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Relationship between Reputational Risk and Financial Performance of Commercial Banks in Kenya

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ABSTRACT:- Financial institutions play a key role in spurring the growth of the economy. The purpose of this study was to determine the relationship between reputational risk and the financial performance of commercial banks in Kenya. The study was anchored on agency theory, stakeholder theory and prospect theory. The population of the study was forty - two (42) commercial banks in Kenya. 32 purposively sampled commercial banks which had audited financial accounts for the years 2016 to 2021 were included in the study. ROA and ROE were used to measure performance while CSR activities and total loans were used to indicate reputational risk. Mixed effects regression model showed that for ROE, the presence of CSR yields an estimate of 0.85 (p=0.754), suggesting a slight insignificant positive effect and for ROA, an estimate of 0.65 (p=0.306), implying a modest insignificant positive effect. Total loans, for ROE, the estimate is -0.15, suggesting a negative relationship, though not statistically significant (p-value of 0.671). For ROA, estimate 0.09, indicating a positive relationship between total loans and ROA. However, this positive effect is also not statistically significant, as the p-value stands at 0.300. This research concluded that there is a link between reputational risk and financial performance of Kenyan commercial banks and recommended that banks engage in CSR activities to boost their reputation among stakeholders and attract business thus better performance.

Key words: Commercial Banks, Corporate Social Responsibility, Financial Performance, Reputational Risk.

I. INTRODUCTION

Financial Performance (FP) of commercial banks as a domain of management has been the center of interest to management executives and researchers over time because of its importance in the life of an organization and this cannot be overemphasized. Many scholars have tried to figure out the factors that contribute to its realization (Abata, 2014). As per Almajali, Alamro and Al-Soub (2012) financial performance is ability of a firm to Meet a span of set financial goals for instance profitability. It shows the degree to which a firm's financial benchmarks has been realized and the accomplishment of financial objectives (Nzuve, 2016). Wang & Sarkis (2017) defines financial performance as the ability of a firm to realize external and internal objectives in other words it is the level to which a firm's financial goals are attained. It can be measured using several operational indicators. Le, Shan, and Taylor (2020) says that it can be calculated using liquidity, return on equity (ROE), firm size and return on assets (ROA) just to mention a few. The success of the banks over the years is measured by ROE and ROA (Paul and Musiega, 2020). ROA reveals further how well the resources of a firm can be used in creation of wealth (Nzuve, 2016). If the company is using its resources efficiently then ROA will be higher which translates to more wealth for stakeholders.

According to Fiordelisi, Soana, Schwizer (2011), the reputational risk increases with the scale and profitability of banks, making the subject even more relevant in a global system characterized by a highly concentrated banking market. Eckert and Gatzert (2017) propose to incorporate reputation risk into an operational risk assessment, representing first steps to obtain a more comprehensive understanding of the impact of operational risks. According to Zhou, Sun, Luo, & Liao, (2021), corporate social responsibility is a costly affair which initially increase bank financial burden and thereby, result in a negative impact on bank financial performance but in the long run brings a positive result. Muchiri, Erdei-Gally, & Fekete-Farkas, (2022) found a strong positive relationship between CSR practices and the financial performance of financial institutions and recommended that financial

institutions should consider investing in social responsibility activities to bolster their financial performance. Institutions face increased business risks from data leakage, asset theft and reputational damage, because of the proliferation of mobile computing, social networking, and cloud-based technology (Carcary, 2013). It is against this backdrop, active reputation management can significantly contribute to safeguarding and increasing the market value of a bank, by means of identifying the reputation risks, prevention and limitation of reputation losses, and preparing measures for generating a reputation gain at the same time. The Kenyan Central Bank has outlined a reputational risk management framework to guide all financial institutions. This means that firms have to constantly protect their reputation in order to maintain their competitiveness.

II. OBJECTIVE

The study sought to determine the relationship between reputational risk and financial performance of commercial banks in Kenya.

III. HYPOTHESIS OF THE STUDY

Ho_1: There is no statistically significant relationship between reputational risk and financial performance of commercial banks in Kenya.

