Reputational Risk in Financial Services – The Need for a Greater Focus

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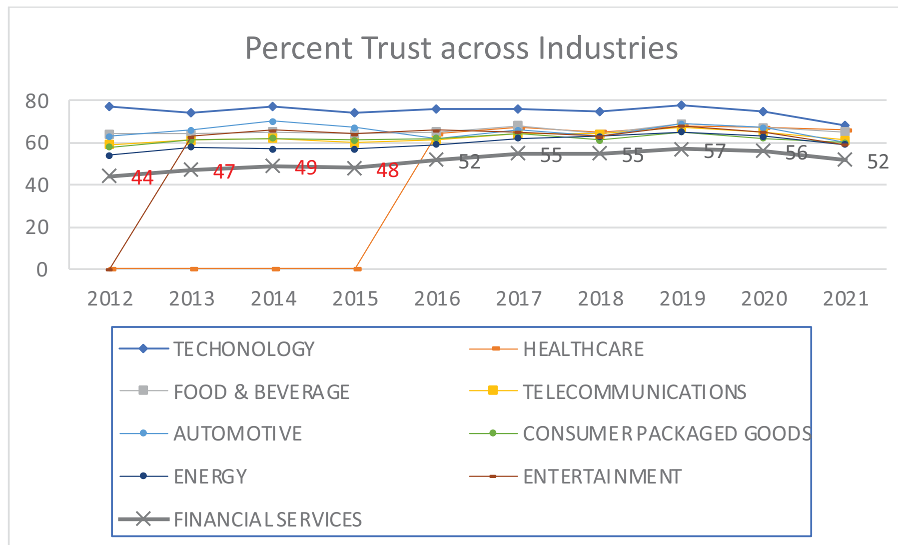
"We can afford to lose money – even a lot of money. But we can't afford to lose reputation – even a shred of reputation." (Warren Buffet)

I. Introduction – why reputational risk?

Reputation is one of the key drivers of the performance of any entity. It encompasses the entire ecosystem of stakeholders of an economy, with a country's reputation at the apex, and cascading down with strong interlinkages among all constituents. A strong positive reputation allows corporate entities to attract human resources and cheaper capital, price their products at a premium that increases profitability, and develop long-term relationships with customers and supply chain partners. As of 1 January 2012, reputation accounted for nearly 26% of the total market capitalization of the S&P 500 (Cole. 2013). Damage to reputation can therefore impact the performance of any ongoing concern, and risks to reputation have to be managed effectively to deliver value to all stakeholders.

The impact of a risk event in financial services can have far-reaching consequences and affect the economy through a ripple effect, as demonstrated during the various financial crises, recent and remote. These have ultimately had a bearing on the reputation of the sector and impacted it negatively. The financial services sector suffers from a marked trust deficit between the participants on the demand and supply sides. Globally, the Edelman Trust Barometer 2021 indicates that trust in the financial services industry is the lowest, a trend that has continued over the last 10 years despite registering an improvement during the decade.

FIGURE 1: PERCENT TRUST ACROSS INDUSTRIES. 2012-2022.



Source: 21st Edelman Trust Barometer

Financial intermediation, however, carries out various necessary functions that are necessary for the efficient performance of a modern economy (Bhattacharya and Thakor 1993; Visco 2012). According to Sen (1991), finance has an important role in the economic development of countries, and in promoting culture and science as well. It is, therefore, imperative for all stakeholders to manage risks in the financial services sector effectively.

Several developments related to reputational risk events in the financial services sector in India have taken place over the years and impacted consumers. Management of reputational risk should accordingly be a priority for policymakers.

Reputational risk, often considered as a composite risk consequential to other risk events, is not an unknown concept. However, attempts to manage it effectively as a standalone risk, have begun only recently. Being based on external perceptions, it is, however, more difficult to manage than other standard risks. (ACE 2013).

Reputational risk is distinct from the actual occurrence of the risk event. The crises resulting from the risk events hurt the reputation of the financial institutions emanating from the actions of one or a few persons, and the ultimate price had to be paid by the consumers. It is, therefore, important to assess reputational risk properly and take adequate mitigation measures to protect all stakeholders in case of an occurrence of the eventuality.

This article explores the various dimensions of reputational risk and concludes with some suggested measures for addressing it more effectively in India.

