REPUTATIONAL RISK PROCESS

ANTIDOTE TO PARANOIA

BY JEFFREY F. INGBER

Over the past decades, the financial industry has been tarnished by multiple incidents of scandal, breakdowns of internal controls, and unscrupulous behavior. These occurrences not only have brought substantial financial injury to banks in the form of fines, penalties, and remediation costs, but also have exacerbated the already low opinion held of them by legislators, the media, and the public.

All of this, in turn, increases the likelihood of additional regulation, enforcement actions and criminal pleas, and enhanced focus on negative financial news.

These developments have led supervisors to express concern about banks' ethical and compliance cultures, to which banks have responded with vigorous reform measures. In the shadow of these efforts is another that is critically important as well—for banks to acknowledge the heightened level of reputational risk they face and to manage that risk more proactively. As Warren Buffett stated with regard to Berkshire Hathaway, "Our top priority, trumping everything else, including profits, is that all of us continue to zealously guard reputation."

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A useful characterization of reputational risk is provided by the Basel Committee on Banking Supervision, which defines it as "risk arising from negative perception on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts, [and] other relevant parties or regulators that can adversely affect a bank's ability to maintain existing, or establish new, business."[1] This definition reflects the fact that protecting reputation is different from maintaining an ethical culture, because negative perception may arise from a range of sources. Reputational risk, one especially important for banks, expressly is among the categories of risks required to be managed to ensure safety and soundness.[2]

Various surveys in recent years have shown that executives and risk managers believe reputation to be the most challenging of risks to manage, for these reasons:

- It is based on perception and thus is difficult to identify or quantify.
- It is driven by a wide range of other risks, such as compliance, legal, and operational, which must all be actively

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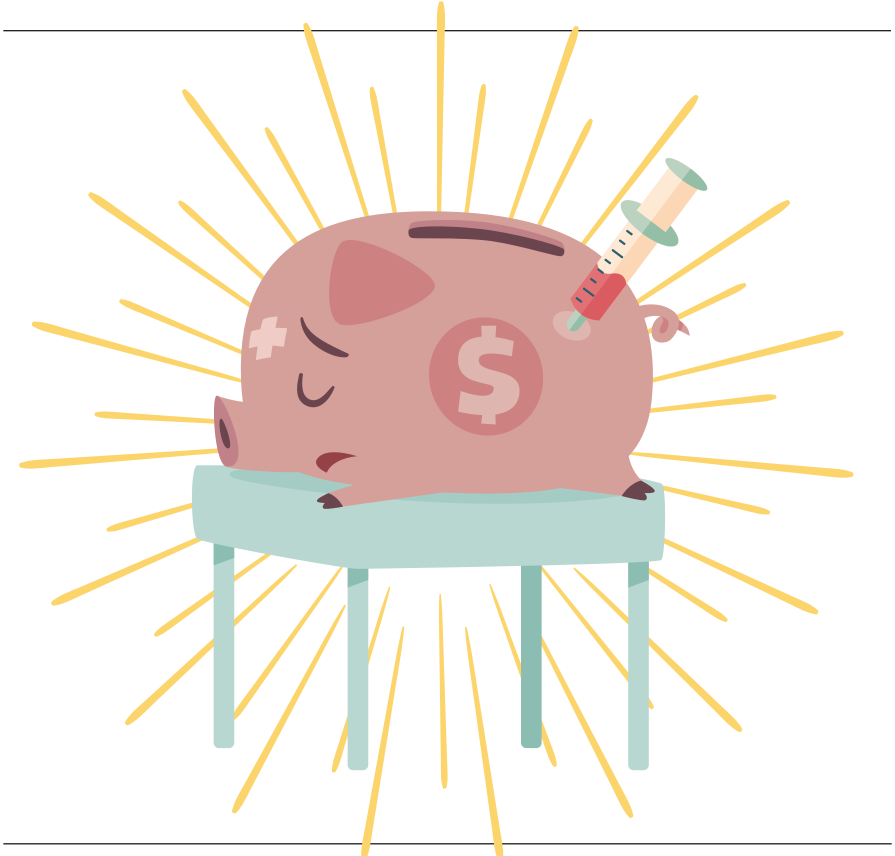

communication, it will not permeate throughout the bank solely through promulgation of static documents such as a code of conduct, mission statement, or a reputational risk policy. The bank's board of directors and senior management must proactively and consistently support awareness of reputational risk through ongoing and open dialogue with staff. Only in this manner can they ensure that an assessment of reputational risk becomes part of every key business decision such that it becomes a part of the bank's DNA.

