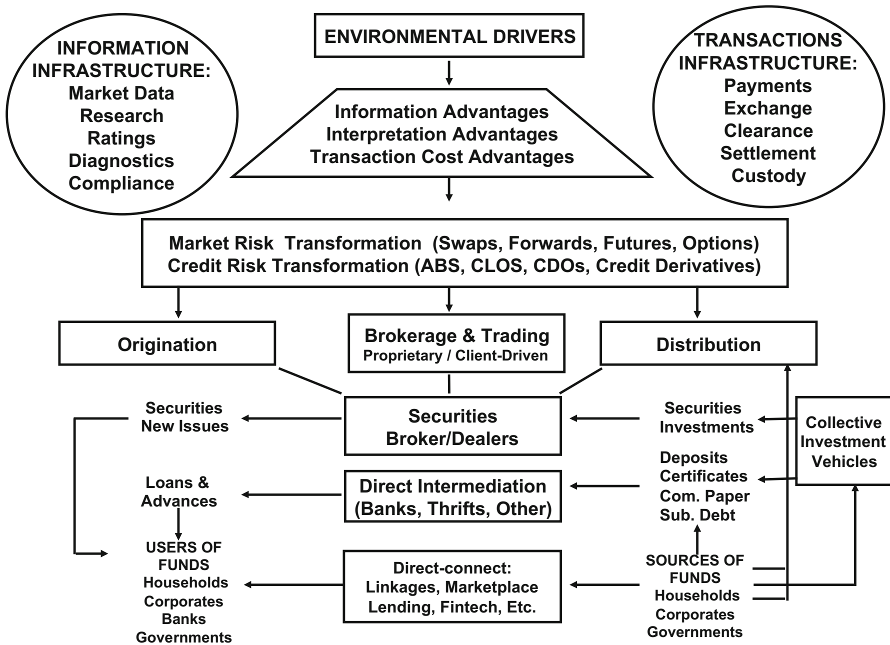

Fig. 1 Schematic of financial functions

have doubtless been dramatic, forcing firms in the industry into new strategies exploiting remaining anomalies and in particular their competitive advantages in *interpreting* market developments. This allows them to trade profitably against counterparties and add value for clients. The intensity of competition in this environment have made life as a financial intermediary a lot tougher, and sometimes the search for an "edge" leads over the edge.

In this dynamic, market developments have sometimes overtaken regulatory capabilities intended to promote financial stability and fairness alongside efficiency and innovation. The regulatory arbitrage that can result had a lot to do with the financial crisis and the ensuing Great Recession, and has been addressed in many of the regulatory measures that have been implemented or proposed. But it inevitably resurfaces in a perennial game of cat and mouse between the financial industry and its regulators. The next chapter in the evolution of the tableau in Fig. 1 may be even more interesting as marketplace lenders, robo-advisers and the rechanneling of intermediation through hedge funds and private equity funds, insurance companies, asset managers and others in shadow banking press competitive advantages and differential regulatory costs.

Large international banks have traditionally dominated cross-border dimensions of the functions identified in Fig. 1, especially in global wholesale financial activities. Many of them have been active as well in multi-local and regional businesses such as retail and private banking, middle-market lending and asset management. A relatively level domestic playing field that allows vigorous competition by foreign-based banks can be highly productive as it typically lifts the performance of all banks and improves local financial efficiency and innovation. At the same time, it exposes international banks to country risk in a general sense as well as through the regulatory environment. Local political economies differ widely, and experienced international bankers soon become adept in striking a viable balance between the domestic regulatory compliance and profitability.

These challenges can be summarized in Fig. 2, a simple matrix that can be applied by partitioning specific client segments (C), geographic arenas of operation (A) and financial products (P). Applying the C-A-P matrix in the real world is anything but simple. The cells (individual markets) have to be calibrated in terms of size and growth potential (depending on classifications used, in many cases assigning a value of zero), competitive structure and conduct, ease of entry and exit, and other factors familiar in the field of industrial organization. The cells are also linked within a given arena by product (scale economies) and clients (cost and revenue scope economies), as well as across arenas—which may run the gamut from seamless global trading platforms to highly specialized niche activities.

The extreme complexity of managing large international banks becomes clear by notionally superimposing the C-A-P matrix in Fig. 2 onto the functional tableau of financial services in Fig. 1 and imagining what separates more successful from less successful players in maximizing global risk-adjusted returns to capital that ultimately drives the value of the firm for its shareholders.