II. Defining reputational risk.

Reputational risk is an extremely nebulous concept. Definitions of reputation, by academics (Fitzsimmons and Atkins 2017), regulator supervisors (Federal Reserve Systems 1995), and standard setters e.g., Basel Committee on Banking Supervision (BCBS) (2009), all emphasize its perception-based nature that cannot be hard coded. The risk is that the reputation will be perceived unfavorably due to the behavior of an organization, its employees, or its associates not meeting stakeholder expectations.

III. Causes of reputational risk.

Reputation risk results from conflicts of interest between the agents of a financial service provider and its customers (Crockett et al. 2003). Sen (1991) has classified conflict of interest as a *behavioral constraint* as a result of which financial agents may compromise the interests of shareholders or of the community in the pursuit of self-serving interests and highlighted the issue of insider trading in this connection.

The range of a financial intermediary's activities is directly correlated to the probability of the organization encountering conflicts of interest situations that can be exploited and the cost of putting safeguards in place. Striking a balance between the two is a key corporate governance issue involving a strong ethical perspective (Walter 2007).

Laws and regulations governing market conduct are based on social mores – the 'fit and proper' criteria for 'key shareholders' to establish their probity and competence (BCBS 1999). This involves assessing the integrity and suitability of managers and directors of financial institutions. Concepts such as integrity based on the intrinsic values of a society may change over time and vary across cultures creating different types of reputational risk. Stakeholder expectations and societal values may differ significantly, the gap becoming more pronounced as financial services evolve.

Causal factors in financial services

"…'Splendid financiering' is not legitimate banking, and 'splendid financiers' in banking are generally rascals or humbugs." *Letter of guidance to bankers from the U.S. Comptroller of the Currency, December 1863* (Group of Thirty 2015).

Reputational risk in financial services has been attributed primarily to poor governance and deviant behavior of taking unacceptable risks for private gains. Financial services is a highly specialized and intensely competitive business with profit margins under constant threat. Compensation and promotion practices have, at times, unknowingly damaged firms' reputation (Walter 2007). Rajan (2005) argues that the changes in the financial sector created some potential for distortion by altering managerial incentives and changing the nature

of risks assumed by the system. Inadequate cybersecurity leading to theft and misuse of data is another key source of reputational risk at present.

Cultural issues related to financial services

The role of corporate culture in reputational risk, particularly in the financial services sector, has been emphasized in several studies. The Group of Thirty Report (2015) defines culture as the mechanism for building trust and goodwill of banks among its key internal and external stakeholders. Cultural issues like hubris, envy, misplaced faith, and herd behavior, apart from ill-designed incentives, were some of the critical factors responsible for the 2008 financial crisis (Rajan 2010).

Commentators have suggested that a culture of *mala fide* is prevalent in the financial sector, and the existing business culture of the banking industry contravening the norms of honesty should be addressed on a priority basis (Cohn et al. 2014). Though the interpretation of the data from this study has been contested by Stöckl (2015), the probability of white-collar crimes – real and virtual – within the organization is one of the key sources of reputational risk in the sector. Personal reputation impacts corporate identity and reputation (Bromley 2002). Bushman et al. (2015) posits that materialistic (identified by ownership of luxury goods) CEOs exhibit a greater proclivity for promoting aggressive risk-taking cultures than their more frugal peers.

Most financial firms can endure business risks that the firms have learned to manage, but reputational losses may be imposed by external reactions and outsiders such as regulators and litigants; analysts and media can become susceptible to external influences, making it difficult to side with a perceived offender (Walter 2007).

Executive compensation in financial services

Executive compensation is strongly linked to corporate culture. It is a vexing issue for the financial sector plagued by perceptions of greed and remunerations incommensurate with performance. The sentiment that profits are privatized but losses are socialized, and the scrutiny of senior management compensation are among the plausible reasons for the erosion of trust in the financial sector (Reddy 2012). Public perceptions – often influenced by media reports – apart, the view that executive compensation policies gaming the compensation system through ex-ante rather than ex-post performance metrics adversely impact the financial sector is supported by academicians (Bebchuk and Fried 2010; Bhagat and Bolton 2013; Rajan 2008), global standard setters (for example, the Financial Stability Board (FSB), and the Basel Committee on Banking Supervision (BCBS)), and policymakers (for example, the Financial Sector Legislative Reforms Commission in India (FSLRC 2013)). [3,4] There are, however, contrarian views on the regulation of executive compensation, in popular (Rand 1957) as well as technical (French et al. 2010) literature. An online debate facilitated by the

[3] FSB Principles for Sound Compensation Practices Implementation Standards. September 25, 2009.

[4] Supervisory review process SRP 35. Compensation practices. Version effective as of 15 December 2019.

