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**A new era for reputation risk in banking:
Reflections on the impact of reputation on the
banking crisis and the financial services
regulatory agenda**

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ABSTRACT

There is only one issue in corporate business at present that really matters: why so many financial institutions have failed: why have they failed, how could we have prevented their failure, and what are regulators, supervisors and banking directors doing about it? Key to analysis of the causes of failure is an understanding of the central role of **reputation** in the process of failure of so many major financial institutions. Almost all key supervisors' and commentators' reviews of recent banking failures have laid the blame at the foot of banks and their failure to manage '**reputational risk**'. As a result of the failures, banks face an uphill battle to restore their battered reputations.

In this paper, I review how reputation contributed to the string of banking failures (and who says so) and examine the responses proposed by global regulators. The proposals and their shortcomings have major implications for reputation management initiatives and the state of the reputation management art. Given the centrality of banking failures to global economic performance and broader management agendas, what happens in banking will have a major impact on all other sectors and areas of corporate practice and will chart the course for development of the art for the next five years. Improving our understanding of what is happening to reputation management in banking is critical to controlling the reputation management agenda.

INTRODUCTION

The turn-around of the reputation of Shell from the dark years of 1995 to the present is widely regarded as one of the great success stories of the 'reputation movement'. Following the debacle of Brent Spar and the accusations around Shell's activities in Nigeria, Shell has carefully, diligently and deliberately staked out the reputation space as a source or improved corporate positioning with interested internal and external audiences, as well as with the public. Even its positioning in the mass market media is around its reputation for responsibility and innovative use of low-environmental-impact extraction. Perhaps, then, it is ironic that following the largest decline in global share-market values since the 1930s, Shell is back in the US District Court in New York defending charges of complicity in the deaths of Nigerian poet Ken Saro-Wiwa and 8 other members Movement for the Survival of the Ogoni People at the hands of Nigerian military junta in November 1995 on the very week of the Reputation Institute conference. The trial in New York will certainly prove a test for the reputation Shell has managed to establish since 1995.

More broadly, reputation and the art of reputation management are confronted today with a far greater challenge than Shell's alleged crimes could ever offer; greater than the supposed evils of GMO technology in agricultural production and greater than habitat destruction in Alaska. Simply put, the world's banking system has imploded. It has not collapsed, but that calamity has only been avoided through the most extraordinary series of nationalisations, part-nationalisations and socialisation of risk the world has ever seen. The accompanying macro-economic measures have seen credit simply imagined in to existence through carefully-labelled programmes of 'quantitative easing' in the US and UK in previously unimagined proportions. And the hostility towards banks and bankers is palpable. Their reputations personally and as an industry are in tatters; regulation that has been fought tooth-and-nail by the industry and more laissez-faire regulatory jurisdictions looks set to sweep its way on to the statute books, driven by finance ministers of countries that have traditionally been more hostile to unregulated finance. The reputations may take a generation to recover; the industry may have altered significantly in that time. The debt that has been created to recapitalise ailing balance sheets of the major banks will be with its ultimate owners – the taxpaying publics of the respective countries – for more than a generation.

When it comes to reputation in 2009, there is simply no other game in town. If the reputation management industry (if there is such a thing) does not engage meaningfully with the reputation challenges facing the banking industry, it will be regarded with derision in that sector and condemned to irrelevance in many others that watch and follow the banking sector. Failure to deal with the complexities of the reputation damages caused by the banking crisis will be a terminal problem for reputation management. And yet the tools of reputation management in other industries do not translate well in to banking. Understanding the differences between reputation in banking and reputation elsewhere is essential to meaningful engagement with that industry.

In this paper, we will look at the causes of the banking crisis and how reputation figures prominently therein; also, we will look at the response of commentators and supervisors, and the resulting regulatory response from the Bank of International Settlements (BIS), the global banking regulator, through its Basel Committee on Banking Supervision (BCBS). We will look at what BIS has done historically and why that has not worked; then at the strengths and weaknesses of the BCBS proposals and how they will be likely to shape the agenda of reputation management for the next decade (at least).

THE 'REPUTATION INDUSTRY' VIEW OF REPUTATION

Before tackling the banking crisis, it is worthwhile revisiting definitions of corporate reputation briefly as a starting point for the differences between banking and other industries. A frequently cited definition is that of Fombrun (1996):

"A corporate reputation is a perceptual representation of a company's past actions and future prospects that describes the firm's overall appeal to all of its key constituents when compared with other leading rivals."