It is unsurprising that the global functional and activity models suggested above would give rise to significant reputational risk exposure for all financial firms, and perhaps especially large international banks. For their part, investors in banks and

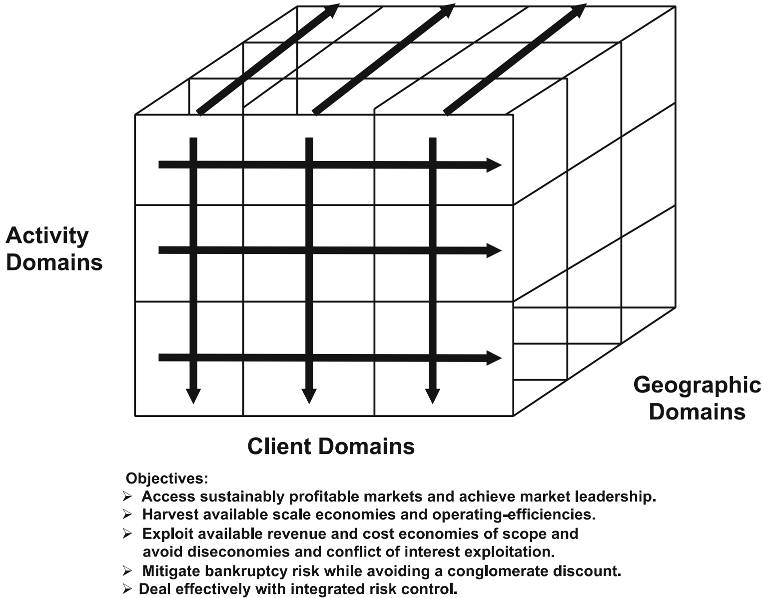

Fig. 2 Creating value in a large internationally active bank

other financial intermediaries are sensitive to the going concern value of the firms they own, and hence to the governance processes that are supposed to work in their interests. Regulators, in turn, are sensitive to the safety, soundness and integrity of the financial system and, from time to time, will recalibrate the rules of the game. Market discipline, operating through the governance process, interacts with the regulatory process in ways that involve both costs and benefits to market participants and is reflected in the value of their business franchises. In turn, excellence in corporate governance is supposed to align the interests of shareholders—through the stock price—with the interests of other constituencies like managers, employees and clients in a sustainable way.

But in the case of systemically important financial institutions like large international banks, the prevailing incentives have demonstrably left taxpayers exposed, allegedly "privatizing returns and socializing risks." So along with the inevitable regulatory reforms and tougher enforcement, the prospect of still further erosion of a bank's franchise through reputational losses can with proper governance improve financial stability going forward.

All the more curious, therefore, is that large international banks have encountered a drumbeat of reputational losses, including new revelations having nothing to do with the financial turbulence. Some examples are listed in Fig. 3. Banks and bankers, some would argue, have somehow drifted in their key role as efficient allocators of capital generators of social welfare toward wealth redistributors from their clients to bank employees and shareholders. The reasons could be:

- Changing competitive market structure.
- Fiduciary obligations—from "client" to "transaction counterparty."
- Product complexity and erosion of transparency.

- Mis-selling worthless payment protection insurance to retail mortgage and credit card customers.
- Promoting in-house products against superior (better-performing or cheaper) third-party products.
- Allowing hedge funds to trade in-house mutual fund shares after the NAV (net asset value) fixing at the close of market.
- Invading segregated customer accounts.
- Facilitating offshore clients' evasion of tax obligations in their countries of residence.
- Facilitating criminal money laundering.
- Evading bilateral and multilateral trade and financial sanctions – "wire-stripping.".
- Selling toxic securities to institutional investors.
- Taking proprietary trading positions against clients.
- Using client advisory relationship to earn kickbacks from product vendors?
- Designing off-balance-sheet structures for clients solely for purposes of financial misrepresentation.
- Submitting false libor quotes to support trading positions. Conspiring with competitors and brokers.
- Submitting false forex fixing quotes to support trading positions. Conspiring with competitors and brokers.
- Undermining primary-dealer or Dutch-auction government bond financings.
- Manipulating commodities markets to gain pricing advantage.
- Aiding and abetting government exchange-control evasion.

