Banks’ Perspective Regarding Reputational Risk in Romania

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Abstract: Banks’ reputation was severely deteriorated by the global financial crisis as public trust in banks diminished considerably. Based on this background, the goal of this paper is to assess the reputation risk perception from the Romanian banks’ standpoint, with focus on the post-crisis period. In order to achieve this purpose, we have resorted to a survey among the major banks operating in Romania and have investigated the regulatory measures implemented to increase trust in banks. The study results reveal that the importance of the reputation risk has increased over the past ten years and customer satisfaction is a relevant factor for bank reputation. The regulatory measures to enhance financial stability and trust in banks include strengthening capital requirements and macro prudential measures to avoid over-indebtedness of households.

Key-Words: Reputational risk, trust, banking sector, regulatory framework, customer satisfaction, Romania
JEL classification: - G20, G21, G28, L14

1 Introduction

Good reputation is a *sine qua non condition* for customers’ trust in banks and reputational risk is one of the most important risks that banks have to manage. Fiordelisi, Soana and Schwizer (2013) have underscored that interest in reputational risk in the financial sector has increased at the turn of the 21st century “after the occurrence of some prominent examples of operating losses due to internal frauds”. By investigating a large sample of European and US listed banks with operational losses between January 2003 and August 2008, the authors underline that: (1) probability of reputational damage increases as bank profits and size increase; (2) in the case of an operational loss, stock market losses are larger for profitable banks than that for non-profitable ones, due to investors’ surprise; (3) investors penalize large banks more than smaller banks, as panic and market reactions for a larger bank are greater than for smaller banks; (4) investors penalize poorly capitalized banks more than well-capitalized ones, by punishing moral hazard behaviour and (5) a higher level of capital invested and intangibles reduce the probability of reputational damage.

Under these circumstances, the main objective of the present paper is to assess how banks perceive reputational risk today and what are the links between reputation and trust in banks, in general, and, in particular, in Romania. Our key hypothesis is that reputational risk is one of the most important risks in the banking sector and that is why the post-crisis regulatory framework includes measures to enhance trust in banks.

In order to achieve this goal, our research is structured around three main sections. In the first section, we perform the literature review, focusing on two important dimensions: (i) definition of reputational risk within the banking community and (ii) trust in banks. In the following section, we focus on an overview of the Romanian banking system, including in analysis the main banks in terms of assets and interpret the results of a survey on reputational risk conducted within the Romanian banking system. The third section is based on the analysis of the post-crisis regulatory measures implemented to enhance financial stability and trust in the Romanian banking system. Finally, the conclusions summarise the main results of our research.

2 Literature review

2.1 Definition of reputational risk in banks

There is not a unique, generally recognized and accepted definition of reputational risk within the banking community. Reputational risk is defined by the Bank of International Settlements “as the risk arising from negative perception on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts, other relevant parties or regulators that can adversely affect banks’ ability to maintain existing, or establish new, business relationships and continued access to sources of funding (e.g. through the interbank or securitisation markets)” (BIS, 2020, p. 12). It may also affect other categories of risks, such as: credit, liquidity, market, operational and legal risks. Reputation impacts profitability (Zaby and Pohl, 2019) and may generate reputational losses (synonym for reputational damage), which can be extremely costly (Sturm, 2013).

Relevant international banks include on their websites their own standpoints regarding the reputational risk. For instance, the HSBC (2020) considers reputational risk as “the risk of failure to meet stakeholder expectations as a result of any event, behaviour, action or inaction, either by HSBC itself, our employees or those with whom we are associated, that may cause stakeholders to form a negative view of the Group”. The Deutsche Bank (2019) defines the reputational risk “as the risk of possible damage to Deutsche Bank’s brand and reputation, and the associated risk to earnings, capital or liquidity arising from any association, action or inaction which could be perceived by stakeholders to be inappropriate, unethical or inconsistent with the Bank’s values and beliefs”. In the view of the Transilvania Bank, first bank in Romania, the reputational risk “represents possible losses of the Group or the failure to realize the estimated profits due to the lack of public confidence in the Group” (Banca Transilvania, 2018, p. 53). According to Commerzbank (2020), „reputational risk is the risk of its stakeholders losing confidence in Commerzbank or its image being harmed as a result of negative events in the course of its business. Stakeholders comprise members of the general public, the media, employees and customers, rating agencies, shareholders, and business partners”. The Reputational risk management department of Commerzbank is in charge with the assessment of “potential environmental, social or ethical risks arising from products, transactions and business relations” (Senft, 2019).