IV. LITERATURE ON REPUTATION RISK AND FINANCIAL PERFORMANCE

Ivell, Seibert and Marks (2016) define reputation risk as risk that arises from adverse perception of an institution by its stakeholders, including customers, investors, and regulators. The management of reputational risk starts with understanding that reputation is all about perception. Reputational risk is currently considered as the biggest threat to modern businesses. Reputation is slippery, easily compromised, volatile, amorphous and impossible to control (Honey, 2017).

Vuong, Dumicic and Kloputan (2017) investigated the relationship between corporate reputation and financial performance in Croatia. This study revealed that some dimensions of corporate reputation could be important predictors of financial performance. A reputational risk of large international banks arises 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 (Walter, 2016). The study results are a defendable reason for managers to choose or prioritize reputation risk as a key concern in the corporate business strategy and thus attach a budget to address.

Zhou, Sun, Luo, & Liao, (2021) researched to investigate the influence that corporate social responsibility has on the financial performance of commercial banks and the outcome of their study showed that CSR would injure bank financial performance in the short term but CSR has a positive relationship with financial performance of commercial banks in the long run.

According to Fiordelisi, Soana, Schwizer (2011), the reputational risk increases with the scale and profitability of banks, making the subject even more relevant in a global system characterized by highly concentrated banking markets. Fiordelisi *et al* (2011) estimated the reputational risk for a large sample of banks in Europe and the US between 2003 and 2008 and yielded two main results. First, that there is the probability that reputational damage increases as profits and size increase and second, that a higher level of capital invested and intangible assets reduce the probability of reputational damage. Muchiri, Erdei-Gally, & Fekete-Farkas, (2022) in a quest to bring out an understanding of the effect of corporate social responsibility on the financial performance of financial institutions in Kenya, focused on examining the effect of ethical, gender-mainstreaming and charitable CSR activities on the financial performance of financial institutions in the County of Kirinyaga in Kenya used stratified and systematic sampling techniques to select a sample of one hundred and seventy one (171) participants from a population of three hundred (300) employees. The study adopted a causal research design and used primary data collected using questionnaires that were administered in person and found a strong positive relationship between CSR practices and the financial performance of financial institutions.

V. 4.1 CONCEPTUAL FRAMEWORK

This is a presentation of the relationship between variables in a research based on the researchers thought, idea and viewpoint by using graphs.The current study is using financial performance as the dependent variable and this were measured by return on assets (ROA) and return on equity ROE. The study also had environmental risk as the independent variable and comprised of three indicators namely comprising of financial risk, technological (transition) risk and reputation risk. The financial risks comprised those highlighted by the Basel III including

liquidity risk, credit risk, interest rate risk and market risk. The study also had a moderating variable as the firm size which was measured using total assets, total loans and total deposits
A dependent variable was measured in the study and what it affects during the study. The dependent variable in this study is financial performance of commercial banks in Kenya.