Fig. 3 Examples of reputation-sensitive banking practices—2000–2015

- Institutional size—too big to manage.
- Institutional complexity—too broad to control.
- Acquisitions-driven growth and poor merger integration.
- Underinvestment in compliance and risk management.
- Asymmetries in revenue generation vs. risk control.
- Regulatory capture, competence, resources and approach to settlement.
- Too systemic to prosecute—regulatory waivers.
- Adverse selection among bankers.
- Failure of market discipline.

If bank size, institutional complexity, potential conflicts of interest and the ability to manage and govern large international banks have been issues in the past. They may be even more compelling going forward as even bigger and broader financial conglomerates have emerged from governments' efforts to stabilize the system. In the process of consolidation, some important things can get lost. An incumbent culture can get washed away in the integration. Underinvestment in risk management and compliance (the "defense") may come under the pressure of cost discipline. Revenue and earnings generation (the "offense") may be emphasized to justify new strategies, reinforced by compensation designs that tilt toward bonus as against malus.[2]

[2] In a large-sample empirical study of honesty in the professional conduct of bank and nonbank employees, Cohn et al. (2014) find significant differences between the two samples. In the case of non-bank employees, no relationship is found between honesty and their professional identification. In the case of banking, their identification with the profession of banking is associated with increased levels of dishonesty. So instead of the "adverse-selection" notion that people tending to dishonesty are disproportionately represented among

Boards, for their part, are supposed to set the tone that dominates everything a bank does and how that is projected into the marketplace. In some cases factors like gaps in industry knowledge of directors, imperial chairmen and a boardroom sociology that puts an excessive premium on "teamwork" can be a problem. Also at fault may be institutional investors who fail to use the power of the proxy to challenge errant boardroom behavior—possibly because they themselves face conflicts of interest doing other business with the banks in which they hold voting shares. This exposes the ultimate owners of bank shares to a "double agency problem"—first via the fiduciary performance of their asset managers and second via those asset managers forcing bank boards to properly carry out their governance mandates. Not least, banking regulators have plenty of problems with conventional risk indicators in large, complex international banks, so that adding often subtle qualitative factors that turn out to be highly reputation sensitive is a real challenge.

3 What is reputational risk?

There are substantial difficulties in defining the value of a financial firm's reputation, the origins and extent of damage to that reputation, and the sources of reputational risk (the likelihood of that damage materializing).

Reputation may be defined as the opinion (more technically, a social evaluation) of the public toward a person, a group of people or an organization.[3] It is an important competitive driver in many fields, such as education, business, online communities and social status. In a business context, reputation helps determine the value of a business firm as a going concern and such metrics as market-to-book or price-earnings ratios. However, both the precise definition and corroborating data relating to reputational risk are lacking. Arguably, many of these deficiencies can be attributed to the fact that theoretical development covering corporate reputation has been deficient. Such problems notwithstanding, common sense suggests some sources of gain/loss in reputational capital—the cumulative value of the franchise of the banking firm, including its self-defined principles of business conduct. These include

- Economic performance—market share, profitability, and growth.
- Stakeholder interface—shareholders, employees, clients, and suppliers.
- Legal interface—civil and criminal litigation and enforcement actions.

Proximate losses in reputational capital are often reflected in:

- Client flight and loss of market share.
- Investor flight and increases cost of capital.
- Talent flight.
- Increases in contracting costs.

Footnote 2 continued
people selecting banking as a profession, this finding suggests that banking itself and its cultural norms are associated with increased dishonesty among otherwise honest individuals.

[3] For more detail, see the discussion of reputational risk issues in Walter (2010).

For practical purposes, reputational risk in the financial services sector is associated with the probability of loss in the going-concern value of the firm—i.e., the risk-adjusted value of expected future earnings. Reputational losses thus may be reflected in reduced operating revenues as clients and trading counterparties shift to competitors, increased compliance and other costs required to deal with reputational issues—including opportunity costs—and an increased firm-specific risk perceived by the market.

Reputational risk is often linked to operational risk, although there are important distinctions between the two. According to long-standing definitions under the Basle principles, operational risks are associated with people (internal fraud, clients, products, business practices, employment practices, and workplace safety), internal processes and systems, and external events (external fraud, damage or loss of assets, and force majeure). Operational risk is specifically *not* considered to encompass strategic and business risk, credit risk, market risk or systemic risk, or reputational risk.[4]

If reputational risk is excluded from operational risk from an international regulatory perspective, then what is it? A possible working definition is as follows:

Reputational risk comprises the risk of loss in the value of a firm's business franchise that extends beyond event-related accounting losses and is reflected in a decline in its share performance metrics. Reputation-related losses reflect reduced expected revenues and/or higher financing and contracting costs. Reputational risk, in turn, is related to the strategic positioning and execution of the firm, conflicts of interest exploitation, individual professional conduct, compliance and incentive systems, leadership and the prevailing corporate culture. It is usually the consequence of management processes rather than discrete events, and, therefore, requires risk control approaches that may differ materially from operational risk management.