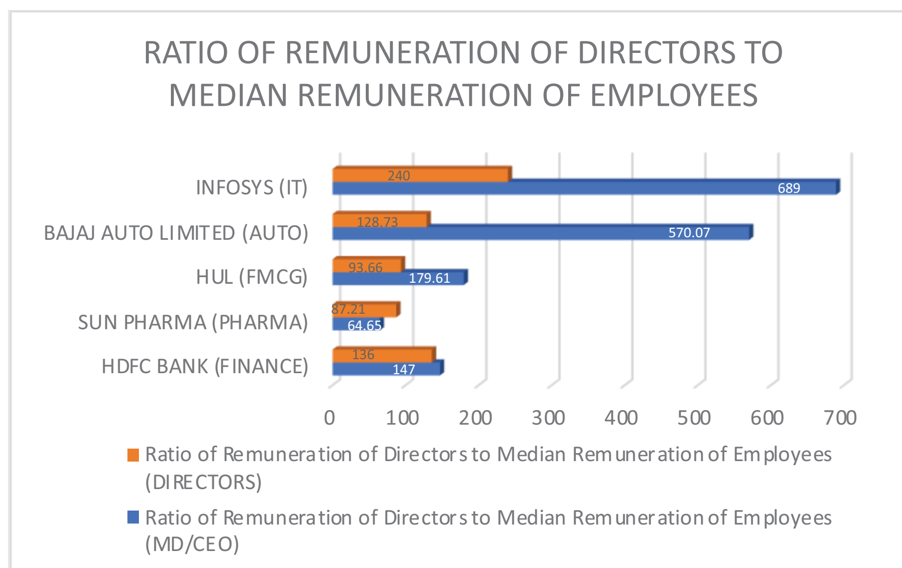
World Bank (Bishop 2012), and a composite presentation of the differing views by Johnson (2010) and Kaplan (2010) provide excellent summaries of both perspectives.

It is interesting to note in this context, that studies (Chang et al. 2022; Myers and Sevier 2018) indicate that disclosure mandates on executive compensation adopted by several geographies, including India in The Companies Act, 2013, neither impact the earnings of senior executives nor meet the objective of aligning pay with performance.

The Reserve Bank of India (2019) guidelines on the compensation of employees of Private Sector Banks (including Local Area Banks, Small Finance Banks, and Payments Banks) and Foreign Banks operating in India[5] are in alignment with the recommendations of the FSB and the BCBS and includes provisions for *malus* and clawback. Interestingly, the instance of clawback applied in the case of a CEO of an Indian bank is cited in the FSB Progress Report (2021). However, unless bankers realized the risks taken by them, regulating the bonuses paid to them would serve a very limited purpose (Rajan 2010).

Although the financial sector is criticized for compensation policies skewed in favor of the top management, a dipstick review of cross-industry executive compensations in India reveals that this is not confined to the financial sector alone. The figure below is a rough and ready dashboard since heads such as financial years, designations, and terms and conditions of payments are disparate across firms. It is nevertheless indicative of a broad trend.

FIGURE 2: RATIO OF REMUNERATION OF DIRECTORS TO MEDIAN REMUNERATION OF EMPLOYEES ACROSS SELECT INDUSTRY SECTORS IN INDIA



Source: Annual Reports of Companies

[5] RBI/2019-20/89. DOR.Appt.BC.No.23/29.67.001/2019-20 November 4, 2019

IV. Reasons for addressing reputational risk in the financial services sector

Good reputation attracts business that should lead to higher profits and enhance the value of the firm. Diamond et al. (2021) have developed the concept of internal governance or *pledgeability* and conclude that the debt capacity of a firm increases with higher prospective liquidity and pledgeability. Minor errors, or errors common to other firms, seem not to result in serious reputational losses (Driver Review 2012). Negative market reactions to restatements resulting from 'technical accounting issues' are more subdued compared to those involving fraud and reflect poorly on management integrity (Palmrose et al. 2004).

From developmental and macro perspectives particularly relevant for India, reputation risk is extremely important for financial inclusion since it impacts inequality (Ratnawati 2020) and attractiveness for Foreign Direct Investments (Kalamova and Konrad 2010).

Poor risk management impacting a financial institution's reputation affects its potential for future business (Laurens. 2012). The contagion effect of reputational risk impacts the entire financial sector, particularly among the financially illiterate population. The collapse of Punjab and Maharashtra Cooperative Bank (PMC Bank), in 2019, caused severe distress to small depositors and led to several suicidal deaths.

