

BEST PRACTICE GUIDELINE

From the Banking Regulation and Supervision Agency:

GUIDELINE FOR REPUTATIONAL RISK MANAGEMENT

Introduction

Reputation is an intangible asset for a bank like goodwill, but it is difficult to measure and quantify. Banks need time and effort to build reputation however, reputational risk can easily cause a prompt and severe loss.

Strong and consistent earnings items, a trustworthy board of directors and senior management, loyal and qualified staff and a strong customer base are the factors that may affect the bank's reputation positively. The good reputation of bank enables relative competitive advantage against the opponents and increases the market and share value of bank. The problems related to reputation may cause the bank's loss of credibility among its counterparties and as a result the withdrawal of funds in addition to the decrease in funds provided to bank.

In the global financial crisis that started in 2007, many banks provided financial support that exceeded their contractual obligations. In order to preserve their reputation, some banks felt compelled to provide liquidity support to their SIVs, which was beyond their contractual obligations. In some cases, banks purchased ABCP issued by vehicles they sponsored in order to maintain market liquidity. As a result, banks assumed additional liquidity and credit risks, and therefore capital ratios of them decreased.

Prior to financial crisis, many banks failed to recognize the reputational risk associated with their off-balance sheet vehicles. In stressed conditions, some banks preferred to support their sponsored securitizations and off-balance sheet vehicles by going beyond their contractual obligations. Thus, the need for sound analyzing all the possible negative situations that may cause reputational risk arose. For example, whether the requirements under the securitization framework have been met and the potential adverse impact of providing implicit support.

FIRST PART

Objective and Scope

1. The objective of this guideline is to present best practice examples about reputational risk management which has great importance for carrying out the bank's activities soundly and which is also a part of the internal capital adequacy assessment process, pursuant to the article 35 entitled "the objective of risk management and the establishment of risk management system" of Regulation on Internal Systems and Internal Capital Adequacy Assessment Process of Banks published in the Official Gazette dated July 11,2014 Nr:29057.

2. This guideline is prepared based on the Article 93 of Banking Law Nr:5411 dated October 19,2005 and the Article 7/A entitled "Best Practices Guidelines" of Regulation on Procedures and Principles For Supervision by the Banking Regulation and Supervision Agency published in the Official Gazette dated July 22,2006 Nr:26236.

3. Reputational risk can be defined as the probability of loss-making because of bank's falling into disrepute or discrediting in consequence of disregarding current legal arrangements or because of the negative opinions of current and potential customers, partners, rivals and audit authority about the bank. Bank's ability to maintain existing, or establish new, business relationships and continued access to sources of funding can be adversely affected because of the negative perception that may arise on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts, other relevant parties or regulators.

4. Reputational risk expresses the possibility of loss in the capital and earnings of bank because of the negative opinions of society (customers, partners, rivals, press, publishing, social media, regulatory authorities etc.) about the bank. This risk may affect the bank's ability to maintain existing, or establish new, business relationships and services and as a result it may weaken the competitive strength of the bank and this risk in essence exists in all activities of bank. Therefore, bank needs to be careful in its relationships with the customers, public authorities, investors, other banks and related third parties. The matters such as unethical and misleading operations of bank in customer relations, bank's acting contrary to law and regulations, frequently being a party to the lawsuits or its poor financial performance are some of the factors that severely threaten the reputation of bank.

5. Reputational risk is multidimensional and reflects the perceptions of other market participants. Moreover, reputational risk exists in every part of the organizations. Reputational risk exposure is basically a composition of the adequacy of bank's internal risk management processes and the mode and competence of administration towards the external effects in the bank's operations.

6. An effective and adequate reputational risk management is expected to be carried out consistent with the consolidated and unconsolidated structure considering the size and complexity of bank's activities in line with the following principles. Each bank needs to manage its activities that can cause reputational risk pursuant to the principle of proportionality.

SECOND PART

Reputational Risk Sources

7. Banks need to understand the reputational risk sources and the appropriate system and controls in order to manage these risks because the reputation which has a great importance for banks may cause risk for several reasons.