According to this definition, a reputation-sensitive event might trigger an identifiable monetary decline in the market capitalization of the bank. After subtracting from this market-cap loss the present value of direct and allocated costs, such as fines and penalties and settlements under civil litigation, the balance can be ascribed to the impact on the firm's reputation. Firms that promote themselves as reputational standard-setters will, accordingly, tend to suffer larger reputational losses than firms that have taken a lower profile—that is, reputational losses associated with identical events according to this definition may be highly idiosyncratic to the individual firm.

In terms of the overall hierarchy of risks faced by financial intermediaries depicted in Fig. 4, reputational risk is perhaps the most intractable among them. Market risk is usually considered the most tractable, with adequate time series and cross-sectional data availability, appropriate metrics to assess volatility and correlations, and the ability to apply techniques such as value at risk (VaR) and risk-adjusted return on capital (RAROC). Credit risk is arguably less tractable, given that many credits are on the books of financial intermediaries at historical values. The analysis of credit events in a portfolio context is less tractable than market risk in terms of the available metrics, although many types of credits have over the years become "marketized" through securitization structures such as asset-backed securities (ABS) and collateralized loan

[4] Basle II at http://www.bis.org/publ/bcbs107.htm.

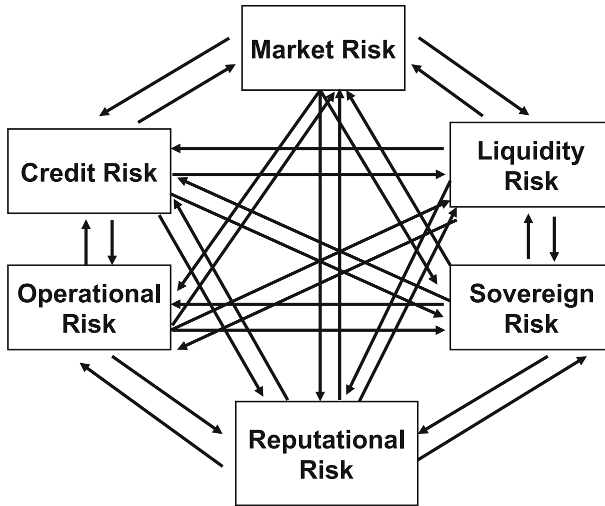

Fig. 4 Key risk domains and their interrelationships

obligations (CLOs), as well as derivatives such as credit default swaps (CDS). These financial instruments are priced in both primary and secondary markets, and transfer some of the granularity and tractability found in market risk to the credit domain. Liquidity risk, on the other hand, has both pluses and minuses in terms of tractability. In continuous-time markets, liquidity risk can be calibrated in terms of bid-offer spreads, although in times of severe market stress liquidity can evaporate and with it the ability to mark to market.

Operational risk is a composite of highly manageable risks with a robust basis for suitable risk metrics together with risks that represent catastrophes and extreme values—tail events that are difficult to model and, in some cases, have never actually been observed. Here, management is forced to rely on either simulations or external data to try to assess probabilities and potential losses. Meanwhile, sovereign risk assessment centers on applied political economy and relies on imprecise techniques, such as "stylized facts," so that the track record of even the most sophisticated analytical approaches is not particularly strong—especially under conditions of macro-stress and contagion. As in the case of credit risk, sovereign risk can be calibrated when foreign currency government bonds and default swaps (stripped of non-sovereign attributes like external guarantees and collateral) are traded in the market. This leaves reputational risk as perhaps the least tractable of all—with poor data, limited usable metrics and strong "fat tail" characteristics.