Critical to managing reputational risk are the control functions—compliance, legal, and risk—and the degree to which they assist businesses in identifying, and resolving, reputational risk issues. These functions need to understand reputational risk management as fundamental to their role and be empowered with independent, ready access to senior officials and veto authority. And if reputational harm occurs within one area of the bank (or at a competitor), these functions should actively participate in an exercise to determine whether a similar problem may exist elsewhere in the bank.

managed (and which is why some argue that reputational harm is not a distinct risk but rather the sum consequence of mishandling other risks).

- It is ever present and unavoidable in every product, service, transaction, and business line.
- It is subject to capricious changes in the political and social environment.

Perhaps most exasperating is that reputational harm may arise regardless of the course of action that is taken or not taken by a bank and despite its best intentions and efforts, strong ethical environment, and robust internal controls. Reputational harm may arise simply because of association with a bad actor (for example, through outsourcing, partnership, or employment) or through inappropriate actions by other banks that taint the entire industry.

Because business outcomes, always unpredictable, are now more visible and readily subject to criticism, the development of a sound process for managing reputation is more crucial than ever. The following basic building blocks apply to the management of every key risk: 1) appropriate policies and procedures, 2) strong internal control processes, 3) targeted training, 4) independent testing, and 5) staff resources and expertise. For reputational harm, there obviously also needs to be a crisis management process.

This article assumes the existence of these fundamental safeguards. But there is a new normal now—one that demands that more proactive and objective methods be added to the mix to better identify, track, measure, and manage reputational risk, including nontraditional ones that require some degree of quantification.

Proactive and Focused Corporate Governance

As with all risks, management of reputational risk begins with appropriate tone from the top: namely, the clear message to all staff members and third-party representatives of the bank emphasizing that reputation must be actively safeguarded and lay out expectations for how this should be done.

But regardless of the strength of this

Internal audit (along with independent compliance), as the third line of defense, should monitor compliance with the bank's reputational risk standards and policies. Periodic reputational risk management audits should be performed and the results escalated to the appropriate board committee. Internal and external audit processes should identify and report on areas particularly vulnerable to reputational risk.

The amorphous nature of reputation makes it difficult to manage on an enterprise-wide basis. Accordingly, a bank must ensure that responsibility for reputational risk is not dispersed among individual functions and persons (senior business managers, the CFO, the CRO, etc.) in a way that leaves it disconnected from overall corporate strategy, without proper board oversight, or with no one having clear and sufficient accountability.

One means of facilitating this is to create the role of a senior reputational risk

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manager (or office) responsible for the following:

- Ensuring timely communication among shareholders, customers, boards of directors, and employees on reputational risk matters.
- Receiving and assessing information, including social media data, to understand how the bank is perceived by customers, investors, supervisors, the media, and the wider public.
- Acting as a confidential and trusted reputational risk ombudsman.
- Coordinating surveys and feedback processes to assess the handling of reputation by management, employees, and third parties.
- Overseeing targeted training programs on reputational risk (that is, those that help guarantee awareness of potential sources of harm).
- Ensuring prompt notification of serious reputational issues to the board and senior management.

In turn, this person should report to a reputational risk committee consisting of senior business and control staff. Such a committee should be chaired by a nonbusiness person (potentially an independent, outside director), operate as a challenge function, and have the authority to halt problematic transactions. Establishing such a committee demonstrates the bank's strong commitment to reputational risk management.

Strong Ethical Culture

Every bank must clearly and publicly communicate its core values and commitment to high ethical standards. But that's low-hanging fruit. Critical to establishing a strong culture is the recognition that, while the vast majority of employees come to work wanting to do the right thing, what is ethical or desirable behavior in different situations often is unclear and subjective.

