

Reputation: Preserving the Essential

Anne-Cécile Harriot, Senior Manager
Jean-Yves Blanc, Associate

The fiery English novelist Jeanette Winterson elevates the safeguarding of one's reputation to the status of a heroic duty: "It's true that heroes are inspiring, but mustn't they also do some rescuing if they are to be worthy of their name? Would Wonder Woman matter if she only sent commiserating telegrams to the distressed?"¹

On the more modest level of the business, reputation is extremely important to protect since it represents a crucial intangible asset that conditions the confidence people have in the company. A good reputation attracts talent, customers and investors, which explains the renewed interest of regulators in reputational risk. As a consequence, reputation requires particular attention and appropriate management.

Reputation: a company asset recognized by the regulator

Although certain texts identify reputational risk, it has yet to become the object of a regulatory capital requirement. Reputational risk has however been linked with non-compliance risk "resulting from failure to comply with the prevailing laws and regulations and professional and ethical standards relating to banking and financial activities or with instructions from the executive body..."²

The Basel Committee on Banking Supervision specifies that, pursuant to the supervisory review process of capital adequacy, a comprehensive assessment of all risks is necessary, even if "'other' risks, such as reputational and strategic risk, are not easily measurable." Nonetheless, the Committee expects the banking industry "to further develop techniques for managing all aspects of these risks."³

The January 2009 consultative document finally puts forward the Committee's definition of reputational risk: "Reputation risk can be defined as the risk arising from negative perception on the part of customers, counterparties, shareholders, investors 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 interbank or securitization markets). Reputational risk is multidimensional and reflects the perception of other market participants. Furthermore, it exists throughout the organization and exposure to reputational risk is essentially a function of the adequacy of the bank's internal risk management

¹ The Independent, January 1990.

² Regulation 97-02 of 21 February 1997, relating to internal control in credit institutions and investment firms. Banque de France – Banking Commission.

³ International Convergence of Capital Measurement and Capital Standards – Revised Framework (Comprehensive Version: June 2006), Basel Committee on Banking Supervision.

processes, as well as the manner and efficiency with which management responds to external influences on bank-related transactions.”⁴

The Committee explicitly requires that reputational risk be taken into account in the internal process of assessing capital adequacy.

Reputation is intrinsically tied to the health of the business as well as to that of the economic sector in which the business operates. Reputation may have a wide-ranging impact on numerous endogenous and exogenous aspects of a firm, such as:

- An investor’s willingness to acquire an interest in the firm;
- The firm’s ability to attract new customers;
- Competitors’ entry into the firm’s market;
- The firm’s relationship with regulators;
- The recruitment of new employees;
- The ability to recruit and/or maintain personnel.

Moreover, in view of the economic crisis, the Committee has turned its attention to the relationship and, in particular, to the interaction between an institution’s reputation and its liquidity risk: deterioration of a bank’s liquidity harms its reputation, which in turn makes refinancing more difficult – a vicious circle in which the cause of the effect becomes the effect of the cause.

Nonetheless, reputational risk analysis should not be limited to studying its correlation with liquidity risk. Indeed, all the aggravating factors that may ultimately have a negative financial impact have to be taken into account. Although often barely perceptible, reputational risk arises when stakeholders’ become aware of the increase in other risks to the bank: market, credit, counterparty, or operational risks, or, for that matter, all the other Pillar II risks.

In an environment where there is less and less of a difference between products and services on offer – which is particularly the case with financial products – reputational risk is currently considered among the most critical. For this reason, it must be dealt with and assessed in the same way as operational and financial risks: in accordance with internal policy and in a centralized and cross-functional way.

Essential in periods of crisis, a good reputation represents an undeniable competitive advantage. Although not easy to quantify, reputation is an intangible asset that is part and parcel of those factors that go to make up the value of the company. For this reason, it is important to manage it just like tangible assets.

⁴ Proposed enhancements to the Basel II framework (Consultative document: January 2009), Basel Committee on Banking Supervision.