4 Sources of reputational risk

Where does reputational risk of large international banks originate? To a significant extent, it appears to arise from the intersection between the bank and the competitive environment on the one hand, and from the direct and indirect network of controls and behavioral expectations within which the bank operates, on the other hand, as depicted

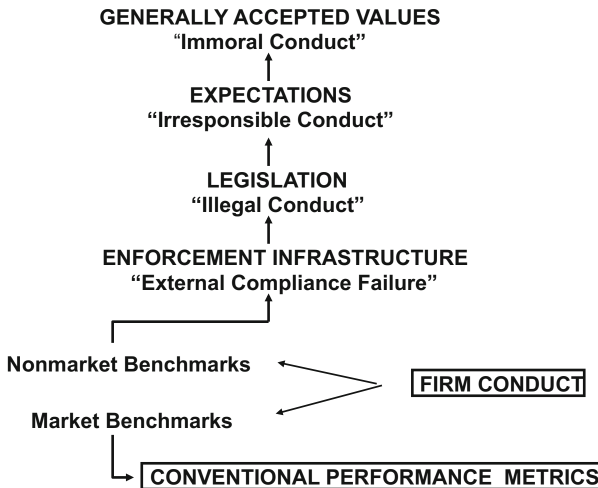

Fig. 5 Reputational risk in context

generically in Fig. 5.[5] The franchise value of a financial institution as a going concern is calibrated against these two sets of benchmarks. One of them, market performance, tends to be relatively transparent and easy to reward or punish. The other, performance against corporate conduct benchmarks, is far more opaque, but potentially comparable in importance as a source of risk to shareholders.

The management must work to optimize with respect to both sets of benchmarks. If it strays too far in the direction of meeting the demands of social and regulatory controls, it runs the risk of poor performance in the market, punishment by shareholders and possibly a change in corporate control. If it strays toward unrestrained market performance and sails too close to the wind in terms of questionable market conduct, its behavior may have disastrous results for the firm, its managers and its shareholders.

Such are the rules of the game, and large international banks, along with all other firms, have to live with them. But they are not immutable. There is constant tension between firms and regulators about appropriate constraints on corporate conduct. Sometimes, financial intermediaries win battles (and even wars) leading to periods of deregulation. Sometimes, it is possible to convince the public that self-regulation and market discipline are powerful enough to obviate the need for costly external controls. Sometimes, the regulators can be convinced, one way or another, to go easy in the interests of financial efficiency. Then, along comes another major transgression, the constraint system reacts and a spate of new regulations arises. A wide array of interests get into this constant battle to define the rules under which financial business gets done—managers, politicians, the media, activists, investors, lawyers and accountants—and eventually a new equilibrium gets established which defines the rules of engagement for the period ahead.

[5] For an early discussion of external conduct benchmarks, see Galbraith (1973).

There is an array of more fundamental factors at work as well. Laws and regulations governing the market conduct of business firms are not created in a vacuum. They are rooted in social expectations as to what is appropriate and inappropriate, which in turn are driven by values imbedded in society. These values are rather basic. They deal with lying, cheating and stealing, with trust and honor, and with what is right and wrong. These are the *ultimate* benchmarks against which conduct is measured and which may be at the root of key reputational losses of large banks.

But fundamental values in society may or may not be fully reflected in people's *expectations* as to how a banking firm's conduct is viewed or assessed. That is, there may be slippage between social values and how these are reflected in public expectations of business conduct. Buildup of adverse opinion in the media, the formation of special interest lobbies and pressure groups, and the general tide of public opinion with respect to one or another aspect of market conduct can be reputationally debilitating even in the same underlying value system.

Neither values nor expectations are static in time. Both change. But values seem to change much more gradually than expectations. Indeed, fundamental social values are probably as close as one comes to "constants" in assessing business conduct. But here, things do change. As society becomes more diverse and mobile, for example, values tend to evolve. They also differ across cultures and are sometimes difficult to interpret. Is lying to clients or to trading counterparties wrong? What is the difference between lying and bluffing, and between lying and staking out a negotiating position? The same conduct may be interpreted differently under different circumstances, so that interpretations of conduct may change over time and differ across cultures, giving rise to some unique contours of reputational risk.

There is additional slippage between society's expectations and the formation of public policy on the one hand, and the activities of public interest groups on the other. Things may go on as usual for a while despite occasional media commentary about inappropriate behavior of a firm or an industry in the marketplace. Then some sort of social tolerance limit or tipping point is reached. A firm goes too far. A consensus emerges among various groups concerned with the issue at hand. The system reacts through the political process, and a new set of constraints on firm behavior develops, possibly anchored in legislation, regulation and bureaucracy; or the firm is subject to class action litigation[6]; or its reputation is so seriously compromised that its share price drops sharply.