This definition either deliberately or inadvertently invokes Karl Weick's concept of sensemaking:

Sensemaking involves the ongoing retrospective development of plausible images that rationalize what people are doing. (Weick, Sutcliffe and Obstfeld, 2005)

Hence, the emphasis on the perception of the audience or perceiver is similar to Weick's characterisation of the 'sensemaker' as "grounded in identity construction". As Weick explains:

The trap is that the sensemaker is singular and no individual ever acts like a single sensemaker. Instead, any one sensemaker is . . . 'a parliament of selves'. (Weick, 1995)

Other key characteristic of sensemaking include that it is retrospective, social, ongoing and driven by plausibility rather than accuracy.¹ Hence, the cues for reputation formation in the perceiver (in Fombrun's representation) or the sensemaker (in Weick's) are subject to the preconceptions of the individual who is, himself or herself, subject to the 'premise controls' (Weick, 1995, Perrow, 1996) of the organisation and belief system within which they operate. As Weick notes:

"Premises include both factual content and value content . . . It is precisely because the truth of these premises is not known that their choice is made on other grounds such as ideology. The stronger the influence these 'other grounds' become, the greater the time pressure and more non-routine the information. And because these 'other grounds' tend to be simpler and more basic, their influence may be more difficult to articulate, more pervasive and more difficult to change."

And thus, even within the organisation, the sensemaker faces challenges to constructing his or her reality when acting as, in Schon's term as a 'reflective practitioner' (Schon, 1983) in that he or she will bring a not only a series of potentially undefined premises but also the paradigms attendant to his or her professional knowledge set. As Schon explains, problem solving is not the only process to be considered: we must also consider

". . . *problem setting*, the process by which we define the decision to be made, the ends to be achieved and the means which may be chosen. In real world practice, problems do not present themselves to the practitioner as givens. They must be constructed from the materials of problematic situations which are puzzling, troubling and uncertain. In order to convert a problematic situation to a problem, a practitioner must . . . make sense of an uncertain situation that initially makes no sense."

Schon continues later, professionals . . .

". . . are coming to realise that although problem setting is a necessary condition for technical problem solving, it is not itself a technical problem. When we select the problem, we select what we will treat as the 'things' of the situation, we set the boundaries of our attention to it, and we impose on it a coherence which allows us to say what is right and what is wrong and in what directions the situation

¹ Weick also states other properties as being: "enactive of sensible environments" and "focused on and by extracted cues."

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needs to be changed. Problem solving is a process in which, interactively, we *name* the things to which we will attend and *frame* the context in which we will attend to them.

Combined with the problem of framing, there is the difficulty that the disciplinary and conceptual boundaries of reputation are disputed, as is the very validity of reputation as a useful analytical construct. For example:

Reputation has come to be seen as both at risk and at the limits of conventional management control. It has become a governing risk object for large organizations and infused with both fear and opportunity. By 2004, the World Economic Forum could declare that 'corporate reputation outranks financial performance as the most important measure of corporate success' . . . [T]he potential scope of efforts to manage reputation is very great and may reach into every corner of organizational life with demands for capacities for external responsiveness and 'reputational attention'. Power 2007

And in another context:

There is something deeply paradoxical about being public about 'managing' reputation compared with committing to substantive changes in performance. The more one is perceived to be attempting to manage public perceptions, the less successful this must be. Nevertheless reputation has emerged as a new management object for private and public sector organisations, naming a domain of exposure and anxiety where organisational identity and economic survival are at stake. Reputation may be a poor diagnostic category but, like operational risk, it plays a role in the organisation of managerial attention and in the creation of new processes and functions.

And if everything may impact on organisational reputation, then reputational risk management demands the risk management of everything.

Against this background, the field of reputation management and its corollary, reputational risk management, must struggle to deal with the single largest loss of value in history: the credit crunch of 2007 – 2009 (and possibly beyond).

THE CREDIT CRUNCH

This problem is exacerbated as analyses of the credit crunch or the "market turmoil" (Institute for International Finance (IIF), 2008) or "market turbulence" (Senior Supervisors' Group (SSG), 2008) have frequently invoked reputational risk as a key driver of the crunch / turmoil / turbulence. A clear analysis of the problems is given by the left-leaning / liberal Levy Institute

On June 17, 2002, President Bush declared that "There is a home ownership gap in America. The difference between Anglo-American and African-American and Hispanic home ownership is too big. And we've got to focus the attention on this nation to address this" (The White House 2002). The goal was to increase minority home owners by at least 5.5 million by 2010. In August 2004, the White House produced a document surveying President Bush's achievements. The document stated that "The U.S. homeownership rate reached a record 69.2% in the second quarter of 2004. The number of homeowners in the United States reached 73.4 million, the most ever. And for the first time, the majority of minority Americans own their own homes" (The White House 2004). Unfortunately, the short-lived increase in homeownership was followed by a record high foreclosure avalanche that has pushed the U.S. economy into one of its worst financial crises since the Great Depression. Billions of dollars in asset write-downs, rising unemployment, sluggish economic growth, and record-high oil and food prices, all of which add up to the end of what has been termed "the democratization of homeownership." This fictitious "democratization" was only made possible by a combination of factors, namely, three decades of financial deregulation, a very-low interest-rate policy by the Fed, an

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aggressive lending strategy by mortgage companies and banks seeking fees and commissions, and a set of financial innovations allowing mortgage loan issuers to unload their loan burden onto Wall Street to be securitized and marketed without any serious supervision or regulation.

