AN ANALYSIS OF REPUTATIONAL RISKS IN ISLAMIC BANKS IN MALAYSIA WITH A PROPOSED CONCEPTUAL FRAMEWORK

Tawfik Azrak
Buerhan Saiti[1]
Engku Rabiah Adawiah Engku Ali

Abstract

The most critical intangible asset that a bank possesses is its reputation. The reputation reflects a bank's relative success in fulfilling the expectations of multiple stakeholders. Establishing a great reputation is a key element of organizational strategy, especially for banks. In case of Islamic banks, this is more important due to the nature of its business which is reputed to be defined by shariah *principles. Any significant issues with regard to the operations of Islamic banks either in terms of* shariah *non-compliant financial products or customer complaints may damage the reputations of Islamic banks, thereby driving away customers, investors, shareholders and counterparties. As such, it is expected that Islamic banks pay more attention to managing reputational risks. This paper provides a review on the annual reports and financial statements of local and Islamic banks in Malaysia in order to assess the transparency of reporting and disclosing their reputational risk management framework. It is found that local domestic Islamic banks in Malaysia are more transparent compared to the locally incorporated foreign Islamic banks. Finally, we propose a framework for Islamic banks to manage reputational risks.*

Keywords: Risk Management, Islamic Banks, Islamic Financial Institutions, Reputational Risk, *Shari'ah* non-Compliant Risks

[1] Corresponding author.

Introduction

In recent times, with the increasing complexity in the financial markets and the on-going financial crises affecting some parts of Europe, the operational risk management, especially for financial institutions, becomes more important due to its significant impact on the future of the financial institutions. Consider, for example, the case of Barclays Bank which hit the headlines in June 2012 after news broke out that executives in its investment banking arm rigged the lending rates between banks. Barclays has since been fined with £290 million by the Financial Services Authority (FSA) in June 2012 after it was found guilty of manipulating the rates banks use to lend to each other in the wholesale market,[2] which was the same month the scandal was revealed in the press. This negative headline over the action of its investment arm have had a negative impact on how consumers view its high street offering as reported by '*YouGov Brandindex*[3] a UK based company. In this case, the *YouGov Brandindex's* metrics score (a scoring metric which measures the average of how customers rate the Barclays brand in terms of impression, quality, value, reputation and satisfaction) slumped to its lowest value of -24.5. This and many other corporate scandals all over the world revealed to us that many operational risks could have a paramount reputational impact to the institutions, often larger than the loss or the inadequate service provided by these institutions to their customers. Therefore, reputational risk management is of paramount importance, especially for those in the financial services industry.

Askari, Iqbal, and Mirakhor argued that a financial institution is different from other economics agent based on their role as financial intermediary and as such comes with serious fiduciary responsibilities, and failure of these responsibilities can lead to a very serious external cost.[4] Reputational risk has always been considered as the subset of operational risk. However, convincing arguments

---

[2] Accessed 20 October 2012, 11.30 p.m., http://www.marketingweek.co.uk/news/barclays-corporate-woes-hit-retail-brand/4002479.article.

[3] Accessed 20 October 2012, 11.35 p.m., http://www.brandindex.com

[4] H. Askari, Z. Iqbal, & A. Mirakhor, *New Issues in Islamic Finance and Economics: Progress and Challenges* (Vol. 753). (John Wiley & Sons, 2011), 36.

have been put forth in order to distinguish reputational risk from operational risk and also to highlight the very significance of reputational risk. Basel II Accord has defined that operational risks are associated with people (internal fraud, clients, product and business practices, employments practices, and workplace safety), internal processes, systems and external events (external fraud, damage or loss of assets). It has also been argued that reputational risk is subtler than operational risk because it deals with intangible assets such as brand equity, intellectual capital, goodwill, trust and relationship, all of them have high replacement cost.[5] It is increasingly important for large, high-profiled and established companies to pay very close attention to the exposures and vulnerabilities of intangible assets such as reputation. It has also been observed that companies with strong positive reputations attract more customers, are perceived as providing more value and have more loyal customers.