Such incidents impede financial inclusion. Anecdotal evidence indicates that poor claim settlement records have been responsible for lower insurance penetration. A demonstrable commitment to providing reasonable access to essential financial services to all segments of society is necessary to reinforce the assertion that finance serves the larger community (Reddy 2012).

According to Sutton and Jenkins (2007), adverse publicity by media and consumer rights organizations can damage reputation. With increasing inequality, organizations perceived as elitist are likely to become vulnerable as well, and public relations and philanthropy cannot mend these damages. Heightened awareness of financial exclusion impacting poverty, would increase such risks.

The increasing power of social media now makes it extremely important to ensure customer satisfaction. The impact of social media in modern times has grown manifold since the time of reputational damage to United Air from a YouTube upload.

Operational loss announcements have a larger market impact for firms with better growth prospects (Cummins et al. 2004). Firms promoting themselves as reputational standard-setters will tend to suffer larger reputational losses (Walter 2007).

V. Quantifying reputational risk

Reputational risk is the least tractable of the risks confronting financial intermediaries because of the lack of data, limited usable metrics, and strong "fat tail" characteristics (Walter 2007). Because of its amorphous

nature, any measure of reputational risk involves an element of subjectivity. There are two types of measures for reputational risk.

The qualitative methods, based primarily on perception-based surveys for determining reputational indices and ratings include the Reputation Institute's RepTrack and the annual Fortune ranking. These are differentiated by the different classifications of the determinants of reputation. Bromley (2002), however, has argued that these are biased and suggested alternatives.

Various measures based on quantitative methods have been suggested in the literature. Though there is no standard methodology for such measures, existing literature on quantifying reputational risk is typically based on ex-post analysis of risk events. Analyses based on event studies have yielded significant evidence of share price sensitivity to reputational risk (Walter 2007).

There are various ways of estimating reputational risk. Kaiser (2014) defines it as unexpected losses resulting from stakeholders' response to changes in the perception of an entity. A large body of literature exists on estimating risks based on the negative impact of different risk events and governance on stock prices and market capitalization. Among these, the study by Micocci et al.(2009) estimates the reputational Value at Risk (VaR) for a monthly event window that represents the economic capital necessary to provide an offset against negative reputational effects (which is directly proportional to the different confidence levels) as 1.08% of shareholders' value at 99.9% confidence level.

VI. Current situation and their (in) adequacies.

Attempts to address reputational risk both through internal governance processes and through regulation and supervision are still at an incipient stage. Globally, there are no directives for allocating risk-weighted capital for reputational risk. Scholarship on reputational risk management in banks is limited in size (Zaby and Pohl. 2019). The focus is more on knee-jerk damage control through managing public relations than managing reputational risks proactively. The role of rating agencies, which are required to be used mandatorily for risk ratings, has come under severe criticism. Most importantly, regulatory teeth have been lacking. Analysts argue that regulations are even less of a substitute for reputation-based transactions because of their ineffectiveness; today's consumers are more concerned with profit rather than reputation (Driver Review 2012).

In India, there have been several recent incidents in the financial services sector that give sufficient reasons for concern and the need to pay greater attention to managing reputational risk. Almost all the cases reflect some of the theoretical premises behind reputational risk events, particularly, the impact of the transgressions of promoter groups on the institution. The Edelman Trust Barometer (2021) indicates that trust in CEOs in India is at an all-time low.

Retail investors in YES Bank AT1 bonds lost approximately Rs. 679 crores because of mis-selling.[6] Interestingly, YES Bank was the first Indian bank to have issued Green Bonds in 2015, creating the image of an environmentally friendly institution.

The cases of Punjab and Maharashtra Cooperative Bank mentioned earlier, IL&FS Financial Services, SREI Infrastructure Finance, SREI Equipment Finance, and a closure of several cooperative banks in recent times indicate poorly managed risks in these institutions. In ICICI Bank, a reputational crisis arose due to the souring of the loans sanctioned despite an alleged conflict of interest. Moreover, consumer grievance redressal processes are complicated and long-drawn. In the cases of IL&FS and the SREI companies, there were lapses on the part of external auditors (in the case of IL&FS, by a Big Four firm) – one of the key risk management mechanisms for any organization. The credibility of rating agencies came under question in the case of IL&FS Financial Services. Currently, there is only one commercial bank in India that has officially adopted the Equator Principles for managing environmental and social risks in project financing.