As managers review the reputational experiences of their competitors, they cannot escape an important message. Most large international banks can endure a credit loss or the cost of an unsuccessful trade or a broken deal, however large, and still survive. These are business risks that banks have learned to detect and limit exposures before the damage becomes serious.

Reputational losses may in addition be the consequence of public reactions that may appear to professionals as unfocused, ambiguous or unfair. They may come from a new reading of the rules of the game, a new finding of culpability or something different from the way things were done before. Although regulators and litigants,

[6] For a discussion, see Capiello (2006).

analysts and the investigative media are accepted by financial professionals as facts of life, they in turn can be influenced by public uproar and political pressure, making a credible defense even more difficult.[7]

In the USA, for example, tighter regulation and closer surveillance, aggressive prosecution and plaintiff litigation, unsympathetic media, stricter guidelines for penalties and sentencing make it easier to get into trouble and harder to avoid serious civil penalties and even criminal guilty pleas. Global banking involves hundreds of different, complex and constantly changing products that are difficult to monitor carefully under the best of circumstances. Doing this in a highly competitive market, where profit margins are under constant challenge and there is considerable temptation to break the rules, is even more challenging. Performance-driven managers, through compensation and other incentives, it is argued, have sometimes encouraged behavior that has inflicted major reputational damage on their firms and destroyed some of them.

The reality is that the value of large international banks to their investors suffers from such uncertain reputation-sensitive conditions. Since maximizing the value of the firm is supposed to be the ultimate role of management, its job is to learn how to run the firm so that it optimizes the long-term trade-offs between profits and external control. It does no good to plead unfair treatment—the task is for management to learn to live within the constraint system, make its case when the system fails to serve the public interest and make the most of the variables it can control.

The overall process can be depicted in Fig. 6, which shows the firm and its internal governance processes in the center and various layers of external controls affecting both its conduct and the reputational consequences of misconduct, ranging from "hard" compliance components near the center to "soft" but potentially vital issues of "appropriate" conduct on the periphery. Clearly, serious reputational losses can impact a large international bank even if it is fully in compliance with the multiple regulatory constraints it confronts around the world and its actions are entirely legal. The risk of reputational damage incurred in these outer fringes of the respective webs of social control in the various markets it serves are among the most difficult to assess and manage; nor is the constraint system necessarily consistent, so conduct which is considered acceptable in a given environment may trigger significant reputational risk in others.

5 Valuing reputational risk

There have been a number of efforts to quantify the impact of reputational risk on share prices of financial firms beginning with widespread professional misconduct issues in the 1980s and 1990s.[8] Given the nature of the problem, most of the discussion has been anecdotal, although a number of "event studies" have been undertaken in cases where the reputation-sensitive event was statistically "clean" in terms of the release of the relevant information to the market. To estimate the pure reputational loss associated with an adverse event, it is necessary to estimate the firm's cumula-

[7] For a full examination of these issues, see Smith and Walter (1997).

[8] For one of the early studies, see Smith (1992).

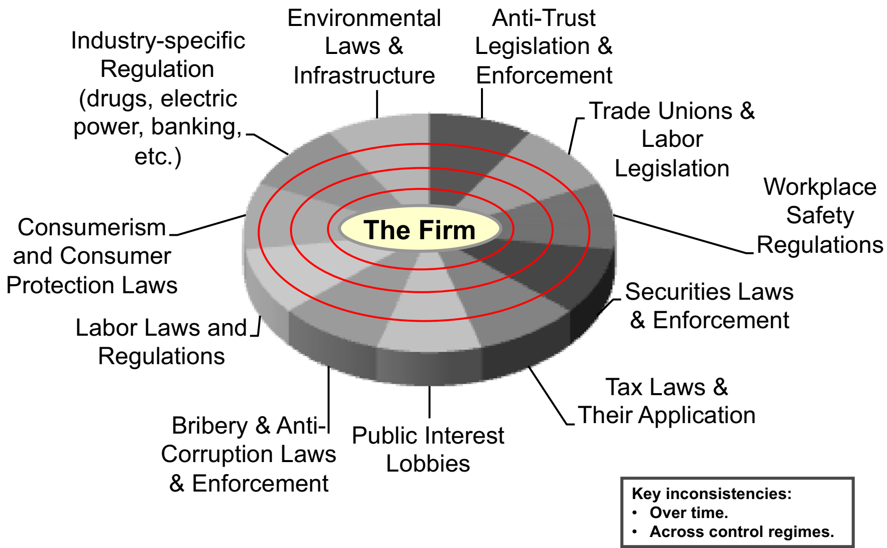

Fig. 6 Reputational (Franchise) risk through the lens of an external control web

tive abnormal market capitalization loss (CAR) and then deduct the present value of expected non-reputation-related costs including accounting write-offs, higher compliance costs, regulatory fines and legal settlements. The residual CAR can be considered associated with a loss of reputational capital.