Thus, each employee with responsibilities such that he or she has the ability to put the bank's reputation at risk needs a sufficiently detailed "playbook" for managing reputation in varying contexts. Such a playbook must be tailored to differing positions and act as a useful guide for everyday behavior and decision making.

Through specialized training and guidance, every employee (and third party), before taking an action on behalf of the bank that may have reputational risk implications, must understand that the maximization of revenues is not the only consideration and should ask the following questions:

- Even if this is legally permissible, is it consistent with the bank's stated values and how the board and senior management have indicated they want the bank to conduct its business?
- In the long term, is this likely to create a win-win situation for the bank and its customer or client?
- Will it present a conflict of interest or the appearance of such?
- Even if this follows longstanding bank and industry practice, is there potential for a change in circumstances such that it might later be perceived as unethical?
- Has a similar action by the bank or another bank in the past caused some degree of reputational harm?

If these issues are considered before significant business decisions are made, there is a stronger likelihood that individuals will not only act ethically but also be smart risk managers.

Reputational Risk Appetite

As with other risks, business strategy must be tied to reputational risk appetite as defined by management and approved by the board. Having a "zero tolerance" for harm to reputation (unlike, appropriately, having no tolerance for statutory or regulatory breaches) is an impractical stance, since any of a bank's activities or decisions can lead to reputational risk if they are perceived negatively by one or more of the bank's stakeholders.

The notion of developing an "appetite" for reputational harm remains a difficult one for many as it is necessarily rather qualitative. However, such an appetite statement is desirable as a means of supplementing management judgment and demonstrating a thoughtful risk management process.

A sound reputational risk appetite statement likely will be a combination of qualitative and quantitative measures that attempt to provide a practical framework for the amount of reputational harm the bank is prepared to accept in pursuit of a particular strategic objective. It should be concise, understandable, and consistent with other, more quantitative risk limits.

Also, the statement should be backed by a set of metrics that management can use to monitor adherence. Such metrics, admittedly difficult to produce and calibrate, may include indicia such as 1) stock price reaction, 2) level of customer loyalty and complaints, 3) loss of business, 4) effect on creditors and equity investors, 5) employee turnover and reduction in productivity, 6) potential for litigation, and 7) possible supervisory response (such as a public enforcement action or Fed statement regarding a CCAR process deficiency). Capital, often a key mitigant of risk, is not particularly useful in the reputational risk context, which is why reputational risk is not subject to direct capital charges.

Accountability

A risk appetite statement is ineffective unless it is appropriately supported. Boards need to demand from business leaders as much accountability for reputational risk management as they do for prudent financial management. To do so, the handling of reputational risk must be consistently linked to decisions about advancement and compensation. Appraisals of senior managers and others who can take significant risk on behalf of the bank should include an evaluation of the individual's handling of reputation, judged by conformity to the bank's policies.

Ever since the financial crisis, there has been a vast amount of thinking about and development of new incentive compensation practices, some of it driven by the Dodd-Frank Act. Modern aspects of compensation structures now encompass features such as deferrals over a period of years, limits on immediate cash bonuses, the use of debt versus equity, and clawbacks. Whatever the compensation program adopted by a bank, it must be structured in a way that promotes the bank's values, business goals, and reputation management.

Meanwhile, compensation practice, beyond being a tool for promoting accountability, is itself a potential source of reputational harm and must be tailored to directly address public and supervisory concerns about excessive and inappropriate incentives. As the Federal Reserve's principles-based guidance provides, incentive arrangements should be balanced regarding financial rewards so as not to encourage employees to imprudently expose their organizations to risk. Thus, a bank's compensation program should mitigate reputational harm in two ways: by disincentivizing the impulse to take undue reputational risk and by punishing individuals for actions that do so.

Scenario Analysis

Reputational harm often occurs with regard to products, service, and types of transactions that for many years represented standard and accepted industry practice (such as credit add-on products, IPO allocations, and market research reports). Inevitably, the political or social environment changes, a politician, prosecutor, or supervisory agency offers a new slant on their appropriateness, and then they are no longer considered ethical.