...that must be managed right

In order to deal effectively with reputational risk, one must have the ability to identify, measure and manage it.

Identify

Identifying reputational risk consists in drawing up a risk inventory, that is, the sum of “bad”-reputational risk-generating events.

Among the risk-generating events, various internal causes may be noted:

- Corporate governance (fraudulent, unethical, irresponsible, deleterious, etc., business practices);
- Quality (production line failure, defective products, poor telephone or internet customer service, etc.);
- Human resources management (negative behavior on the part of a company director or other employee, gross incompetence, company director salary and compensation practices subject to criticism, etc.);
- Financial performance (failure to reach expected results, inflexibility to risks, etc.);
- Compliance and legality (non-compliance with regulation, tax fraud, etc.);
- Image management (inappropriate, non-existent or out-of-touch public relations, brand management problems, etc.).

No less diverse external causes may also hurt a firm’s reputation:

- Negative comparative advertising;
- Libel/slander;
- Litigation, third-party lawsuits (with an employee, customer, supplier, etc.);
- Regulator warnings;
- Unfair competition;
- Counterfeiting, piracy, etc.

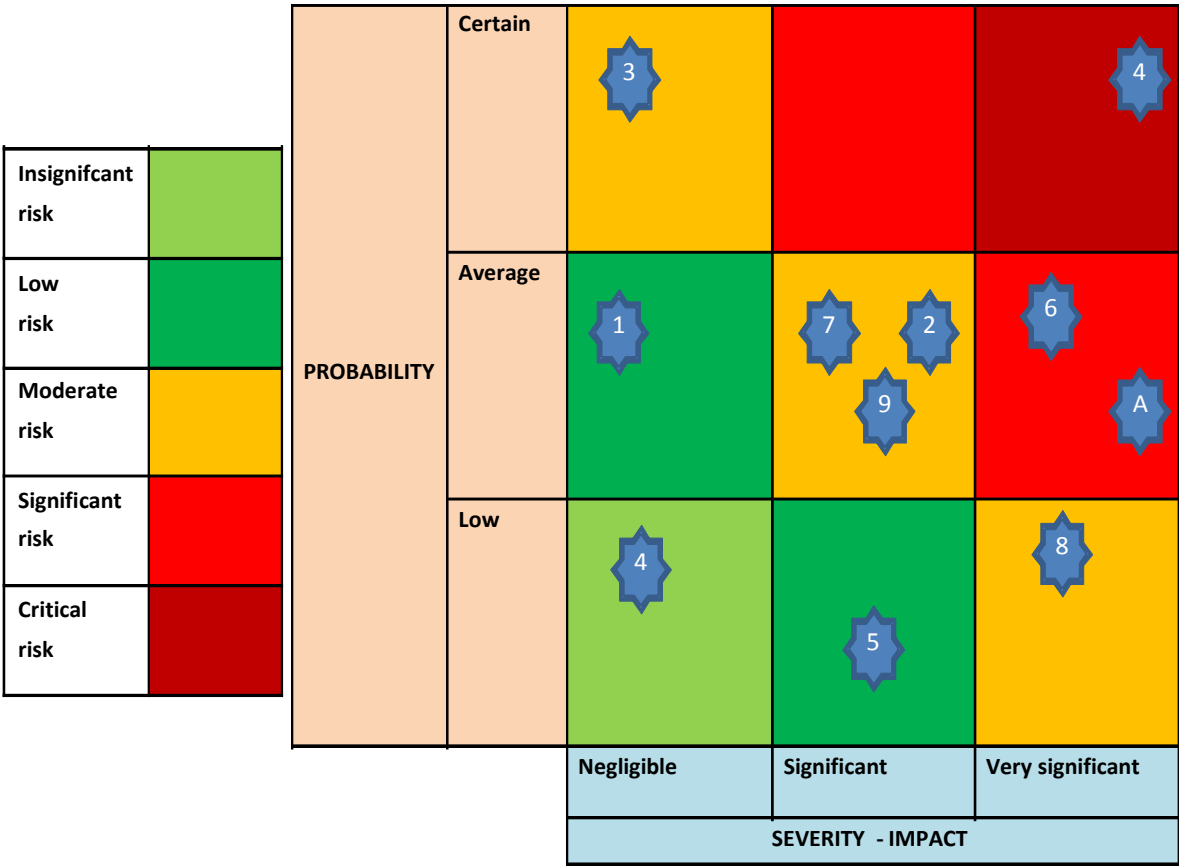
Inventory work requires definite expertise because of the lack of a standard common typology. In particular it will require analysis of media reports and articles unfavorable to the company; examination of financial analysis reports; an awareness of legal precedents; as well as inquiries being made of the parties concerned (key firm managers or, if need be, external parties identified by firm management).