Event studies in recent years have yielded a growing body of evidence on the share price sensitivity to reputational risk. For example, Cummins et al. (2006) undertook a large sample study of operational and reputational events contained in the Fitch OpVar™ database. De Fontnouvelle et al. (2006) use loss data from the Fitch OpVar™ and SAS OpRisk™ databases to model operational risk for banks that are internationally active. In a series of robust statistical estimates, they find a high degree of regularity in operational losses that can be quantified, underlining the importance of maintaining significant capital against operational risk. The paper goes on to segment the losses by event type and by activity line, as well as whether or not the operational losses occurred in the USA. The largest losses involve retail and commercial banking activities. As with other studies, the authors do not distinguish the associated accounting losses due to legal settlements, fines, penalties and other explicit operational risk-related costs from reputational losses, so the estimates may understate the actual losses to shareholders.

Focusing on the differential impact of reputational shocks on accounting and market values, Gillet et al. (2010) attempt to isolate the pure reputational effect of the operational loss event on market returns by estimating for the difference between the market value loss of capital and the announced accounting loss. The results show negative abnormal returns at the loss announcement date, and in cases of internal fraud the loss in market value is larger than the announced accounting loss, interpreted by the authors as a sign of reputational damage.

Using a different approach, Fiordelisi et al. (2013) estimate the determinants of reputational risk for a sample of European and American banks during the period

2003–2008. The dependent variable is assigned a value of 1 if the bank experienced a cumulative abnormal return in the top third of the CAR distribution, a value 2 if the CAR fell in the middle third of the distribution and a value 3 if the CAR fell in the lowest third of the distribution. The study concludes that reputational damage increases as bank profits and size increase, and that a higher level of bank capital and intangible assets both reduce the probability of reputational damage. In another study, Sturm (2013) concludes that firm characteristics are more important in explaining reputational damage than the specific characteristics of the loss event.

One study that tries to focus specifically on "pure" reputational losses is that of Karpoff et al. (2008). The authors attempt to distinguish book losses from reputational losses in the context of US Securities and Exchange Commission enforcement actions related to earnings restatements or "cooking the books." The authors assemble a dataset of 2532 regulatory events in connection with all relevant SEC enforcement actions from 1978 to 2002 and their respective monetary costs in the ensuing period through 2005. These monetary costs are then compared with the cumulative abnormal returns estimated from event studies to separate them from the reputational costs. The reputational losses attributed in the study (66 %) are far larger than the cost of fines (3 %), class action settlements (6 %) and accounting write-offs (25 %) resulting from the SEC enforcement actions.

A pilot study of 49 reputation-sensitive events excluding operational events (Walter and DeLong 1995) finds negative mean CARs of up to 7 % of market capitalization, depending on the event windows used.[9] The results do not, however, distinguish between the overall CARs and the pure reputational loss components.[10]

Whereas such studies try to isolate the equity price effects of reputation-sensitive events, one would expect the fixed income market to react as well through the affected firm's ability to maintain debt service—e.g., if the reputational shock triggers a revenue collapse. Plunus et al. (2012) examine bond market reactions to the announcement of operational losses by financial firms. They interpret the abnormal bond market returns for firms suffering reputational losses as part of operational loss announcements. Although less severe than in the case of stock prices, the time series discussion in the study suggests that the bond price impact of reputational risk is indeed significant. In cross-sectional analysis, the study finds that high leverage has a negative impact on the performance of the bonds on the first press release of the reputational shock as well as on the settlement date. The absolute level of debt likewise affects the abnormal return on the event announcement.[11]

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[9] Based on an empirical study of reputational risk conducted at the Stern School of Business, New York University.

[10] Ongoing empirical work on reputation-sensitive financial services events with Gayle De Long and Anthony Saunders.