The objective of this paper, therefore, is to review the definition and practice of reputational risk management from both conventional and Islamic financial systems. Literature review on the importance of reputational risk management, especially in the conventional financial institutions will be investigated, followed by recent developments of similar academic research for the Islamic financial institutions. Documents and library-based research and analysis are then carried out to investigate past cases involving Islamic financial institutions that have negative reputational impact to the Islamic financial industry; and also to look at the current practices by Islamic banks in Malaysia to mitigate and address any potential reputational risk issues in their respective institutions. Information is analyzed using publicly available information from most of the Islamic banks in Malaysia. The latest available annual report of each Islamic bank will be investigated and any potential gap or issues in the management of reputational risk by those institutions will be highlighted. Finally, a proposed qualitative framework for managing reputational risks in Islamic banks will be presented.

The remaining of this paper is organized as follows. The next section will discuss various literature regarding reputational risk management; Section 3 will cover the importance of managing

[5] Ibid.

reputational risk for Islamic financial institutions. Section 4 will discuss the current state of reputational risk management by Islamic banks in Malaysia and Section 5 will highlight the potential reputational risk management framework that could be adopted by Islamic banks. The conclusion is in the final section.

2. Literature Review

Literature on the importance of reputational risk management, especially in the conventional financial institutions will be investigated, followed by recent development of similar academic research for the Islamic financial institutions.

2.1 Reputational Risk in Conventional Financial System

A simple definition of reputational risk is the failure to meet stakeholders' reasonable expectation of an organization's performance and behavior. [6] Basel Committee of Banking Supervision (BCBS), on the other hand, defined reputational risk as "the risk arising from negative perception on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts,? ability to maintain existing, or establish new, business relationships and continued access to sources of funding". [7] Furthermore, the Committee states that "reputational risk is multidimensional and reflects the perception of other market participants". Therefore, in the case of the financial service industry, reputation is considered a zero tolerance risk because trust and confidence are the heart of a firm.[8]

In the last few years, mainly as a result of the erosion of public confidence in business organizations and the securities markets, corporate reputation and reputation risk have emerged as significant issues in corporate studies and banks. A research conducted by the Conference Board Business Information Service on business magazine articles and academic journals illustrates that the number of

[6] Derek Atkins, Lynn Drennan, and Ian Bates, *Reputational Risk: A Question of Trust*. (Global Professional Publishing, 2006), 146.
[7] Basel Committee, (2009a), 19.
[8] Godwin and Freese, (2005), 14.

publications containing (in their title or abstract) the phrases "corporate reputation" and "reputation risk" has more than doubled since the year 2000. The depth of the studies in this field is also maturing.[9] An alternative definition of reputational risk and a survey of the scarce empirical literature on reputational risk in banking are provided by Walter.[10] Since the history of operational risk is still young when compared to the ones of credit and market risk, data availability on operational risk is limited. Consequently, empirical research on operational risk is still being hindered by the lack of data available. The number of studies related to the financial industry is still very limited. However, in a more general (i.e., not banking specific) context, there are several studies dealing with aspects closely related to operational risk and reputation such as fraud.[11]

All these studies had estimated reputational losses using the event study method, by focusing on an event window of 1 day (i.e. 0:1). The results of those studies consistently find the existence of statistically significant reputational losses, especially in the case of operational losses due to internal frauds.[12] also take into account various factors in their study (e.g., firm size, price-to-book ratio, level of liabilities, return on asset (ROA), the number of employees, and the type of loss) that have an influence on reputational damages. Research on the relevance of corporate reputation or reputation risk in the current business environment is detailed in Table 1:

Table 1: The Sources of Reputational Risks

1	In a modern, service-oriented business environment, intangibles, such as corporate reputation, can constitute the bulk of an organization's assets;
2	Public perception of a business positively affects corporate profitability, market-to- book value, and total sales;
3	About 35% of investment decisions are based on factors such as reputation and image of a company;

[9] M. Tonello, "Reputation Risk: A Corporate Governance Perspective, 2007.
[10] I. Walter, "Reputational Risk and Conflicts of Interest in Banking and Finance: the Evidence so Far), *Variations in Economic Analysis*, Springer New York, (2010), 80.
[11] Sturm, (2010), 195.
[12] Perry and De Fontnouvelle, (2005); Gillet et al., (2010); Fiordelisi et al., (2011); Gillet et al. (2010)