2.2 Reputational risk and trust in banks

Many of the reputational risk definitions link the reputational risk with the risk of loss of trust in banks. The issues related to trust in banks have gained more attention after the triggering of the global financial crisis, when the financial markets faced lack of trust among counterparties. At the same time, investors lost confidence in financial intermediaries. Against this background, the reputation of banks was severely affected in many countries. However, the issue of banks’ reputation is not new and it manifested long before the global financial crisis. A well-known case that reveals the importance of reputation in banks is the crisis of German Herstatt Bank. Following their risky foreign exchange operations, the bank was closed by German authority on 26 June 1974, at the end of the working day in Frankfurt, but in the morning in New York. Due to different time-zones, several operations remained unfinished. The consequences of that crisis were multiple. On one hand, the crisis raised issues on international banking supervision. On the other hand, the reputation of all German banks was affected (Mourlon-Druol, 2015). As underlined by Spero (1982), that crisis led to a severe decreasing of trust among banks participating in the foreign exchange market.

The cross-country analysis performed by Fungáčová, Hasan and Weill (2016), covering 52 countries over the period 2010-2014, concludes that: trust in banks largely differs across countries; countries with higher income per capita and those affected by a recent financial crisis have lower trust in banks; men trust banks less than women; religious persons have greater trust in banks; trust in banks tend to decrease with education and also age. The differences among countries are also revealed in Järvinen (2014), investigating consumers' trust in 29 European countries. According to the survey results, which was performed in 2012, consumers' trust in banks was low in the European over-indebted countries – Spain, Iceland, Portugal, Ireland, Italy – and some Eastern European countries – Bulgaria, Hungary, Romania, Poland. Banking accounts were the services that consumers trusted most, while investments and pension funds were at the opposite end of the spectrum. Consumers in Malta, Finland and Luxembourg had the highest confidence in all these services. The other countries with high trust level in banks were: Estonia, Germany, Latvia, Norway, Denmark, France and Austria. The lowest trust level in banks was experienced in Spain.

EACD-Caliber (2019) calculates the average Trust & Like Score for 124 financial companies in 13 countries based on 13,281 answers. The result for banks is 61.6, as compared to insurance companies, of 66.5 (both included in the average category, between 60 and 69). Unlike the aforementioned survey, at present, people in Denmark and Sweden record the lowest levels of trust in financial institutions, one explanation being that Danish and Swedish largest banks have been hit hard by significant reputational crises over 2018, relating to money laundering activities in their Eastern European operations. By contrast, banks in China and Brazil are well perceived, due to lack of specific scandals and crises within the financial sector in these countries.

Other studies focus on analyses conducted at a single country level. For instance, Knell and Stix (2010), referring to the Austrian banks, synthesize that: (1) in spite of the global financial crisis, the situation in Austria could not be described as a genuine „trust crisis"; (2) it was recorded a decline in trust but that was „restrained", attributable to policy measures (such as the extension of deposit insurance coverage) which were successful in maintaining trust; (3) financial trust was influenced by the "perceived and expected performance of banks" (reflected by lack of bank collapses or customers' losses), which was satisfactory for Austrian bank customers and (4) trust, seen as an attitude, depends on other attitudes and subjective variables, its change can be rapid and unexpected. Jansen, Mosch and van der Cruijsen (2013) take as example the Dutch banking sector and underscore that: (1) the relative importance of trust drivers varies over time; (2) the most robust reason why people lose trust in banks relates to large bonuses; (3) depending on the survey year, negative media reports, a drop in share prices, and opaque product information are also important factors; (4) government intervention (in particular through nationalizations) is not a major reason for losing trust. The research conducted by Gârdan, Geangu and Roșu (2011) reveals, among others, that, in general, at that time, the Romanian customers did not trust the mobile banking services. Based on evidence for Spain, Carbo-Valverde (2014) suggests that banks can improve the customers' level of trust by changing the services they provide.