Moreover, constant vigilance is necessary in monitoring what the outside world is thinking and saying: deciphering market movements of company stock, unfavorable coverage in the press, in the blogs, on-line, etc.

Measure

Measuring reputational risk consists in determining the level of exposure to risk factors. The classic qualitative approach uses a chart intersecting probability of occurrence (from low to certain) with severity (from negligible to very significant) in order to define the degree of risk.

Each risk factor identified in the inventory (indicated by number on the table below) is positioned on the chart and represents the risk map:



The quantitative approach to assessing potential loss resulting from an unforeseen event leading to a degradation of reputation – similar to the advanced statistical calculation methods of operational risk – is still being studied due to a lack of baselines.

Manage

Within reputational risk management, two principal orientations determine the tasks to be carried out: preventive reputational risk management and corrective reputational risk management.

Preventive reputational risk management is particularly important not least because, as Thomas Paine observed, “Character is much easier kept than recovered.” It principally entails giving oneself the means to offer high-quality products, to apply sound, and ethical, governing and management practices, and to strengthen compliance with regulations that promote solvency and liquidity. Implementing programs that popular opinion considers positive, such as sustainable development policies or charitable work, can also prove beneficial to a firm’s reputation as long as the policies are sincere and genuinely supported. Public (and internal) relations that explain the company’s strategy, its new projects and results, is equally indispensable to strengthening the company’s image.

Moreover, knowing the speed with which “critical” information spreads, whether through traditional media (newspapers and television) or on the web, companies must not only control their message, but also anticipate events that may prove harmful to their image and consequently to their performance, and, in the worst-case scenario, generate losses.

That said, prevention alone is not enough. The firm must be up to responding to attacks to its reputation (smear campaigns, mistrust as a result of the financial crisis, etc.).

To this end, good communication is of course a key element that must be handled carefully. But it is not the only one. The firm must have an action plan (supplemented in extreme cases with a crisis management plan) that provides for, in case of an unforeseen event that generates reputational risk, an exact idea of the course of action to take.

The action plan must at minimum include:

- a communications plan (internal and external);
- a list of actions to be carried out, including, if need be, legal action;
- and specific governing practices – a necessary part of good risk management – adapted to the multi-faceted set of problem the firm faces and, for this reason, involving decision-makers representing the different areas concerned so as to ensure a forceful response.

In addition, simulation exercises at appropriate intervals allow the firm to be ready to strike back within the shortest timeframe – time being a key factor in corrective reputational risk management.

Put back on the agenda by the political authorities and regulators, corporate social, and in particular financial, responsibility can only encourage firms to pay closer attention to protecting or restoring their good name as well as that of their industry. Beyond the more or less coercive aspect of regulations, which, in the future, will require capital coverage of reputational risk, the implementation by executive management of a voluntary policy of reputational risk management will at once benefit and reinforce company value. As the Roman poet Publilius Syrus put it in the first century AD, “A good reputation is more valuable than money.” Without a doubt: safeguarding reputation means preserving the essential ■