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REPUTATIONAL AND OPERATIONAL RISKS IN EUROPEAN BANKS

Theoretical Article

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Abstract

In the past 20 years operational and reputational risk has become more intriguing due to the public scandals of rogue tranding in banks like Barings Bank, Allied Irish Banks, Enron. The purpose of this study is to find the connections between operational risk and reputational risk. Our research shows that there may be a loss of reputation due to operational loss events. Moreover, every type of operational risk, from internal fraud, external fraud, legal and liability losses, processing errors, information security breaches, inappropriate business practice, physical security breaches conduct to a loss of reputation. The limitations of this paper are represented by the fact that do not have enough data to show the real impact of the reputation risk to the financial results of the European Banks.

Introduction

Reputation in business has never been more noteworthy. Nowadays companies have much more to lose due to a bad reputation because any time a lawyer, a journalist or an upset client may disclose negative things about the company. This unfavorable information about the organization may lead to a loss of share value and penalties. The price of a bad reputation is preponderant. Moreover, an organization may have a loss of share value, lawsuits, consumer boycotts. Furthermore, employees may pay for their bad reputation even with their liberty. For instance, rogue traders as Nick Leeson from Barings Bank and Jerome Kerviel from Societe General were imprisoned for their frauds of $1 billion and €4.9 billion. To this extent, it is clear that there were managers, executives, board members, investors who did not know what happened in their company untill it was too late and the losses were colossal. Thus it is important to know and to manage operational and reputational risk. These two risks are difficult to measure and to prevent. Trying to prevent these types of risk is foolish because it would mean that a company should give up on its employees, clients, processes and even on their computers. In this circumstances a profitable company would not exist.

There is a great interest in researching reputational and operational risk in financial institutions. An amount of literature exists on this subject. Some of the academic authors interested in reputational and operational risk are: Dale Neef (Neef, 2003), Judy Larkin (Larkin, 2003), Phillip Sturm (Sturm, 2013), , Cummins, Cristopher &Ran (Cummins, Cristopher, & Ran, 2006), De Fountnouvelle and Jason (de Fontnouvelle & Jason, 2005), Roland, Hubner and Plunus (Roland, Hubner, & Plunus, 2010).

In Section 2 we present reputational risk and the possible causes which may have a great impact on the loss of reputation, and thus, on the financial returns of the company.

In Section 3 we study operational risk, more precisely the types of operational risks which have a percussion on the reputation of a bank.

In Section 4 we show the impact of operational losses on reputation and on the firnancial performance of the European Banks.

Reputational risk

One of the most accepted definition of reputational risk is the definition established by the Basel Committee on Banking Supervision (Basel Committe on Banking Supervision;, 2009):

’’Reputational risk can be defined as the risk arising from negative perception on the part of customers, counter parties, shareholders, 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 continued access to sources of funding (e.g. through the inter-bank or securitisation markets).”

Garry Honey (Honey, 2009) identified six causes of reputational risk: legal, ethical, executive, operations, associations and environment.

Ethical

Ethical risks involve the relationship between companies, different departments and business units and they disclose different values, and that discrepancy puts the entire department at a reputational risk. If this department and business units do not have the same values as the entire organisation, it may increase the risk of reputation because they do not have the same organisational behaviour as the other departments.

Association

Association risk or external risk refers to the relation between two or more companies. This may be a contamination risk and their actions may affect the reputation. The principles of the employees, employers and companies with whom we work may not be adjusted to our values and that may affect the reputation of our company. Sometimes the values may be so different that it creates a collision between them. This discrepancy must be labeled as a reputation risk.

Legal

Legal risk is the risk imposed by an external regulator. If a company has to pay penalties because a client complained about the quality of our product, this may affect the reputation of the company. The other clients will think that the company is a defrauder. Consequently, the clients or the potential company will not want to have any transaction with such an organization. Correspondingly, there will be a reputationl risk with severe impact on the profitability of the company in discussion.

Executive

The executive risk refers to the senior management decision making. If senior management changes the strategy of the company in a negative way, these may lead to loss of reputation. For instance, if senior management decides to dismiss a large number of employees, it will mean that the company has financial problems. Moreover, if this company is a commercial bank the clients will want to withdraw their money from that financial institution.

Operations

Operations risk refer to middle management functional activity. This risk is frequent in production and delivery channels where a mistake is made in the construction process. Furthermore, the consumers will remember that the quality of the products purchased now is not the same with the one’s of the product purchased in the past. Consequently, it will be registered as reputational risk, because clients will not purchase the products from that company in the future because they will assume that the company has a low quality product.

Environment

Environment risk refers to commercial or physical impact. For instance, a company from The United States of America opens an agency in Japan. It will face a reputational risk, if the managers will not take into consideration the culture of clients from Japan. Another environment risk is a hurricane or a fire. If the company is forced to close its business because the company does not have an insurance, it will lead to a major reputation loss.

Operational risk

Operational risk is unique. ''It is defined by numerous international sources, including government agencies, quasi-governmental bodies, professional organizations, and consulting firms" (Dickstein & Flast, 2009). All of them define operational risk as the Basel Committee on Banking Supervision, which defines operational risk as: ''the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events'' (Basel Committee on Banking Supervision, 2006).