3 The survey on reputational risk conducted within the Romanian banking system

According to the *Annual Report* 2018 issued by the National Bank of Romania (NBR), at the end of 2018, the Romanian banking system was made up of 34 credit institutions, of which 27 Romanian legal entities and 7 branches of foreign credit institutions. The first ten credit institutions in Romania, ranked by their market shares were: (1) Banca Transilvania – 16.48%; (2) Banca Comercială Română – 15.05%; (3) BRD – Groupe Société Générale – 11.99%; (4) UniCredit Bank – 9.21%; (5) Raiffeisen Bank – 8.88%; (6) ING Bank N.V., Amsterdam – 8.51%; (7) CEC Bank – 6.50%; (8) Alpha Bank – 3.76%; (9) OTP Bank – 2.45%; (10) Garanti Bank – 2.27% (NBR, 2018a). Among them, there were nine credit institutions, Romanian legal entities, and one branch of a foreign credit institution - ING Bank N.V. The most part of the credit institutions Romanian legal entities were institutions with majority foreign capital. A single institution – CEC Bank – was a state-owned credit institution. Also, Banca Transilvania – the credit institution with the most important market share – was the only one with majority domestic private capital. Due to the cumulative market share of these ten credit institutions, totalizing 85.1% of the local market, our analysis is primarily focused on them.

The survey on reputational risk in the Romanian banking sector was conducted in February and March 2020, using as a working tool the questionnaire developed by Zaby and Pohl (2019) that, in the mentioned study, investigated banks in Germany and Switzerland. That allowed us to make international comparisons and identify similarities and differences between Romanian and banking sectors in other countries. In the first stage, the questionnaire was distributed via email to the ten largest banks in Romania. As the number of responses received was not satisfactory, the questionnaire was sent again in early March 2020. However, one limitation of the survey is the reluctance expressed by some banks. In this context, valid responses were received from 8 respondents, which, although cannot be considered representative for the entire Romanian banking system, are a benchmark and a first step in assessing how banks in Romania manage reputational risk.

Reputational risks are considered by most respondents (5) to be extremely important. However, only one respondent believes that reputational risk is less important than the traditional credit risk or market risk.

The overwhelming majority of survey participants (7) stress the increasing importance of reputational risk assessment over the past ten years, which highlights the impact the global financial crisis has on risk management in the banking sector. These results are in line with the results of the survey conducted by Zaby and Pohl (2019). *Customer satisfaction* and *the quality of internal processes* are considered by most respondents (8 and 7 nominations, respectively) as factors relevant to the banks' reputation they represent. On the following positions rank the *financial performance* of the bank (4 respondents) and the *legislative and regulatory requirements* (3 respondents). Surprisingly, the *social requirements* are considered relevant by only 2 respondents, which is a noticeable difference from the results of the survey conducted on the banking market in Germany and Switzerland, where the social requirements are considered as one of the most important factors influencing the banks' reputation. One explanation for these differences could be that in Romania, unlike the developed countries, the social responsibility has become an area of interest for companies (even multinational) much later, only after 1990. The *crises in other banks* and the *mass media* are nominated by few respondents in the Romanian banking system (1 nomination and 2 nominations, respectively). In comparison, in Germany and Switzerland, these two factors are considered decisive for the reputation of a bank.

Regarding the **means used by banks to identify the reputational risks**, the *surveys performed among the clients* were mentioned by the majority of the respondents (6 nominations). The *evaluations carried out by analysts, fund managers or rating agencies* are recognized as means of identifying the reputational risks by 5 respondents. The same number of respondents attaches importance to the *assessment of the requirements and expectations of all stakeholders*. The *surveys performed among employees* are considered by only 2 respondents, which suggest that the banks management pays less attention to their employees' opinions. All respondents believe that information on reputation is used to undertake risk prevention and mitigation measures. Reputation related information is also used to influence banks' important decisions (6 nominations), and increasing the awareness of the employees (6 nominations also). Several departments have responsibilities on reputational risks, among which: the risk management departments, audit, the public relations and communication, the complaints management departments.

4 Regulatory measures for enhancing trust in the Romanian banking system after the global financial crisis

Romania, as an EU member state, has transposed into national banking law the European directives on prudential regulation, aimed to strengthen the financial stability. Beside these directives, Romania applies the EU regulations in the field. Through their objectives, these documents also contribute to the depositors' and the public finances' protection, with positive impact on restoring and enhancing trust in the banking system.

The EU prudential framework for banks includes: regulation of capital requirements (the Regulation (EU) no. 575/2013 and the Directive 2013/36/EU); the Directive 2014/59/EU on recovery and resolution of credit institutions; the Directive 2014/49/EU on deposit guarantee.

The European rules require banks to hold capital of at least 8% of risk-weighted assets. To have sufficient liquid assets, certain liquidity requirements have been imposed. Also, in accordance with the provisions of the post-crisis regulatory framework, additional capital requirements have been introduced in the form of capital buffers.

