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Financial Services

POINT OF VIEW

REPUTATION RISK ON THE RISE

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REPUTATION RISK ON THE RISE

Reputation risk is generally understood as the risk arising from adverse perception of an institution by its stakeholders.

In the financial services industry, the aftermath of the global financial crisis has seen a proliferation of non-financial risks. Reputation risk is one topic that has grown in prominence, with headlines around the world highlighting the importance of effective reputation risk management.

In yet another negative story to beset the industry, the Panama Papers have recently led to allegations of several firms facilitating tax avoidance and public corruption. Mis-selling has led to mass demonstrations in a European capital; bankers have been summoned before parliamentary committees to justify their business practices; and payment system outages and increasingly frequent cyber attacks have resulted in regulatory fines, media attention and considerable brand damage.

Often tough to manage, and even more difficult to measure, some firms have done little to actively manage reputation risk. However, they can no longer afford to neglect this area. Heightened public scrutiny of the financial services industry, and the amplification of relevant issues through social media, suggest that this risk is likely to grow. Leading players are adapting to this new reality, drawing on the lessons learned from other industries (such as aviation), and from an emerging group of peer best practices.

> *"It takes 20 years to build a reputation and five minutes to ruin it. If you think about that you'll do things differently."*
>
> **Warren Buffett**

REPUTATION MATTERS: IMPACT ON EARNINGS AND CAPITAL

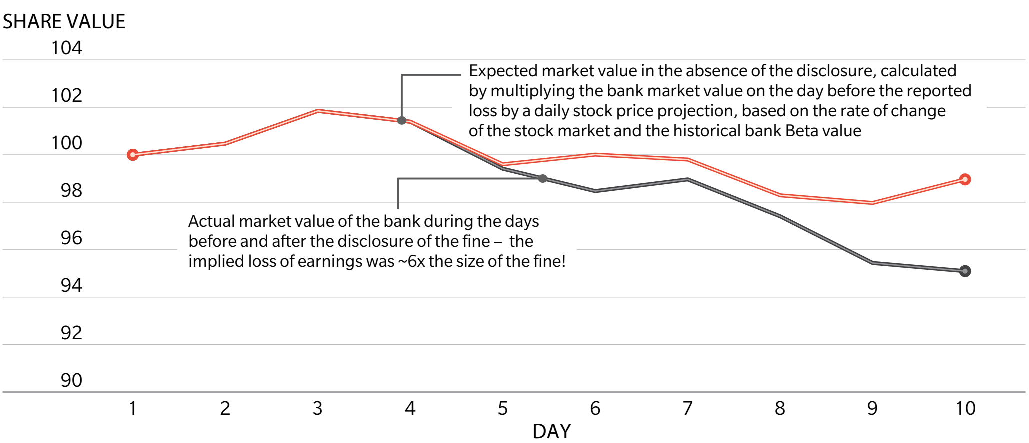
Measuring the cost of reputation risk is difficult, in part because it can arise as a secondary consequence of other risks. One way in which it can be measured is through changes in stock prices, which are well placed to capture the many indirect effects of reputation damage through their reflection of lost future earnings. Such projected shortfalls in earnings might then inform capital planning.

The effect of reputation damage on stock prices is very real. Following the disclosure of a sanctions violation, the implied loss of earnings for one bank was six times the size of the fine, when the change in market value was compared to that of a representative set of peers. This episode is illustrated in Exhibit 1.

Regulators have responded to such events with increased scrutiny. The Financial Conduct Authority (FCA) in the United Kingdom formally recognises reputation risk within their overall supervisory approach.[1] The Office of the Comptroller of the Currency (OCC) in the United States revised its risk assessment guidance in 2015 to incorporate both the quantity of reputation risk and the quality of reputation risk management.[2] Similarly, the Supervisory Review and Evaluation Process (SREP) questionnaires of the European Banking Authority (EBA) require formalised policies and processes for the identification, management and monitoring of reputation risk, and the existence of contingency plans to deal proactively with reputation issues.[3] At an international level, the recent G30 report, *Banking Conduct and Culture*, recommends that "boards should build a reputation, values, and conduct risk tolerance dashboard."[4]

As a result, reputation risk is increasingly becoming an agenda item for boards and senior management.