Thus, managing reputation requires a bank to constantly update its understanding of what key stakeholders expect and are sensitive to—and react to that proactively. A powerful tool for doing so is to apply scenario analysis to each key reputational risk decision, especially ones that push the bank to the borders of its reputational risk appetite.

The use of scenarios is an effective way for business leaders, working with their risk manager, to anticipate a transformation of views about acceptability (which may be driven by a variety of factors, such as an economic downturn, adverse market conditions, or a misunderstanding or improper use by a customer or client). Possible mitigating or remedial actions can then be appropriately considered.

Monitoring of Social Media and Its Policies

The task of managing reputational risk is all the more difficult in the age of social media, when information and opinions regarding a bank, whether true or not,

are broadly accessible and reputation can be attacked with ease (consider a former disgruntled employee who publishes an unfairly critical op-ed piece in a major newspaper that is picked up by numerous media outlets).

Every bank now actively participates to some degree on social networks in order to stay connected with its customers and create additional sales and marketing channels. Involvement in social media also can provide a crucial opportunity to detect early warning signs of reputational issues. Banks need to actively use modern technology to monitor key media sources for negative publicity so they can preemptively address it.

Another proactive measure to head off reputational harm is to establish and inculcate in the bank's culture a social media policy that delineates its expectations for employees and other key stakeholders on the handling of tweets, posts, blogs, e-mails, personal websites, and chat rooms. Here are some examples of key guidelines to be included in such a policy:

- Delineating the types of confidential, nonpublic bank information that should not be disclosed.
- Avoiding posts that could be perceived as 1) defamatory or intentionally harmful to another's reputation, 2) contributing to a hostile work environment, 3) a violation of financial disclosure laws, or 4) promotive of insider trading.
- Requiring that any personnel associated with the bank state that their expressed views are personal and not necessarily those of the bank.
- Refraining from excessive use of social media while on worktime.
- Not using bank-owned equipment for personal use of social media.
- Contacting the bank's designated social media spokesperson if in doubt about the propriety of using social media.

Prepare for Examination

Given the heightened reputational risk environment, examiners may be more focused on assessing how well a bank manages reputational risk. (Ironically, bank supervisors themselves have been criticized by Congress for using reputational risk as an unfair "political tool" against certain financial entities, such as payday lenders.) In preparing for supervisory examination of its reputational risk management, a bank should, among other things, conduct an assessment of the following:

- Measures taken to ensure that a consistent message on the importance of ethics and reputation has permeated throughout the organization.
- The inclusion of a discussion on maintaining brand and reputation in corporate press releases, letters to shareholders, and other corporate communications.
- Bank effectiveness in responding to expressed concerns from customers and other stakeholders.
- The bank's process for addressing reputational risk when entering into new products, services, business lines, or delivery channels—particularly reputationally sensitive ones.
- The quality and integrity of bank oversight of data and communications related to reputational risk.
- Responsiveness to deficiencies in internal control and compliance risk management systems, such as those related to BSA/AML/OFAC, that may significantly affect reputation.

Conclusion

Management of reputational risk, an arena traditionally thought of as a "soft science," needs to be approached proactively and concretely, in a way that strikes the right balance between being sufficiently protective of the bank but not causing undue burden or "paralysis by analysis."

Because public perceptions are transparent and fickle, and business outcomes uncertain no matter how strong a risk management process is in place, establishing a demonstrably robust process for protecting the institution from reputation harm must be considered a fundamental component of business planning and strategy. ®

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Notes

1. The Federal Reserve, in its Commercial Bank Examination Manual, defines reputational risk as "the potential that negative publicity regarding an institution's business practices, *whether true or not,* will cause a decline in the customer base, costly litigation, or revenue reductions" (emphasis added). In 2007, in a supervisory letter, the Fed, OCC, and FDIC issued interagency guidance for recognizing and managing reputational risk, but this guidance is limited to complex structured-finance transactions.

2. See Federal Reserve Supervisory Letter 08-08 ("Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles," October 16, 2008). Reputational risk is one of the Federal Reserve's categories of safety and soundness and fiduciary risk (credit, market, liquidity, operational, legal, and reputational) and one of three categories of compliance risk (operational, legal, and reputational).