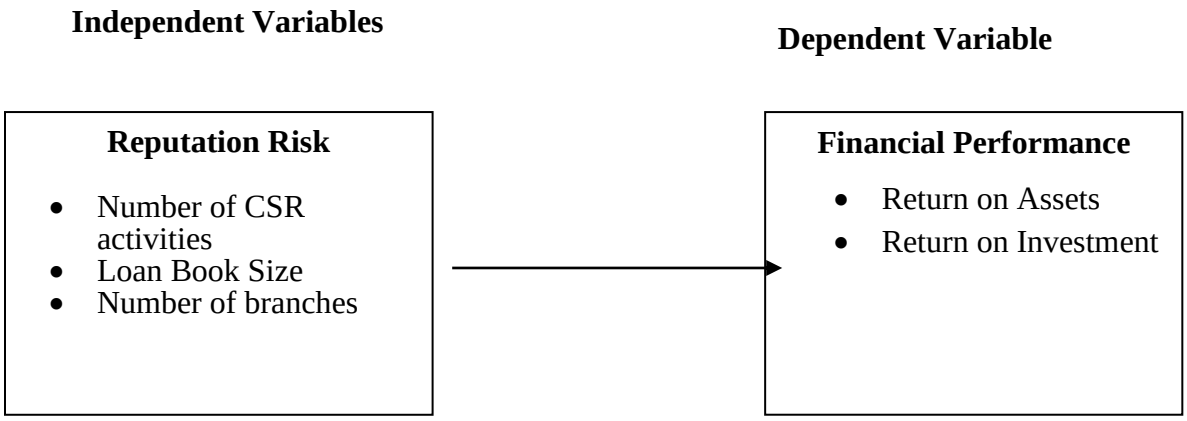

Figure 2.1 Conceptual Framework

Source: Researcher 2024

VI. METHODOLOGY

This study adopted a longitudinal and cross-sectional research design and utilized panel data in an attempt to study the trend of reputational risks on financial performance of commercial banks in Kenya for a period of 6 years covering the periods 2016-2021 (inclusive).

The target population of the study was 42 commercial banks however, a total of 8 banks were excluded for several reasons including liquidation, merging with other banks and their data not being available in the CBK database. The data set was therefore 6 (number of years under consideration) per bank which made 204 data sets. For this study 34 commercial banks were included as they met the condition that they had audited accounts for the years 2015 to 2021(inclusive). The study used purposive sampling where only banks that meet the threshold requirements to be included in the study were picked.
This study utilized secondary data which were collected from the databases of Central Bank of Kenya and individual banks under study.

To achieve the set objective being direct relationship, linear mixed effects regression model was used to test hypothesis H_{O1}. The test statistics was computed and derived for comparison and to confer judgment on the hypothesis included the regression coefficient (Beta coefficient) and the p-values were generated. The Inter Class Correlation (ICC) was also used to assess if a mixed effects model is necessary.
To determine the influence of the independent variables on the dependent variable, linear mixed effects regression models was used to test H_{01} as follows:
H_{01}
$Y_{jt} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3jt} + \mu_i + e_{it}$
Where:
Y_t: Financial performance at time t
X_1: CSR activities at time t
X_2: Number of branches at time t
X_3: Loan book size at time t
e_t :is the residual error term for the *j*-th bank at time t

VII. RESULTS AND DISCUSSION

6.1 Descriptive statistics

To assess the relationship between reputational risk and financial performance, we used the availability of CSR activities, total loans and total number of branches. Table 4.3 provides a detailed distribution of reputation risk factors across the years 2016 to 2021.

VIII. Table 6.1: Distribution of reputation risk factors from 2016 to 2021

Year							
Reputational risk factors	2016 (N=34)	2017 (N=34)	2018 (N=34)	2019 (N=34)	2020 (N=34)	2021 (N=34)	Overall (N=204)
Availability of CSR activities							
No	9 (26.5%)	9 (26.5%)	8 (23.5%)	7 (20.6%)	5 (14.7%)	3 (8.8%)	41 (20.1%)
Yes	25 (73.5%)	25 (73.5%)	26 (76.5%)	27 (79.4%)	29 (85.3%)	31 (91.2%)	163 (79.9%)
Total loans (millions)							
Mean (SD)	62200 (87600)	58000 (85600)	60200 (102000)	57800 (113000)	139000 (318000)	120000 (318000)	82800 (200000)
Median [Min, Max]	16000 [0, 373000]	19500 [3240, 412000]	13100 [0, 456000]	11300 [0, 540000]	21000 [4.37, 1660000]	21600 [0, 1800000]	17200 [0, 1800000]
total number of branches							
Mean (SD)	39.9 (48.8)	39.0 (49.3)	39.2 (49.5)	38.9 (50.8)	40.8 (52.9)	40.8 (52.9)	39.7 (50.1)
Median [Min, Max]	19.0 [3.00, 198]	19.5 [3.00, 199]	18.0 [2.00, 196]	18.0 [0, 203]	18.0 [2.00, 203]	18.0 [2.00, 203]	18.0 [0, 203]

Over the six-year period, the data shows a gradual shift towards entities engaging in CSR activities. In 2016, 73.5% of the entities (25/34) reported having CSR activities, while 26.5% (9/34) did not. This trend continued to strengthen each year, reaching 91.2% in 2021 for entities with CSR activities, and only 8.8% without. The overall distribution for the entire period indicates that 79.9% (163/ 204) of the entities engaged in CSR activities, showing a growing focus on corporate social responsibility as an integral part of reputation risk management.