Exhibit 1: Share value of affected institution vs. representative peer-set following a sanctions violation



1 FCA FG15/4:Social media and customer communications; "Risk management encompasses all relevant risks, including legal and reputation risk, as well as regulatory risk"

2 OCC, Updated Guidance on Risk Assessment System

3 EBA/GL/2014/13 Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)

4 G30 report on Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform

MANAGING REPUTATION RISK

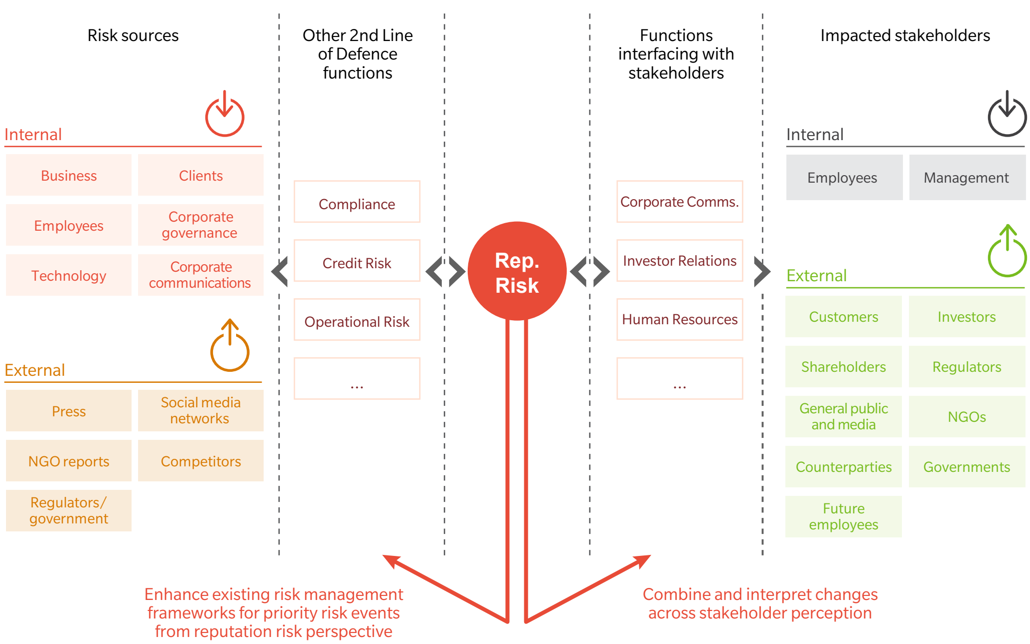
Reputation risk arises from a broad range of potential events, and has an impact on an array of stakeholders.

Given the distributed nature of both sources and impacts, the management of reputation risk has to become part of the day-to-day life of every employee of the firm. Indeed, such a responsibility cannot be centralised in one unit in the same way that financial firms typically manage credit, insurance or market risks (see Exhibit 2).

Successful approaches are designed with this conclusion in mind by:

- Promoting a shared understanding of reputation risk across the whole organisation.
- Focusing risk management on where real business decisions are made.
- Recognising the need for prioritisation to make the problem manageable.
- Putting in place effective crisis management.
- Creating management information that permits senior leadership oversight.

Exhibit 2: Example role of reputation risk management, connecting risk sources with impacted stakeholders



A shared definition of reputation risk – which should cover both sources and impacts – is critical in promoting a shared understanding and awareness across the firm. A clear articulation of risk appetite is equally important in allowing risks to be escalated effectively. One important question firms need to decide is whether reputation risk should only be deemed material when it has reasonably direct financial consequences (for example, on margins, volumes and funding).

Reputation risk management should be focused on real business decisions. These range from the strategic (such as closing retail branches in rural areas) to the operational (such as defining limits on downtime for mobile banking). In practice, this means that reputation should, as far as possible, be included in existing risk identification and assessment. Reputation risk can then be considered as a potential impact alongside remediation cost, regulatory fines and so on.

Reputation risk management thus becomes an integral part of business decision processes, ranging from new product approval and credit decisions to procurement. It can involve explicit tools and checklists, such as those used to restrict lending to sensitive sectors or prevent exploitation of workers at third party companies. Some firms use clear escalation channels, with governance structures in place that involve the relevant stakeholders in preventing and minimising reputation risk. Such measures could include blocking a new product or voting to syndicate a deal, rather than having the bank as the sole sponsor.