In less combative terms, the same sequence of events has been explained by the OECD:

Financial innovation and new mortgage products, combined with often imprudent (and at times fraudulent) policies pursued by mortgage lenders, built up problems of a crisis to come. Lenders' originate-to-distribute business model, the securitisation of risky mortgage loans, and the use of financial derivatives and financing vehicles to off-load these risks from balance sheets of regulated institutions helped to transfer and spread the risk in an increasingly leveraged global financial system, and was bound to act as a powerful amplifier of the crisis

From poor underwriting standards of mortgage brokers to lack of due diligence by investors in structured products, complacency was widespread. Risk managers' warnings often remained unheard under pressure not to lose out on a buoyant market. Securitisation and the originate-to-distribute model helped to off-load risks almost as quickly as they were generated (the remaining warehousing risk was becoming significant only once markets started to dry up).

The issue of reputation as it has been widely discussed in terms of the credit crunch relates to structured investment vehicles (SIVs) – tax- and capital-efficient companies sponsored by the major banks which issued the securitized debt instruments. OECD explains the role of regulation in the development of the SIV model:

“The growth of structured investment vehicles (SIVs) and conduits has been attributed to banks' capital requirements, especially those established under the first Basel Accord (Basel I, 1988). The creation of off-balance sheet vehicles allowed banks to circumvent minimum capital requirements established by Basel I and encouraged them to shift risky activities to such weakly regulated entities. Furthermore, due to their low capital requirements, mortgages were particularly favoured under Basel I. Under Basel II, effective as of the beginning of 2008 and devised to overcome some of these problems, risks from off-balance sheet vehicles have to be included in the more comprehensive and model-based calculation of capital requirements, but other loopholes remain. In particular, Basel II enables banks to reduce their capital requirements through securitisation. This provision was widely anticipated by banks before Basel II became effective, and is part of the explanation for the acceleration of RMBS issuance post-2004 (when Basel II was issued).²

A clear analysis of the “set of financial innovations” is given by the group responsible for the supervision of the world's major banking firms, known as the Senior Supervisors' Group. Its report on the market turbulence, published almost exactly six months before the watershed failure of US investment banking giant Lehman Bros (which occurred in September 2008) states:

Moreover, some firms were required to fund contractual commitments back-stopping a range of off-balance-sheet financing vehicles that they had not anticipated they would have to fund themselves, such as ABCP (asset-backed commercial paper) conduits. In other cases, firms under no contractual obligations still provided voluntary support to these and other off-balance sheet financing vehicles, including structured investment vehicles (SIVs), because of concerns about the potential damage to their reputations and to their future ability to sell investments in such vehicles if they failed to provide support during the period of market distress . . . (sic) and led to some further expansion of the firms' liquidity and capital needs.

The logic of this is simple and was recognized by a seminal paper by Diamond (1989):

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A reputation arises (sic) from learning over time from observed behaviour about some exogenous characteristics of agents. Reputation effects on decisions arise when an agent adjusts his or her behavior to influence data others use in learning about him.

Simply put, the banks adjusted their behaviour – underwrote the SIV losses – to influence the data that debt purchasers use to learn about whether they stand behind the debt they sponsored *de facto* but not *de jure* (as it was issued by the supposedly separate SIVs). If they didn't, they could never use tax-efficient SIV structures again as debt issuers.

Most commentaries on the financial crisis up to mid-2008 used the same line of thinking to lay the proximate (if not the root) cause of the crisis on reputational risks:

- Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience
- The President's Working Group on Financial Markets Policy Statement on Financial Market Developments, March 13, 2008
- Institute of International Finance, Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations: Financial Services Industry Response to the Market Turmoil of 2007-2008, July 2008
- The Report of the Counterparty Risk Management Policy Group (CRMPG) III, Containing Systemic Risk: The Road to Reform, August 6, 2008

all contain discussions of the role of reputational risk in the banks' decisions to back the capital requirements of their SIVs; all propose a series of broadly similar regulatory changes, including in relation to reputational risk.

By the time the leaders of G20 countries met in Washington in mid November 2008, Lehman Brothers had collapsed and the world seemed on the edge of a major global recession of proportions approaching the 1930s. The final communiqué called on action from a range of parties, including the Bank of International Settlements' Basel Committee on Banking Supervision (BIS BCBS). The G20 leaders called for immediate actions by 31 March 2009. Reputational risk was not mentioned in the communiqué, but BCBS was aware of the pressure from the antecedent reports. Its response, issued on 16 January 2009, contained material comment on reputational risk, and will drive banks' thinking on reputation as the sector moves to rebuild its reputation – left in tatters by the bail-outs of unprecedented magnitudes and the debt burden the bail-outs will imply for decades to come.