VII. Mitigation of reputational risk – policy directions.

Reputational risks, like other risks, can be managed through internal processes and regulations. The financial crisis of 2007 has often been blamed on regulators who were accused of 'permissiveness and stupidity' (Driver Review 2012). According to Walter (2007), market developments have periodically overtaken regulatory capabilities for promoting stability and fairness as well as efficiency and innovation. According to Reddy (2012), a major reason for the erosion of trust in the financial sector possibly arises from the sense that there has been a comprehensive capture of regulation of the financial sector by the finance industry, particularly in the leading advanced economies. A key reason for this is a conflict-of-interest situation often faced by regulators themselves. As a wing of public policy authority, it behooves central banks to maintain ongoing trust and confidence in the financial sector.

Increasing complexities in the financial sector have reduced the importance of reputation, but regulation can substitute reputation only to the extent that it ensures a level playing field so that the need for reputation is lessened. However, there are studies indicating that the management of reputational risk is sometimes counterproductive. Hill (2019), for instance, argues against expansive regulation of reputation risks since there is little evidence that regulators can accurately predict and prevent bank reputational losses. Furthermore, reputational risks are mostly subjective, and regulators can use them to further political agendas undermining faith in the regulatory system and eroding trust in banks.

[6] Securities and Exchange Board of India Adjudication Order No. Order/SM/MG/2021-22/11306-11309. April 2021.

Similarly, the findings of Miklaszewska et al. (2020) in their study of CEE-11 listed banks, indicate that since large risky banks scoring low on reputation had the potential for performing better, appropriate management of reputational risk might not be a priority since it could negatively impact the assessment of the performance of banks. This is probably why many banks dealt with reputational risk by managing crisis instead of reputational risk.

It is nevertheless necessary to have comprehensive guidelines for managing reputation risks for financial stability and ensuring consumer protection. A broad contour of such guidelines is suggested below.

1. Ongoing research for providing future directions. A study by Adeabah et al. (2020) indicates that the entire body of research on the subject is from developed countries, and the reputational risk management of banks has not gained the global attention it deserves.
2. Regulatory initiatives that have a strong bearing on the issue:
    a. Capacity building – an area, the deficiencies of which have been highlighted by Levine (2012), and in India by the FSLRC Report (2013), which is also critical of "transplanting civil service structure to regulatory authorities." In this context, it may be worth exploring the separation of monetary policy and regulation-supervision functions in India, in line with several jurisdictions.
    b. Reassuring the public about minimizing the scope for comprehensive regulatory capture, reinforced through improving the public image of central banks and their governors (Reddy 2012).
    c. Judicious operation of monetary policy and macro-prudential measures for risk management resulting from perverse incentives (Rajan 2005).
    d. Allocation of capital for reputational risk as estimated by models similar to that of Micocci et al. (2009). Bhagat and Bolton (2013) recommend capitalizing banks with significant additional equity for compensations having equity components.
    e. Micro-prudential regulations to ensure consumer protection and public good. Material Risk Takers responsible for taking risks and selling them should have skin in the game by requiring them to have a part of their remuneration invested in the funds they manage to be paid over a period and frozen for a specified time (Rajan 2005 and 2010; Bhagat and Bolton 2013). The Securities and Exchange Board of India has moved in this direction regarding the remunerations of Asset Management Companies.[7]
3. For building trust in the financial services sector, financial intermediaries should focus on a culture building on their unique role in an economy, and the initiative must come from within instead of being an imposition

[7] Securities and Exchange Board of India Circular SEBI/HO/IMD/IMD-I/DOF5/P/CIR/2021/553. Dated 28 April 2021.

(Laurens 2012). Regulatory compulsions are poor substitutes for self-governance and integrity. Honesty cannot substitute proclivities for perverse behaviors to game the system for self-serving objectives.

As recommended by The Group of Thirty (2018), a sustained focus on conduct and culture with the boards and senior management leading by example is essential. At the operational level, the specific recommendations made in the report should be taken up seriously for implementation. Unfortunately, there has been no effort in this respect in India.

4. Legal initiatives that can fast-track resolutions of disputes relating to financial irregularities. In the USA, there have been many *nolo contendre* (no contest) settlements although these did not create any future legal directions (Walter 2007). Fast track courts in India, established primarily for socially sensitive issues, have been ineffective. A separate entity for addressing financial crimes could address this issue.

An innovative and dynamic financial sector without excess risk and outrageous behavior, while difficult to attain, is a worthwhile aspiration (Rajan 2010). For that, taking a cue from Aristotle, who said that "it is better for a city to be governed by a good man than good laws", what is probably most important for managing reputation to ensure financial stability are a few good men!

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