As firms seek to embed reputation risk management into their business decisions, robust prioritisation is required. To prioritise, the reputation risks inherent in business decisions can be grouped into three categories:

1. The financial and reputation impacts of a risk are highly correlated. For example, firms have market risk limits in order to protect them from market price induced losses. Since the reputational damage from such a loss is directly proportional to its magnitude, if market risk is managed well, so is reputation risk. A risk tolerance discussion should be held that captures the appetite for reputation risk, which may be below the financial loss that the balance sheet could sustain.

2. The financial and reputation impacts diverge. For example, a technology outage may be inexpensive to resolve internally but may still cause significant reputational harm with counterparties and clients. Here, additional controls may be required to ensure the specifications reflect this concern when designing the relevant systems.

3. The reputation risk exists without a corresponding financial impact. This applies only to selected areas but has given rise to dedicated specialist disciplines in the industry such as disreputable lending and responsible investment.

In our experience, it is the latter two categories that require the bulk of work when implementing reputation risk management to a consistent standard. In prioritising the work, it is important to define which stakeholder groups should take priority. For example, a firm may decide in the short term to place higher importance on its standing with regulators and investors than with graduate recruits. Such prioritisation allows targeted due diligence in areas of heightened risk. A cyclical review schedule, similar to an audit plan, can be put in place to ensure continued adherence to the defined risk appetite.

Besides improving those controls designed to prevent or limit the fallout from adverse events, it is equally critical to have the right crisis management processes in place to deal with such events as they unfold. Leading firms have established event management protocols and action plans, designed to cover breaches of the reputation risk appetite. This allows the firm to respond quickly to mitigate potential damage to its reputation.

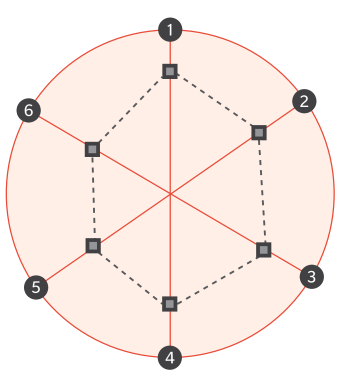
Some of the best approaches we have observed draw on lessons learned from the aviation industry, where planned responses minimise the decision making required in the heat of crisis. In the case of financial institutions, a great deal of decision making can be predetermined, thus avoiding the risks of vacillation and inaction.

Such responses might, for example, include a "war room" set-up, in which senior executives of relevant functions gather to help steer the firm through the crisis. This set-up is periodically tested in a simulated "fire drill" to ensure that it is up to date, to identify potential weaknesses and to train the relevant parties for the real incident.

Effective management information distils key risks and tracks the perceptions of the firm's most important stakeholders (see Exhibit 3). Leading institutions have put reputation risk radars in place that look to combine both the internal and the external view of a firm's reputation, thereby facilitating senior management engagement and oversight.

Exhibit 3: Example of a sanitised reputation risk dashboard at a leading universal bank

Aggregate scoring of consumer| engagement from customer survey



1. **Customer perception (Country A)**
2. **Customer perception (Country B)**
3. **Employee relations**
   Tracking of relative satisfaction index from Group report
4. **Investor perception**
   Comparison of buy-hold-sell ratings of analyst reports from set group of banks
5. **Media perception**
   Weighted scoring of positive, neutral, and negative media reports
6. **Corporate/social responsibility perception**
   Average of external CSR reports

HOW TO GET STARTED

In order to get the reputation risk management process started, we recommend the following steps:

- Establish a clear and consistent understanding of reputation risk.
- Assign a single leader to coordinate risk management efforts.
- Involve the business in identifying critical decision points.
- Insert reputation risk considerations into existing risk management tools, processes and controls, and launch targeted remediation efforts where gaps need to be filled.
- Establish a crisis management protocol, coordinating with all interested parties.
- Design management information to engage senior governance bodies.

Firms' progress in developing an effective approach to reputation risk has been extremely varied to date. What is consistent is the significant long-term damage that such events can have on brand and customers. The rapidly changing and uncertain world in which we live today means that it is no longer viable to take a reactive approach. Reputation risk is an increasing concern for senior management and we expect ambition levels to increase dramatically in the near term.

A failure to invest and improve at the current time is a false economy. Rather than simply hoping that the worst won't happen, firms need to put in place effective risk management. This will help to minimise the likelihood of future events and will also steady the ship if and when a reputation crisis hits. Those who have done the most to develop frameworks have often been reacting to a significant event they have faced – and wished they had acted earlier.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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