Before turning to what BCBS said, however, it is worthwhile revisiting what was in place prior to the currently proposed regulatory changes.

THE HISTORY OF REPUTATIONAL RISK IN BANKING REGULATION

Prudential and supervisory regulation of financial institutions globally is regulated at national level which, in the European Union, must fall in line with the European Commission rules and directives. Those rules and directives, in turn, comply with the guidance laid down by the Bank of International Settlements; in effect BIS is a global regulator without specific jurisdiction; its force of law is limited to a series of arcane protocols and agreements to implement guidance; its principal role is as a banker ("prime counterparty") to around 140 central banks in their financial transactions.

The global framework for regulation of banks' capital requirements is provided by the BCBS' International Convergence of Capital Measurement and Capital Standards: A Revised Framework,

known as Basel II. Basel II contains three distinct elements or 'pillars' relating to regulation of banks:

- Pillar 1: **Minimum capital requirements** which outlines the constituents of banks' capital and various approaches to calculation of minimum requirements for three classes of risk: credit risk, market risk and operational risk. Approaches for credit risk and operational risk vary, from simple ratios at one end to advanced approaches to probability of losses from these risk types based on internally-generated and calibrated probabilistic and stochastic models, which require supervisory approval prior to use at the other end. Pillar 1 also outlines a series of conditions of approval of more sophisticated approaches relating to rigour of analysis and application of models within the firm.
- Pillar 2: **The supervisory review process**, which introduces a requirement for firms to undertake a comprehensive assessment of risk and prudential capital requirements and provides the terms on which supervisors will review and, if they consider it necessary, adjust these calculations
- Pillar 3: **Market discipline**, under which institutions are required to disclose information relating to their risks, risk management practices and capital adequacy.

Basel II is 347 pages in its current incarnation (including 11 Annexes) and some 826 paragraphs. Of those, only two refer to reputation or reputational risk. These are (emphases added):

PILLAR 1

A. Definition of operational risk

644. Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, *but excludes strategic and reputational risk.*

PILLAR 2

Other risks: Although the Committee recognises that 'other' risks, such as *reputational* and strategic risk, are not easily measurable, *it expects industry to further develop techniques for managing all aspects of these risks.*

and that is it.

There is no evidence that the expectation expressed by BCBS that industry should 'further develop techniques for managing' reputational risk has been fulfilled. The simple truth is that use of Pillar 2 by institutions and supervisors has not been effective in driving either adequate levels of prudential capital in risk elements not covered by Pillar 1 (including but not limited to reputational risk) or in driving management attention or analytical skill levels and 'organisational competence' in those non-Pillar 1 risks (including but not limited to reputational risk). The lack of attention to reputational risk was noted in an earlier (2003) BCBS paper:

Only a few institutions include reputational risk in their economic capital methodology. Most firms exclude it because it is difficult to quantify and it is not perceived as a separate risk; rather, it results from the occurrence of other risk events.²

The Committee of European Banking Supervisors interprets EC directive and provides commentary on BCBS rules. In a paper on Pillar 2 implementation in January 2006, CEBS greatly increased the references to reputation and reputational risk, including the following definition:

² BCBS / The Joint Forum, *Trends in risk integration and aggregation*, August 2003, p.22

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Reputation risk: the current or prospective risk to earnings and capital arising from adverse perception of the image of the financial institution on the part of customers, counterparties, shareholders, investors or regulators.

CEBS made it clear in that paper that reputation(al) risk should be addressed under Pillar 2 processes, known as the individual capital adequacy assessment process or ICAAP. Immediately following that paper, the UK's Financial Services Authority published a consultation paper which listed the elements required to be considered in a firm's ICAAP (based largely on earlier – May 2004 – work by CEBS). That list included:

<p>Element 1 Adequacy of Pillar 1 risks</p>	<ul style="list-style-type: none"> • Credit risk • Market risk • Operational risk
<p>Element 2 Risks not fully covered under Pillar 1</p>	<ul style="list-style-type: none"> • Residual risk • Securitisation risk • Underestimation of credit risk (model risk)
<p>Element 3 Risks not covered by Pillar 1</p>	<ul style="list-style-type: none"> • Interest rate risk in the banking book • Concentration risk • Liquidity risk • Settlement risk • Reputation risk • Strategic risk • Underwriting risk • Pension risk • Transfer risk • Underestimation of credit risk using standardised approach • Weaknesses in credit risk mitigation
<p>Element 4 External factors</p>	<ul style="list-style-type: none"> • Business risk (earnings and costs) • Strategy • Economic and regulatory environment

By the 2009 paper, BCBS had amended the definition of reputational risk. At para. 48 of the 2009 paper, BCBS defines reputational risk as follows:

. . . 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 (eg. through the inter-bank or securitisation markets). Reputational risk is multidimensional and reflects the perception of other market participants.

