Defining and Managing Reputation Risk

IIB Risk Management-Compliance Seminar
Managing Reputation Risk in an Internet World

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Defining Reputation Risk

- What is reputation risk and why is protecting against reputation risk so important for international banks?
- What is “reputation”?
  - Reputation is an intangible asset. As described in one Federal Reserve Bank’s statement, reputation could be perceived as “synonymous with goodwill, but . . . . more difficult to measure and quantify.”
  - “It takes years to build a reputation and minutes to destroy it.”
Defining Reputation Risk

- Basel Committee (2001) — Reputation risk is “the potential that adverse publicity regarding a bank’s business practices and associations, whether accurate or not, will cause a loss of confidence in the integrity of the institution.”

- Basel Committee (2009) — “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.”
Defining Reputation Risk (cont’d)

– FRB Commercial Bank Examination Manual defines reputation 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.”

– Reputation risk may result from or create credit, liquidity, market and legal risk.

– The speed and scope of internet communications can magnify the risks or enhance the benefits of a reputation event.
Benefits of Strong Reputation

- Benefits to an International Bank of a Strong, Positive Reputation
  - Resilience in the event of crisis
  - Strong customer base and business relationships
  - Strong market position and increased shareholder value
  - Lower cost of funding; strong capital position
  - Lower risk of litigation, fines and penalties
  - Loyalty of shareholders and clients
  - Ability to attract and retain top notch employees

- Events can damage a reputation, but a strong reputation can have a positive influence on how an event is interpreted.
Risks from Loss of Good Reputation

- Consequences of Loss of Good Reputation
  - Loss of current and future customers
  - Exit of key employees and managers; inability to recruit top talent
  - Loss of current or future business partners
  - Increased costs of funding in credit or equity markets; loss of market capitalization
  - Loss of revenue
  - Decline in stock price and shareholder confidence
  - Fines, penalties, and/or litigation
  - Decline in global recognition and prestige
  - Years of effort required to recover and rebuild good reputation.
Factors that May Threaten Strong Reputation

- Key Threats to a Strong Reputation
  - Internal fraud and mismanagement
  - Formal enforcement actions and penalties due to regulatory noncompliance
  - Data security or privacy breaches
  - Poor product/service quality or financial performance
  - Business associations with parties that have tarnished reputations
  - Negative publicity from social media
  - Business practices that might be perceived as unethical
  - Lawsuits; adverse judgments
  - Ineffective responses to unexpected external events
A Good Reputation May be Destroyed Quickly

- Although a good reputation takes much time and effort to build, it can seemingly be destroyed in an instant.
- Special challenges to managing reputation risk presented by the Internet
  - Instantaneous travel time for positive and negative information that can reach a broad audience
  - Possibility that negative publicity will have an immediate effect on share price, market capitalization and liquidity
  - Possibility that an adverse internal or external event anywhere in the world will result in immediate, significant damage to reputation on a global basis
  - Influence of social media can benefit or damage a bank’s reputation
The Need for a Formal Strategy to Manage Reputation Risk

- Many executives view reputation damage as a significant risk facing their companies, but they do not always have an effective risk management strategy in place.

- Basel Committee has consistently emphasized that a strong reputation risk management program can help management respond effectively and efficiently to a crisis.

- U.S. banking regulators also view reputation management as a necessary component of a strong internal risk management program.

- There is an expectation that reputation risk management will be part of a banking organization’s enterprise-wide risk management program.
Components of a Strong Program to Manage Reputation Risk

- Identify potential sources of reputation risk.
  - Business lines, new products and activities
  - Affiliates and their operations
  - Off-balance sheet vehicles
  - Investors
  - Vendors
  - Counterparties
  - Information security systems
  - Unexpected economic, political, market or regulatory developments
  - Unanticipated consequences of business transactions or operations in other countries
Components of a Strong Program to Manage Reputation Risk

- Develop a strong corporate governance structure to manage reputation risk
  - Board of directors must exercise appropriate oversight of risk management policies and procedures — a clear and comprehensive policy statement on reputational risk (either stand-alone or part of risk management policy) needs to be endorsed by the board.
  - Maintain strong channels of communication among board of directors, senior management, employees, customers and shareholders.
  - Each of the risk management, compliance and audit functions should develop and implement appropriate policies and procedures to manage reputation risk.
Components of a Strong Program to Manage Reputation Risk

- Develop robust policies and procedures to support a strong reputation.
- Develop and enforce a strong code of ethics.
- Develop a culture of compliance based on comprehensive internal controls and practices; comply with current laws and regulations.
- Make consideration of reputation risk a part of decision-making process for new business initiatives.
- Identify possible reputation risk events, their potential impact and appropriate mitigation or corrective measures.
Components of a Strong Program to Manage Reputation Risk

- Develop a **crisis management program** to mitigate consequences of a particular reputation event
  - Board of directors and senior management should oversee development and implementation of crisis management program.
  - Appoint a crisis management team that is authorized to act quickly when necessary.
  - Work with public relations specialists and experts as appropriate, pro-actively as well as in a crisis situation.
  - Develop crisis scenarios and specific plans of action.
Components of a Strong Program to Manage Reputation Risk

- Develop reputation risk awareness among officers and employees.
- Convey the importance of discretion to employees when using social media – set expectations through a formal social networking policy.
- Support reputation risk awareness at all staff levels; train employees to identify and respond to reputation risk.
Components of a Strong Program to Manage Reputation Risk

- Develop a plan to monitor media reports and internet communications about events that might affect bank’s reputation
  - Make certain that monitoring of external media reports and events includes a continuing review of internet sources that might convey negative information or perceptions -- blogs, Twitter, Facebook.
  - Monitor home country media as well as U.S. media.
Components of a Strong Program to Manage Reputation Risk

- Develop a **communications strategy** for crisis situations
  - Acknowledge concern
  - Express commitment
  - Fully address the situation and outline plans to prevent recurrence
Cross-Border Issues

- A strong program to manage reputation risk needs to acknowledge and address potential cross-border reputation risk issues.
- Differing regulatory cultures and expectations.
- Extra-territorial aspects of new rules and regulations.
Cross-Border Issues

- Key Head Office personnel need a clear understanding of cross-border risk that may result from differing regulatory expectations in home country and United States:
  - Foreign Corrupt Practice Act (“FCPA”) issues
  - Office of Foreign Assets Control (“OFAC”) issues
  - Dodd-Frank Act compliance issues
  - Data security and privacy laws and issues
  - Increased risk of U.S. enforcement actions from more “activist” CFTC and state regulatory agencies
Cross-Border Issues

- Key U.S. compliance, business line and management personnel need to understand any important differences between home country and U.S. regulatory requirements and expectations.
  - Need to convey the importance of understanding and following U.S. rules with respect to U.S. activities.
  - Need to work with Head Office to develop appropriate cross-border approaches.
- Liaison committees between Home Office and U.S. operations can plan a very important role.
- Some banks have informal boards or committees that have some oversight responsibility and also provide a mechanism for strong communication.
Even the strongest reputation risk protection measures can break down under the extreme pressure of sudden, unexpected internal or external events.

The challenges of developing an appropriate response are greatly magnified in the current era of instantaneous communications.

While preventive measures are clearly prudent, it is also essential to have a strong crisis management approach that can be implemented immediately if a reputation risk event occurs.
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