8. Reputational risk mostly arises because of the deficiencies in the management of risks which cannot be quantified. There are many sources of reputational risks which may be connected to each other.

9. Banks may be obliged to provide implicit support in order to avoid reputational risks. This may give rise to credit, liquidity, market and legal risk – all of which can have a negative impact on a bank's earnings, liquidity and capital position. Banks should identify potential sources of reputational risk exposures. These sources can be ranged as the following though they are not limited to them:

- Financial Soundness / Business Viability
- Customer Satisfaction
- Legal / Regulatory Compliance
- Contagion Risk/Rumor
- Corporate Governance
- Management Integrity
- Staff Competence
- Ownership structure of the bank
- Corporate Culture
- Risk Management and Control Environment
- Crisis Management
- Transparency/Accountability

THIRD PART

Implicit Support and Securitization

10. In contrast to contractual credit exposures, such as guarantees, implicit support is a more subtle form of exposure. Implicit support arises when a bank provides post-sale support to a securitization transaction in excess of any contractual obligation. Such non-contractual support exposes a bank to the risk of loss, such as loss arising from deterioration in the credit quality of the securitization's underlying assets.

11. By providing implicit support, a bank signals to the market that all of the risks inherent in the securitized assets are still held by the organization and, in effect, had not been transferred. In the event that the risk arising from the potential provision of implicit support is not captured *ex ante* under Pillar 1, it must be considered as part of the Pillar 2 process. In addition, the processes for approving new products or strategic initiatives should consider the potential provision of implicit support and should be incorporated in a bank's ICAAP.

12. Reputational risk may arise, for example, from a bank's sponsorship of securitization structures such as ABCP conduits and SIVs, as well as from the sale of credit exposures to securitization trusts. It may also arise from a bank's involvement in asset or funds management, particularly when financial instruments are issued by owned or sponsored entities and are distributed to the customers of the sponsoring bank. In the event that the instruments were not

correctly priced or the main risk drivers not adequately disclosed, a sponsor may feel some responsibility to its customers, or be economically compelled, to cover any losses. Reputational risk also arises when a bank sponsors activities such as money market mutual funds, in-house hedge funds and real estate investment trusts (REITs). In these cases, a bank may decide to support the value of shares/units held by investors even though is not contractually required to provide the support.

FOURTH PART

Reputational Risk Management

13. The reputational risk management process of bank includes identifying, assessing and controlling the risk, risk monitoring and reporting, communication and disclosure. Reputational risk management process should be built on solid basis with the bank's policy, procedures and guides.

14. The board of directors and senior management of bank are responsible for developing risk management practices necessary for reputational risk management, carrying out these practices and establishing and approving policies, procedures and guides about this.

15. Banks should charge adequate qualified personnel in risk management or control units for establishing, implementing, coordination and monitoring reputational risk management process. The management of this process concerning reputational risk should not be carried out by only one control unit of bank, it should be shared by units of each activity level.

16. Reputational risk management process may be integrated into other risk management processes consistent with the bank's management structure and the nature and complexity of its activities, and it may be independent or centralized but it may enable senior management to take prompt action and to report if necessary.

17. A bank's stress testing processes should take account of reputational risk so senior management has a firm understanding of the consequences and second round effects of reputational risk. In order to get a firm understanding of policies and procedures concerning reputational risk by all the bank staff, bank should inform them adequately and should provide training if necessary.

18. Corporate governance is the basis of effective reputational risk management and it should enable a framework that will lead the actions taken for reaching the vision, objectives, values and strategies of the bank and that will meet the expectations and needs of the stakeholders. In a sound corporate governance, all the staff should have a role and effort in raising the reputation of bank. In this context, the adaptation levels of banks to the provisions of "Regulation on Banks' Corporate Governance Principles" published in Official Gazette dated November 1, 2006 Nr:26333 are important for reputational risk management.

i. Policy and Procedures

19. Bank management should have effective and written policies and procedures in place to identify sources of reputational risk and to establish a structure concerning reputational risk management when entering new markets, products or lines of activities. These policies and procedures should include plans about identifying, assessing, controlling, monitoring of risks and reporting them to the board of directors regularly with the necessary actions.