BCBS then qualifies this definition:

Furthermore, [reputational risk] exists throughout the organisation and exposure to reputational risk is essentially a function of the adequacy of the bank's internal risk management processes, as well as the manner and efficiency with which management responds to external influences on bank-related transactions.

The initial part of this definition lists potentially economically relevant parties (often referred to as “stakeholders”, which we will use hereafter for convenience) whose perception may be relevant to or impact the institution:

- customers
- counterparties
- shareholders
- investors
- regulators

While a comprehensive list of stakeholders is seldom useful, *debt-holders* and *analysts* and *employees* and *supervisors* belong on this list. It is, however, useful to distinguish between direct-exchange stakeholders (with whom the bank directly transacts) and influencers (who influence direct-exchange stakeholders)³.

The latter part of para. 48 asserts that exposure to reputational risk is . . .

- a function of the adequacy of the bank’s internal risk management processes, [and]
- the manner and efficiency with which management responds to external influences on bank-related transactions

However, this definition does little to assist firms to understand reputational risk and how to manage it effectively, including how to provision capital for it. First, even a properly adequate internal risk management (and control) process may result in actions (or lack of actions) by staff that attract negative response externally; that is part of doing business. Secondly, the meaning of the second part is unclear and provides no guidance for firms. Thirdly, the point that reputational risk may (in some circumstances) be a ‘second-order’ effect is implied in the statements, but only addressed specifically in para. 54:

54. Bank management should have appropriate policies in place to identify sources of reputational risk when entering new markets, products or lines of activities. In addition, a bank’s stress testing procedures should take account of **reputational risk** so management has a firm understanding of the consequences and **second round effects of reputational risk**. (*emphasis added*)

This idea is captured in the definition given in CEBS sister organization for insurance supervision, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). CEIOPS’ November 2008 *Issues Paper on Implementing Measures on System of Governance under Solvency II* (the EC-authored insurance equivalent of Basel II for insurers) states:

6.76. Reputational risk is defined as the risk of potential loss to an undertaking through deterioration of its reputation or standing due to a negative perception of the undertaking’s image among customers, counterparties, shareholders and/or supervisory authorities. **To that extent it may be regarded as less of a separate risk, than one consequent on the overall conduct of an undertaking**. (*emphasis added*)

The impact of this point is acknowledged in one recent major industry analysis of the financial markets crisis, which states that most analyses of . . .

³ See, for example, Keith MacMillan et al., Giving your organization SPIRIT: An overview and call to action for directors on corporate governance, corporate reputation and corporate responsibility, *Journal of General Management*, Vol. 30 No. 2, Winter 2004, figure 1, p.20

. . . the events of the last 12 months have focused on the inability of firms to see the totality of the risk they faced [**and to provide prudential capital against these risks, as envisaged by Pillar 2**]. This problem was the result of several causes, including: (1) inadequate risk aggregation systems, (2) systems or processes that did not pull together all exposures because they were viewed as outside the scope of the firm's risk, (3) siloed business or risk management units, and (4) simply a lack of understanding.⁴

In relation to reputation, all these problems are likely to have been present in some, if not many, firms fully five years after BCBS' original exhortation in Basel II.

Response of national regulators and, as a result, supervisory attention to the BIS exhortation of 2004 in relation to reputational risk has been both inadequate and insufficient, at least in jurisdictions with which we are familiar. For example, UK guidance on implementing ICAAP omitted reference to reputation and reputational risk completely in some documents⁵ and referred to it only in passing in others.⁶

Also, as BIS and many other commentators note, recent failures among institutions perceived to operate leading-edge risk management systems, which were caused at least partly by failure properly to address reputational risk, attest to the inadequacy of response by institutions to BCBS' exhortation to 'develop further techniques' in assessment, analysis and management of reputational risk.

This raises the question of whether reputational risk management is meaningful or can ever be effective. The point is put forcefully by Power (2007):

In the emerging field of disparate reputation management practices, it is increasingly difficult to distinguish strategies for the management of primary or first-order risks . . . from the management of institutional risks arising from the management process itself. A new kind of risk management has internalised and absorbed this tension; reputation permeates approaches to risk, so much so that the distinction between primary and secondary risk is now unclear. The new risk management is characterised by an emphasis on the possibility of account-giving [to third parties]. Arguably, reputational effects may arise from and be attributed to anything and everything.

In parallel with the BCBS paper enhancing Basel II, BCBS released a paper on improving stress testing – the technique of using increasingly rarely observed events to determine levels of prudential capital to be held. Combined with scenario analysis – invented scenarios for original or emerging conditions for analysis of prudential capital requirements – stress testing also emerged as a favoured topic among recommendations for reform in analyses of the credit crunch and market 'turmoil'.