The typical forms of operational risk are: internal fraud, external fraud, legal and liability losses, noncompliance with regulations, processing errors, information security breaches, inappropriate business practice, disaster recovery and business continuity, physical security breaches.

Internal fraud

One of the most common internal fraud is the act of rubbery made by the employees. One may make mistakes in putting the clients' funds in the wrong bank account. Other internal frauds are employee extortion, the international misconduct of the assets of the organization, incorrect pricing inventory. The internal frauds may conduct to a bad reputation, if they are made public.

External fraud

One of the most common external fraud is made by people who are not clients of the bank. They commit robbery and let the banks and their clients without funds. This kind of fraud may lead to a loss of reputation because they imply that the banks do not invest in protection system and security.

Legal and liability losses

In Europe the lawsuit against banks has the propensity to be very common. Moreover, litigation is very expensive for the companies, even if the company made it all by the book. By all means there may be lawsuits because the company did not have a compensation system in accordance with emplyee performances, or employees who should be promoted do not receive a better position in the company. All this may generate a reputation loss. Qualified people will not want to work in that company because they do not consider they will be apreciated there, and clients would not want to buy products from the company because they will think that there are unqualified employees and low quality products and servicies.

Physical security breaches

A company should ensure the safety of its client and employees. It should have secure doors and windows to prevent external theft or even the injury or murderer of their clients and employees. Moreover, it should have insurance for natural disasters and for fire, flood. If a company does not have an insurance to protect its goods, employees, and clients, it will suffer a reputation loss if that negative events take place.

Information security breaches

One of the most frequent information security breaches is made by hackers. A simple loss of a tablet, a phone or a laptop that stores a client data. Another information breach is the loss of paper which contains information about the client or about the company. Moreover, this type of information may lead to identity theft. Furthermore, clients may lose all their money from the bank accounts and they could do nothing to recover their money. This kind of action unequivocally conducts to a reputational risk.

Innapropriate business practice

The most important inappropriate business practice is the way employees treat the clients of the company and how they manage the business. It is important that employees do not make false advertising, to behave in an inadequate manner with the clients or to sell inappropriate products. It is significant the way the front-desk employees communicate with the clients and how they make them feel that they could get the services and the products that are best for them. If a client does not feel safe and does not like the employee of the company, they will make a bad reputation to the institution.

The impact of the operational losses on reputational risk in European Banks

In section 3 we observe that operational risk has an impact on reputational risk. Unfortunately, there is little literature on the impact of operational risk on reputational risk in the financial industry.

De Fountnouvelle and Jason study the stock market reaction to operational losses. They have analysed 115 operational loss events materialized in financial institutions in the period 1974-2004. Their results show that the market value decreases twice as much as the rate of operational losses when this loss is due to internal fraud and in the case of the external fraud the reduction of the rate of market value is the same as the increase of the rate of operational losses. They deduce that losses as a result of internal fraud have unfavourable percussion on the reputation of the company.

Cummins, Cristopher and Ran realize a research established on a sample of 492 banking and insurance operational loss events. Their results demonstrate that the stock price feedback to the disclosure of operational losses is substantial. As reported by their results, they consider that the amount loss in stock value due to the decrease of reputation is more sizable than the sum lost from operational events.

Gillet, Hubner and Plunus analyse the stock market reaction to disclosing operational risk events and losses. Their results show that in the USA institutions losses from internal fraud are smaller than the loss in the stock market due to a bad reputation. These results are contradictory with the results obtained from the analysis of European banks. In this case they do not find a correlation between operational risk and reputation risk. Thus operation losses do not affect the stock value of the organization in Europe.

Moreover, from our knowledge there is one paper that offers empirical evidence of the implication of operational risk in reputation risk in European banks.

Sturm's analysis shows that there is no correlation between external fraud and the loss of reputation, the company returns did not suffer from loss of reputation. Moreover his results suggest that the operational events did not injure the reputation of the firm because the stock returns of the company were not damaged.

The empirical evidence shows that financial firms with a high level of liabilities endure a bigger reputation loss due to operational loss events than companies with increased equity.

All these empirical results may be from the poor disclosure of operational and reputational risk, because it seems unrealistic that people do not react when they acknowledge that the banks with whom they work confront rough trading and lost millions of euro or that an employee of the bank lost a document with the client information and all the funds from that client's bank account had vanished and that client has been robbed with the ''help" of the bank.

Conclusion

This paper studies the relationship between operational risk and reputational risk. Almost all types of operational risk may conduct to a loss of reputation of a bank. internal fraud, external fraud, legal and liability losses, processing errors, information security breaches, inappropriate business practice, physical security breaches. Despite the fact that in a logic manner an operational risk would lead to a reputation loss, and a reputation loss would decrease the profit of a bank, the empirical results from the literature show that operational risk events do not affect the reputation of a bank, because the returns seem not to decrease due to a loss of reputation.

Our future research will be focused on the measurement and management of reputational risk and how reputational risk influence the financial results of commercial banks from the European Union.

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