Table 6.1 also reveals fluctuations in the mean and median values of total loans, indicating changing financial conditions within the banks. In 2016, the mean total loans stood at Ksh 62.2 million (with a standard deviation of Ksh 87.6 million), while the median was Ksh 16,000, with loan values ranging from Ksh 0 to Ksh 373 million. As the years progressed, there were variations in these statistics, culminating in 2020 with a substantial surge in both mean and median values. In 2020, the mean total loans skyrocketed to Ksh 139 million (with a significant standard deviation of Ksh 318 million), while the median value was Ksh 21,000, ranging from Ksh 4.37 million to a staggering Ksh 1,660 million. However, 2021 saw a slight decrease in the mean to Ksh 120 million, with a median value of Ksh 21,600. This wide range in loan values reflects the financial diversity and dynamism among the banks in the study.

The final reputational risk aspect explored is the total number of branches maintained by the banks. This provides insights into the geographical reach and scale of operations, which can impact reputation risk. The mean and median values fluctuated slightly over the years. In 2016, the mean was approximately 39.9 branches (with a standard deviation of 48.8), and the median was 19 branches, ranging from 3 to 198 branches. These numbers remained relatively stable, with subtle variations each year, ultimately resulting in a mean of approximately 40.8 branches in 2020 and 2021 (with a standard deviation of 52.9), and a consistent median of 18 branches (ranging from 0 to 203 branches). This data suggests that the banks in the study maintained a similar scale of operations, with only marginal changes in the number of branches, indicating a degree of stability in their geographical presence over the years.

Inferential Statistics

VIII. Table 6.2: Mixed effects regression model fitted to determine the relationship between reputational risk and financial performance

	Return on equity			Return on assets		
Predictors	*Estimates*	*CI*	*p*	*Estimates*	*CI*	*P*
(Intercept)	7.13	-1.38 – 15.64	0.100	-0.26	-2.20 – 1.69	0.794
CSR						
No	ref					
Yes	0.85	-4.49 – 6.19	0.754	0.65	-0.60 – 1.90	0.306
Total loans	-0.15	-0.84 – 0.54	0.671	0.09	-0.08 – 0.25	0.300
Total number of branches	0.11	0.04 – 0.18	0.003	0.01	-0.00 – 0.02	0.185

ROE model Interclass correlation (ICC)-0.52
ROA model ICC- 0.32

Table 6.2 presents the results of a mixed effects regression model aimed at determining the relationship between reputational risk and financial performance, with a specific focus on Return on Equity (ROE) and Return on Assets (ROA).

This table gives insights into how various factors contribute to or mitigate reputational risk and subsequently impact financial performance. The intercept represents the baseline estimate for ROE and ROA in the absence of any other predictors. For ROE, the intercept is 7.13 with a 95% confidence interval spanning from -1.38 to 15.64. This suggests that, without considering other factors, the baseline ROE falls within this range. Similarly, for ROA, the intercept is -0.26 with a confidence interval of -2.20 to 1.69, indicating that the baseline ROA hovers around this interval. The p-values for both intercepts are relatively high (0.100 for ROE and 0.794 for ROA), implying that these baseline values are not statistically significant, and other predictors may have a more substantial influence.

The regression analysis also includes the presence of CSR activities as a predictor of reputational risk and financial performance. Entities engaged in CSR activities are represented as "Yes," while those without CSR activities are the reference category labeled "No." For ROE, the presence of CSR activities (Yes) yields an estimate of 0.85, suggesting a slight positive effect on ROE. However, this effect is not statistically significant, as indicated by the relatively high p-value of 0.754. Similarly, for ROA, the presence of CSR activities (Yes) corresponds to an estimate of 0.65, also implying a modest positive effect. However, like ROE, this effect is not statistically significant, with a p-value of 0.306. This indicates that, within the scope of this model, CSR activities do not exhibit a statistically significant direct impact on ROE or ROA.

Total loans, representing the financial magnitude of loans held, was also included as a predictor for both ROE and ROA. For ROE, the estimate is -0.15, suggesting a negative relationship, though not statistically significant (p-value of 0.671). This implies that an increase in total loans may be associated with a slight decrease in ROE, but the effect is not strong enough to be considered statistically significant. Likewise, for ROA, the estimate is 0.09, indicating a positive relationship between total loans and ROA. However, this positive effect is also not statistically significant, as the p-value stands at 0.300. These findings imply that, within this model, total loans do not exhibit a significant direct impact on either ROE or ROA.