The BCBS consultative document *Principles for sound stress testing practices and supervision* includes multiple references to reputational risk, as well as its views on appropriate treatment of reputational risk in a firm's scenario and stress testing programmes for Pillar 2 prudential and economic capital calculations. Yet the discussions in the BCBS' stress testing paper are not referred to in the BCBS Basel II enhancements paper. This is a curious omission.

Counterparty Risk Management Policy Group III, *Containing Systemic Risk: The Road to Reform*, August 6, 2008

⁵ UK Financial Services Authority, *ICAAP submission: suggested format*, November 2007

⁶ UK Financial Services Authority, *CP 06/3 Strengthening Capital Standards 2*, February 2006

However, simply addressing stress-testing guidelines and resulting economic capital provisions does not, in itself, improve the management of a firm's reputation or its reputational risk management. As BCBS (2003) notes:

. . . capital alone is unlikely to provide an adequate safeguard against the damage to the franchise that might result from an event that impairs the firm's reputation.⁷

The case for BCBS, in the Basel II enhancements paper or elsewhere, to provide guidance on reputation management and reputational risk management is strong. Unlike, say, a credit loss, capital provisioning does not address the damage to reputation; the effects in reduced performance – effectively a reduction in *relational capital* – are on-going until the firm's reputation is restored, at least relative to its peers.

THE IMPACT ON THE REPUTATION MANAGEMENT INDUSTRY

However, the inclusions we recommend here, and have recommended to BCBS in response to its Basel II enhancements paper, are unlikely to be incorporated in to the final BCBS guidance, whenever it may emerge. Instead, it appears likely that BCBS will persist with its current definition. This will give rise to a bifurcation in reputational risk and related practice:

- On the one hand, the 'normal' approach to reputation risk based on identifying strongly with existing methods
- And on the other, capital-focused, implicit support definition of reputational risk related to securitisation and use of off-balance-sheet vehicles in banking with an emphasis on stress testing to determine capital requirements for ICAAP under enhanced Basel Pillar 2 requirements

This represents an enormous challenge to the reputation management 'industry': As Power (2007) states:

"Reputational management practices are hybrid, and often contested, constructions from different elements of knowledge. While this is true to some extent of all managerial practices, the term 'reputation management' is not yet fully institutionalised as a practice category, even for consultancy organisations where this would be expected and where metrics have been developed. Without something like the regulatory backing for operational risk, the field of reputational management remains an archipelago of different labels, categories and sub-areas."

The difficulty for reputation management is that now, when the regulation emerges in the sector in which risk management is most keenly developed and debated, financial services, backed by the impetus of the deepest financial crisis in living memory, it circumvents the majority of existing practice in risk management and focuses on 'the numbers' and analytical models. Silence on more traditional focuses of reputation management practice spells death.

The problems this causes are two-fold:

- Problems for the reputation management industry, and
- Problems for the banking sector

⁷ BCBS / Joint Forum (2003), p.22

Problems for the reputation management industry

Already struggling with the disciplinary challenges described by Power (2007), above, reputation management will now face the challenge of analytical reputation risk management – stress testing for reputation effects. This may well displace other types of reputation management both in terms of regulatory and management attention and media coverage. Furthermore, by ‘missing out’ on the evolution that such analysis represents, the reputation management industry misses the single largest opportunity for legitimacy in its history.

Schon (1983) notes three components of professional knowledge:

1. an *underlying discipline* or *basic science* component upon which the practice rests or from which it is developed;
2. an *applied science* or ‘engineering’ component from which many of the day-to-day diagnostic procedures and problem-solutions are derived; and
3. A *skills* and *attitudinal* component that concerns the actual performance of services to the client using the underlying and applied knowledge.

Prof. Power is quite correct: at present, the ‘reputation management industry’ lacks these components. Without the ability to contribute comprehensively to the debate on enhancing banking firms’ management of reputational risk through contribution to the analysis of capital requirements, reputation managers will lose relevance. That loss of relevance will not be recovered quickly.

Problems for the banking sector

No other sector is as desperately in need of meaningful tools and techniques to enhance its reputation as the banking sector; as noted earlier:

. . . capital alone is unlikely to provide an adequate safeguard against the damage to the franchise that might result from an event that impairs the firm’s reputation. (BIS / Joint Forum, 2003)

Rebuilding that franchise cannot be achieved through focusing analytically on capital requirements associated with reputation. If banking regulators confine their observations on reputational risk to capital issues associated with implicit support for off-balance-sheet vehicles, they will do the industry a disservice. Greater guidance on managing reputation and risks to reputation is vital.

Without clear guidance on *reputation*, *reputational risk* and *management of reputational risk*, development of approaches in industry has been almost non-existent, which has contributed to the failures of institutions during the current crisis. Without clear guidance, it remains unlikely that effective reputation management and reputational risk management approaches will develop spontaneously in industry. While the BCBS Basel II enhancements paper clearly identifies implicit guarantees as an area for analysis of reputational risk exposure and advocates enhanced analysis of this exposure – effectively *reputational risk analysis*, the discussion is neither broad enough nor sufficiently focused on the extent and boundaries of reputation and reputational risk to encourage development of a meaningful response by the industry, as envisaged in the 2004 guidance on Pillar 2.