In order to avoid over-indebtedness of households, the Romanian authorities adopted some regulations to limit the debt-service-to-income ratio (DSTI), i.e. the ratio between the borrower's total monthly payment obligations and its net income. The NBR Regulation no. 6/2018, which amends the Regulation no. 17/2012, stipulates that the DSTI cannot exceed 40% (NBR, 2018b). In order to discourage lending in foreign currency, a limit of 20% has been set for foreign currency loans granted to unhedged debtors. The results of the Nier, Popa, Shamloo, and Voinea (2019) support the regulations adopted by the NBR. The authors provide empirical evidence that proves the importance of these measures for reducing the probability of borrower defaults.

Macro-prudential measures aimed at strengthening financial stability include the imposition of a maximum maturity for the consumer loans, which may not exceed 5 years. Also, the NBR imposed caps on the loan-to-value ratio (LTV). The stipulated limits differ according to the currency and the destination of the loan. For the mortgage loans denominated in domestic currency, the LTV may not exceed 85%. This limit decreases to: 80%, in the case of mortgage loans denominated in foreign currency granted to hedged debtors; 75%, for mortgage loans denominated in euro, granted to unhedged debtors and 60%, for the other mortgage loans in foreign currency granted to unhedged debtors. The highest limit of the LTV - 95% - applies to the loans granted within the Prima Casă ("First Home") government social program, dedicated to the first home buyers. This level applies both for the loans granted in domestic currency and for the loans denominated in foreign currency. The cap for the consumer loans was set at 75%. In order to avoid regulatory arbitrage, both the measures on loan maturity, as well as the provisions regarding the LTV have to be respected by banks and non-bank financial institutions (ESRB, 2019).

Under the current situation caused by the outbreak of the corona virus pandemic, the banks in Romania should bring their own contribution to solving the problems generated by the temporary lack of liquidity of companies and individuals affected by the pandemic. In addition, banks should safely continue their activity and provide financing for the economic recovery.

Similar to the practice in other countries, measures have been adopted to suspend the payment of loans also in Romania. The OUG 37/2020 allows borrowers affected by the Covid-19 crisis to request banks to suspend the payment of credit instalments for a period of 1 to 9 months (but not later than the end of 2020). According to a press release of the Romanian Association of Banks issued on May 18, 2020, Romanian banks received 317,000 requests for suspension of payment obligations related to credit agreements, which, so far, have been solved in proportion of 83%. The overwhelming majority of these requests belong to individuals (303,000, approximately 96% of the total number).

The European Central Bank (ECB) encourages banks in the Euro area not to pay dividends during the pandemic period, so that the capital conserved in this way and additional funds they have at their disposal, as result of temporary relief measures, to be used to finance the economy or absorb losses (ECB, 2020). This recommendation could also be applied by the Romanian banks, even if they do not belong to the Eurozone, which would contribute to improving their image among customers and, consequently, increasing their reputation.

5 Conclusions

The banking community considers reputational risk as one of the most important risks that it has to manage. The multiple dimensions of this risk have become even more relevant as the result of the global financial crisis triggered in 2007-2009 and different frauds episodes. Reputation risk is often linked with risk of deterioration of banks image among stakeholders – customers, in special –, and diminishing of trust in banks.

The results of the survey performed among major banks of the Romanian banking system reveal that reputational risk is crucial nowadays and, moreover, its importance is increasing in the past ten years. Customer satisfaction and the quality of internal processes are the most relevant drivers of reputation in the Romanian banking system, while the surveys performed among the clients are considered very useful to identify the reputational risks.

The post-crisis regulatory standards were set to improve financial stability but also to restore the confidence in the banking sector. In line with the European and international trend, the Romanian authorities adopted measures to enhance banking capital, including capital buffers. In order to avoid over indebtedness of households that generated major issues in the post-crisis period, triggering conflicts between banks and customers, were introduced some regulations to limit the debt-service-to-income ratio and to discourage lending in foreign currency to unhedged debtors. Macro-prudential measures include also the imposition of a maximum maturity for the consumer loans, and caps on the loan-to-value ratio.

At present, it is too early to assess the impact of the Covid-19 on the reputation of the Romanian banking sector. However, it is evident that banks' behaviour during this crisis and also in the post-crisis period will strongly influence customers' attitude towards banks. The amount of liquidity available for both companies and individuals and especially the borrowing costs will impact customers' satisfaction and trust in banks and, consequently, banks' reputation.

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