20. The documents of bank on this matter should include the provisions which will lead to the staff's behaviors and attitudes in addition to the provisions about reaching the business objectives related to its vision and values and these documents should be shared by relevant parties. Banks should determine the acceptable risk limits about the activities of relevant business lines by considering the potential effects of proposed activities (on customers and generally on public) in these documents and should inform all the relevant parties about these limits.

21. These policies and procedures include identification of risk factors, the structure of committees, requirements on transparency and operation/product review and issues about approval processes.

22. These policies and procedures should be reviewed and updated periodically.

ii. Risk Identification, Assessment and Control

23. It is necessary to improve a systematic approach in order to identify, define, assess and control all the risks that include potential threat and that may have a negative effect on the bank's reputation. This approach should be consistent with business plan and risk profile and should be designed in line with the bank's needs. The process concerning the definition of reputational risk should include the following matters:

- Clear identification of risks that may cause reputational risk and determination of their place in the general risk management policy,
- Disclosing the bank-specific main sources of reputational risk including bank's shareholders, upper management and personnel,
- Considering all types of risks that may affect the bank's reputation and that may arise from new business lines or projects.

24. In risk identification, in addition to all relevant units and staff of the bank, it should be utilized from all other sources such as reports about bank and stakeholders, internal control and analysis reports or early warning indicators. Identification of important stakeholders which may affect the bank's activities and reputation, understanding their demands and expectations and determining the matters and threats that may affect their perceptions, predicting the potential actions that they may take if their expectations are not met, attaching new matters and threats to this identification process when deemed necessary, are the most important issues of relations with stakeholders.

25. Banks should establish procedures about assessing and prioritizing their risks by analyzing the probability of events that may threaten their reputation directly. During this scenario assessment, different techniques and tools can be used including the followings:

- a) Control Assessment: To assess the probability of risks through analyzing the risk sources, current controls in risk management and the effectiveness of these controls.
- b) Stakeholder Impact Assessment: To assess the risk impact by determining which one of the stakeholder groups is more sensitive to the risk and by deciding which ones of these groups have significant effects on the bank.
- c) Stress Testing: Banks should assess the potential effects of risks on banks reputation under different stress scenarios.

26. After identifying potential exposures arising from reputational concerns, banks should measure the amount of support they might have to provide (including implicit support of securitizations) or losses they might experience under adverse market conditions. In particular, in order to avoid reputational damages and to maintain market confidence, banks should measure as precisely as possible the effect of reputational risk in terms of other risk types (e.g. credit, liquidity, market or operational risk) to which it may be exposed. This could be accomplished by including reputational risk scenarios in regular stress tests.

27. Banks should determine the appropriate actions that they will take as measures and actions for starting legal measures and/or prosecutions that exist in the valid legislation by considering the identified risks and the risk assessment results. The action plans including the contingency plan should be reviewed regularly.

28. In the analyses of risk sources, bank's business lines, liabilities, affiliated operations, off balance sheet vehicles and the markets in which it operates should be included.

The risks that arise should be incorporated into the bank's risk management processes and appropriately addressed in its ICAAP and liquidity contingency plans..

iii. Risk Monitoring and Reporting

29. A bank, by charging adequate qualified staff, enables the effectiveness of actions plans that will keep the risks under control, reviews whether these plans are carried out or not and reports them. In addition, a bank establishes an early warning system which informs it about the potential risks that may directly give harm to its reputation. The issues which may cause reputational risk should be reported to the senior management promptly for corrective actions.

30. In this context, banks should determine early warning indicators for different areas such as performance indicators, disruptions in banking services, news in media about the bank, increases in customer complaints or in lawsuits filed against the bank.

iv. Communication with Stakeholders and Disclosure

31. The communication of bank with its stakeholders may be through annual reports, web page, annual general meeting, press conferences and press statements etc. This communication which includes disclosure in any case, should be open, honest, transparent, timely and consistent and it should meet the needs of stakeholders and should not give way to rumors.