For national regulators, firms themselves and their supervisors to address the vital issue of reputational risk more fully, BCBS must provide more fulsome guidance than is offered in the final version of the BCBS Basel II enhancements paper.

AN ALTERNATIVE PRESCRIPTION FOR THE BANKING SECTOR

Because it relates to perception of the firm by stakeholders, reputation is, as noted, often a second-order effect of other risks – “it results from the occurrence of other risk events,” as noted by BCBS (2003), quoted above⁸. Reputation acts on other risks in certain ways: reputation **amplifies** other risks by increasing the effect of an event or other impact, because it . . .

- translates risk between classes of risk
- transmits other risks across stakeholder groups
- accelerates risk impact

As a consequence, reputation cannot be managed like other risks; but, in common with other risks, it must still be managed actively and consciously. By its nature, reputational risk is unpredictable and chaotic; therefore, it does not yield to the usual probabilistic analysis of risk. SSG notes this point explicitly in relation to the early stages of the current financial crisis:

Regardless of whether firms had employed firm-specific or market-wide scenarios, their contingency funding plans generally assumed severe stress events and were not designed to address conditions in which they would need to make business decisions to maintain their reputation and position in the market Firms had also not anticipated the need to deal with intense media coverage or to incorporate reputational risk considerations into funding decisions.⁹

While many institutions have developed tactical responses, such as crisis-related communications capacities, public relations programmes and corporate social responsibility programmes, very few institutions have adopted reputation management and reputational risk management approaches which are integrated in nature or strategic in focus.

Because reputational risk is, in effect, a *transmitter* and *amplifier* of other risks (including sometimes external risks – through contagion effects), management of reputational risk requires, relative to other risk types, a more integrated and strategic approach from firms in relation to the expectations and perceptions they allow and encourage stakeholders to form, through their actions and communications. Without such integrated, strategic programmes within firms, the management of reputation – and the risks associated with reputation – will not rise above the tactical efforts referred to, and will not align firms’ behaviour – its peoples’ actions, its products or its processes and systems – to the expectations of its stakeholders in its markets. Hence, if limited to tactical programmes only, management of reputation fail to contribute materially to the effective management and sustained performance of banking and securities firms.

ORGANISATIONAL CHALLENGES IN REPUTATIONAL RISK MANAGEMENT

Unlike other risk types, especially those addressed by Pillar 1, there is typically no organisational function responsible for the firm’s reputation or risk to its reputation. Because reputational risk is often a second-order effect, for firms robustly and properly to address reputational risk requires a degree of cross-functional co-ordination that differentiates reputational risk from other risk types.

Effective reputational risk management not only requires a firm to adopt an integrated and strategic approach to its reputation, but also to consider risks to reputation across and between ‘first-order’ risk types and in relation to all relevant stakeholders. It requires a clarity of organisational agenda

⁸ BCBS / Joint Forum (2003), p.22; see fn 11, above.

⁹ SSG (2008), p.12

that supports alignment of key messages of the firm across stakeholder groups and throughout the firm itself to support reinforcing relationships with and between stakeholder groups.

Responding to reputation issues or events requires a detailed understanding of different stakeholders' perceptions before the event (which is typically external from the organisation) occurs. Whether the stakeholders are internal or external, data to support such a detailed understanding is time-consuming and expensive to gather and complex to interpret.

From this understanding, the organisation must determine the **drivers** of reputational risk across and within stakeholder groups. These drivers are the gaps between stakeholders' expectations of a firm's behaviour and their perception of its behaviour as they experience it directly or indirectly through media and other information sources, and how motivated to action – and to which actions – are the stakeholders by their perceptions and the expectation/perception gap. These *transmitters* and *amplifiers* of reputational risk are where the firm needs to respond to reputational risk once a *reputation event* has been observed. However, without foreknowledge of drivers and transmitters/amplifiers, effective response to a reputation event will be problematic. Understanding these drivers and transmitters/amplifiers is the focus of a reputational risk management programme.