[11] A paper by Bushman et al. (2015) posits that bank CEOs who display extremely high consumption levels are associated with significantly higher bank risk-taking cultures. Materialistic bank CEOs became more numerous in the cohort after financial deregulation during the 1994–2004. At the same time, they pared back attention to risk management and boosted downside tail risk in their banks, which surfaced particularly during the financial crisis of 2007–2009. Replacing highly materialistic bank CEOs with more modest leadership reversed many of these effects.

It is likely that the broader the range of a financial intermediary's activities, (1) the greater is the likelihood that the firm will encounter exploitable conflicts of interest and reputational risk exposure, (2) the higher will be the potential agency costs facing its clients and (3) the more difficult and costly will be the safeguards necessary to protect the value of the franchise. If this proposition is correct, costs associated with reputational risk mitigation can easily offset the realization of economies of scope in large global banking firms, scope economies that are supposed to generate benefits on the demand side through cross-selling (revenue synergies) and on the supply side through more efficient use of the firm's business infrastructure (cost synergies). As a result of conflict exploitation, the stand to gain initially but subsequent adverse reputational and regulatory consequences (along with efficiency factors such as the managerial and operational cost of complexity) can offset or reverse these gains.

It seems plausible, therefore, that the broader the range of services that a financial firm provides to a given client in the market, and the greater the cross-selling pressure, the greater is the potential likelihood that conflicts of interest and reputational risk exposure will be compounded in any given case, and, when these conflicts of interest are exploited, the more likely they are to damage the market value of the financial firm's business franchise once they come to light.

6 Conclusions

This paper attempts to define reputational risk and to outline the sources of such risk facing large international banks. It then considers the key drivers of reputational risk in the presence of transactions costs and imperfect information, and surveys available empirical research on the impact of reputational losses imposed on banks.

Market discipline, through the reputation effects on the franchise value of large internationally active banks, can be a potentially powerful complement to regulation and civil litigation. Nevertheless, market discipline-based controls remain controversial. Financial firms continue to encounter serious instances of reputation loss due to misconduct despite the threat to the value of their franchises. This suggests material lapses in the risk management and corporate governance.

Dealing with reputational risk can be an expensive business, with compliance systems that are costly to maintain, and various types of walls between business units and functions that impose significant opportunity costs due to inefficient use of information and resources within the organization. Moreover, management of certain kinds of reputational exposure in banking and financial conglomerates may be sufficiently difficult to require structural remediation by divesting or separating certain businesses. On the other hand, reputation losses can cause serious damage, as demonstrated by reputation-sensitive events that seem to occur repeatedly in the global banking industry. Indeed, it can be argued that such issues contribute to market valuations among financial conglomerates that fall below valuations of more specialized financial services businesses.[12]

[12] Laeven and Levine (2007), Schmid and Walter 2009. See also Kanatas and Qi (2003) and Saunders and Walter (2009).

One would like to believe that market discipline, through the reputation effects on the franchise value of financial firms, can be a powerful complement to regulation and civil litigation in avoiding or remedying damage created by unacceptable financial practices. Yet, civil litigation seems ineffective in changing bank behavior despite "deferred prosecution" agreements not to repeat offenses, and market discipline-based controls remain controversial. Financial firms continue to encounter serious instances of reputation loss due to misconduct despite their effects on the value of their franchises.[13] This suggests continued material lapses in the governance and management process, increasingly recognized in the "qualitative" components of stress tests applied annually to systemic banking organizations in the USA, Europe and elsewhere.

In the end, it is probably leadership more than anything else that separates winners from losers over the long term—the notion that appropriate professional behavior reinforced by a sense of belonging to a quality franchise constitutes a decisive comparative advantage. The alternatives will rely even more on intrusive and sometimes possibly regulation to protect the general public from systemic risk, ultimately at substantial cost to financial efficiency and economic growth.

Managements and boards of large internationally active banks must be convinced that a good defense that incorporates reputational capital is as important as a good offense in determining sustainable competitive performance. This is something that is extraordinarily difficult to put into practice in a highly competitive environment for the banks and for its highly skilled professionals. A good defense requires an unusual degree of senior management leadership and commitment (Smith and Walter 1997). Internally, there have to be mechanisms that reinforce the loyalty and professional conduct of employees. Externally, there has to be careful and sustained attention to reputational capital as a disciplinary mechanism.

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[13] For an in-depth discussion of corporate culture, see Gillet et al. (2010).

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