The total number of branches maintained by entities is another predictor considered in the model. This variable had a more substantial and statistically significant impact on both ROE and ROA. For ROE, the estimate is 0.11, indicating that an increase in the total number of branches is associated with a positive effect on ROE. This effect is statistically significant, with a p-value of 0.003, suggesting that a larger branch network contributes to

higher ROE. Similarly, for ROA, the estimate is 0.01, implying a positive relationship between the total number of branches and ROA. While the effect is positive, it is not statistically significant, as the p-value is 0.185. This indicates that, within the model's scope, the total number of branches has a statistically significant impact on ROE but not on ROA.

IX. DISCUSSION

The findings indicating that there is a statistically significant link between reputational risk and financial performance of commercial banks in Kenya supports those of Ivell, Seibert and Marks (2016), Vuong, Dumicic and Kloputan (2017), Fiordelisi, Soana, Schwizer (2011), Zhou, Sun, Luo, & Liao, (2021) in the long run, Fiordelisi *et al* (2011) in their first finding that there is the probability that reputational damage increases as profits and size increase, Muchiri, Erdei-Gally, & Fekete-Farkas, (2022) The findings contradicts those of Zhou, Sun, Luo, & Liao, (2021) in the short run, Fiordelisi *et al* (2011) in their second finding that a higher level of capital invested and intangible assets reduce the probability of reputational damage

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

In summary, this study scrutinized the relationship between banking reputational risks and corporate social responsibilities. Reputational risk was determined using the availability of CSR activities, total loans and total number of branches. The evaluation demonstrated a non-significant relationship between CSR activities and financial performance in the banking field. It highlighted the increasing importance of effective management in reputational risks in the banking industry over the years in alignment with Coulson and Dixon (1995) who found that any association of a bank to a borrower that is unfriendly to the environment can damage its reputation irrespective of compliance with all the legal requirements. Nevertheless, the study demonstrated that the corporate social responsibility behaviours and the costs involved did not significantly affect the returns on assets and equity. The results show that credit and financial risks emerged as critical factors in influencing financial performance in the financial industry, significantly impacting ROA and ROE. The findings showed that banking institutions need to prioritize risk mitigation strategies by monitoring financial performance and risk management to achieve the required stability of the institution. There were fluctuations in the mean and median values of total loans, indicating changing financial conditions within the banks. For number of branches, the data suggested that the banks in the study maintained a similar scale of operations, with only marginal changes in the number of branches, indicating a degree of stability in their geographical presence over the years.

In conclusion, the study found evidence against the null hypothesis that there is no statistically significant relationship between reputational risk and financial performance of Kenyan commercial banks and concluded a statistically significant relationship exists between reputational risk and financial performance of Kenyan commercial banks. Reputational risk was measured by availability of CSR activities, total loans and total number of branches. In conclusion, since the total number of branches emerges as a predictor with a statistically significant positive impact on ROE but not on ROA. These findings highlight the complexity of reputational risk management in the financial sector, emphasizing the multifaceted nature of factors influencing financial performance and reputation risk. This finding provides evidence against the null hypothesis, meaning the study proceed to reject the null hypothesis and therefore conclude that there is a statistically significant relationship between reputational risk and financial performance of commercial banks in Kenya. The study further confirmed that there has been increasing emphasis on CSR activities, indicating that they have become increasingly important in managing reputational risk over the years. Total loans exhibited considerable variation, reflecting financial diversification among banks, while branch numbers remained relatively stable, highlighting the consistency of geographical reach and operational level. Both CSR activities and costs had no significant impact on financial performance (ROE and ROA). However, the total number of branches had a statistically significant positive effect on ROE but not on ROA.

From the study, it is recommended that the banking industry's alignment with the environmental and social values of the community provides the industry with a positive reputation, hence expanding its customer base. Further, aligning the banking industry with social and environmental values is essential in fostering trust and goodwill from the public, which is a critical reputational defense for banks.

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