REPUTATIONAL RISK MANAGEMENT PROGRAMME ELEMENTS

To implement an effective risk management programme requires the following steps:

- A. *Understanding the current reputation of the firm in its stakeholder groups.* Many firms will already hold valuable information on stakeholders' expectations and perceptions of the firm. These need to be understood more fully in terms of drivers and transmitters/amplifiers through review of existing research or commissioning new research to fill the gaps.
- B. *Valuing the firm's reputation and assessing risks to that value.* This can take a range of forms depending on the requirements of the firm and the information available. It involves understanding the contribution of the firm's reputation to its value creation and can be measured absolutely or relatively (where it may be positive or negative). BCBS places considerable emphasis on stress testing which forms an invaluable part, but only a part, of a robust reputation valuation and risk analysis.
- C. *Defining clear objectives for the firm's reputation and strategies for achieving those objectives.* Only by defining the firm's objectives for reputation in its respective stakeholder groups and key subsets within those groups can a firm control the reputation agenda across its stakeholder community. The agendas must be aligned and complementary – reputational risk transmits risk across stakeholder groups; they must be credible and realistic, otherwise incredulity from one stakeholder group can easily transmit to another (for example, financial analysts marking down a company for unrealistic growth plans in a market which is skeptical about the firm's products or service levels); performance on progress on the agendas must be observable and measurable.
- D. *Setting realistic and meaningful plans and delivering against them.* This requires alignment of people, processes and products and services, and an integrated programme of message formulation and communication inside the firm and into its markets with consistent and complementary messages being communicated. The better the

integration of change initiatives, agendas and messages, the more the transmission effects of reputation will produce a positive impact for the firm. Also, the firm must have tracking systems in place to track comment in commercial and social media and clear response plans to react should reputation be threatened.

- E. *Monitoring both impact on reputation and reputation value, linked to refinement of objectives, delivery tactics and plans and to additional information/research needs.*

Those are necessary preconditions for effective reputational risk management. In style, they are more similar to cross-firm capital management to management of a single risk type.

CONCLUSIONS

For the reputation management industry to contribute effectively to rebuilding the reputation of the banking sector as a whole and as individual institutions, both need to change – both their current paradigms and their proposed approaches to development. First, the reputation management industry must adapt and evolve to understand the disciplines of the financial services sector and analysis of risk therein. It can only do this by professionalizing and by attracting analytical expertise capable of mastering both the existing frameworks for management of reputation and the quantitative approaches of the banking sector to analysis of risk generally and reputational risk specifically.

Secondly, currently proposed regulatory instruments relating to reputational risk in the banking sector should be broadened to look to future reputational risk events as well as historic ones. While the issue of implicit support for off-balance-sheet vehicles has been singular in scale and disruption, other reputation issues exist and must be addressed by regulation and by regulatory capital.

Thirdly, financial institutions must recognize that addressing the second-order risk of reputation involves cleaning house – addressing the underlying drivers of poor reputation. If it is to recover its standing in the public's perception, the banking industry and individual institutions must address the causes of public anger ranging from pay practices for traders to speed of payments processing to transparency of charges, etc.

Fourthly, banking regulators, supervisors, shareholders and executives must address a system that has demonstrably failed at one of its principal objectives: management of risk. The causes of the failure are complex, but the issue of the competence of directors to oversee enormously complex financial instrument and corporate structures **must** be addressed. The cost to taxpayers of recent bank failures and requirements for socialized risk holding through capital injections necessitate that fundamental changes be made to the ways in which banks assume and spread risk.

Fifthly, both 'the reputation management industry' and banking sector participants must recognize that external representation of a 'return to normalcy' will achieve no greater or lasting benefit than it did when Herbert Hoover coined the phrase in 1920. Simply boosting the public image of the banking sector through public relations campaigns will simply delay progress and limit profitability. Real and meaningful changes are required in firms' understanding of risk – particularly in relation to structural and behavioural aspects of risk management. Without improved regulatory focus, supervisory attention and management commitment, real change will not occur. Attempts to

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represent superficial change as more meaningful will founder amid unprecedented legislator and customer skepticism, and will simply damage both industries.

The current crisis is an unparalleled opportunity for reputation management to establish itself as an effective contributor to the process of (re-)building corporate value in the devastated banking industry. To realize it will take vision, determination and a commitment to professionalism that have often been lacking to date.

Biography

Peter Bonisch

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Peter one of the UK's leading advisors on risk governance in financial services and corporate sectors. He works with boards of directors and senior executives on improving their governance processes around risk and assurance, and on enhancing and protecting corporate reputation.



Peter is a former National Director of Assurance Services for Ernst & Young in New Zealand, where he was also President of the Institute of Internal Auditors. He has worked internationally with leading clients on risk management and lectures in the UK on corporate governance.

From 2008 – 2009, he was a partner in the UK's leading corporate governance advisory firm, and was managing director of a London-based risk and assurance consultancy from 2002 to 2005.

His earlier experience includes senior roles in investment banking, telecommunications, insurance and banking firms, and is a former micro economist for NZ Treasury. He subsequently advised firms across all financial services sectors, in a wide range of corporate sectors and for variety of government agencies. He has advised companies in UK and Europe, South Asia and East Asia, Australasia and North America.

Peter has a post-graduate degree in international relations. He is a Fellow of the Securities & Investment Institute and sits on their Advanced Operational Risk Advisory Panel. He is a regular contributor to debates on governance, risk and control in the UK and Europe.