Reputational Risk Management in Financial Institutions

Book Presentation

Prof. Dr. Thomas Kaiser, Petra Merl
Frankfurt a. M., 30.06.2015
## Agenda

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### Introduction

- Reputational Risk is an emerging topic in today’s business world that a corporation has to deal with.
- In the post-crisis environment, financial institutions have suffered from tremendous losses in one of their key assets, reputation.
- This raises the question to which extent institutions should implement and impose suitable structures to better manage this form of risk.

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### BACKGROUND

- Reputational Risk Management in Financial Institutions is meant to contribute towards the evolution and development of Reputational Risk Management as a new risk discipline. With the increase of regulatory scrutiny in this area, the demand for a practical guide to the potential pitfalls of managing this very capricious and hard-to-quantify risk has increased.

### STATUS QUO

- While some major financial institutions have already implemented Rep Risk Management processes, regulators have only recently started to tackle this topic (e.g. EBA SREP).
- However, in the absence of dedicated rules, regulators have started to investigate under the umbrella of Pillar II audits how banks deal with this topic, which has resulted in observations and findings.
- Major banks and insurance companies have started an exchange of ideas in Rep Risk, e.g. in the forum published by the editors.
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### Overview about the book

*Reputational Risk Management in Financial Institutions* provides illustrative case studies, tracing the history of this risk type, demonstrates best practice methodologies and processes for managing it, examines the changing regulation requirements and compliance issues, and discusses what the future holds for reputational risk in banks and financial institutions.

### Book details

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<tr>
<th><strong>Editors</strong></th>
<th>Thomas Kaiser, Petra Merl</th>
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<tr>
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<td><strong>Publish date</strong></td>
<td>28. November 2014</td>
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<tr>
<td><strong>Length</strong></td>
<td>348 pages</td>
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<td><strong>ISBN</strong></td>
<td>9781782721017</td>
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Discount code (20%): RepRiskPres
## Part I: Reputation and Reputational Risk Management

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<td>Sergio Scandizzo</td>
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Background of the Reputational Risk Survey

■ Reputational Risk (RepRisk) can be defined as the risk of unexpected losses due to stakeholder reactions triggered by changed perception of a company. The list of stakeholders comprises amongst others customers, employees, counterparties, shareholders and regulators.

■ KPMG has conducted a survey amongst the Global Systemically Important Banks (G-SIBs) in late 2013 and early 2014. Out of the 28 G-SIBs, as of March 2014 responses for nine have been collected. They cover all major geographical areas (Europe, North America and Asia) to a similar degree. Due to the relatively small number of responses, the survey should not be seen as fully representative. Also a differentiation of the results by region was not feasible.

■ The results of this global Survey have been compared to those of a broader, but geographically more focused KPMG reputational risk study which was conducted and published in 2012. This latter survey also aimed to illustrate the ‘current’ state and planned activities of reputational risk management, but with only leading German financial institutions as its foundation. The questionnaire has been completed by 18 institutions out of the 23 firms that were asked to participate. Thirteen participants belong to the 20 biggest banks in Germany, while the remaining five were made up of medium-sized banks and building societies.

■ Due to the financial crisis, regulators start to have a closer look at RepRisk management.
Due to the interdependencies with operational risk and other risk types, reputational risk should be treated in a comprehensive manner.

- **Credit Risk**: Loss resulting from defaults
- **Market Risk**: Trading loss
- **Operational Risk**: Loss resulting from operational failures
- **Liquidity Risk**: Loss due to liquidity shortage
- **Business Risk**: Loss of customers / business
- **Reputational Risk**: Consequential risks from reputational risk, mainly business, liquidity and operational risk
Question 1: How did you define RepRisk? (Global and German Study)

As a basis for managing reputational risk, this risk type has to be clearly defined, including boundaries to other risk types. At the time of writing there is no market standard for this. Two thirds of the surveyed institutions define reputational risk as an independent risk category both for the G-SIBs as well as for the German study. The majority of the remaining third define reputational risk as consequential risk. It is recommended therefore that attention be paid to reputational risk as a trigger of other risks.
Question 2: Did you classify RepRisk as material in your risk inventory? (German Study)

According to the revision of the German Minimum Requirements for Risk Management (MaRisk) dated 15.12.2010 banks have to conduct a risk inventory. This includes classifying materiality of the risk types assessed. In light of the financial crisis and the loss of trust associated therewith it is not surprising that the majority of banks treat RepRisk as material.

- Yes: 61%
- No: 28%
- RepRisk not included in risk inventory so far: 11%
Question 3: How did you include RepRisk in the risk strategy? (German Study)

A risk strategy is a starting point for managing risks effectively. The RepRisk strategy should be closely linked with the business strategy and aligned with the strategies for other risk types. The results show a tendency to include RepRisk in existing overarching risk strategies.
Employees at all levels have to contribute to the management of reputational risk. An appropriate risk culture and awareness amongst employees is needed for that. That necessity has been recognized by most of the polled banks and has been implemented by a variety of instruments.

* e. g. guidance on complaints management, manuals, policies, presentations to management
Management of RepRisk towards the Stakeholders

The expectations of single stakeholder groups diverge, which may create reputational risk.

<table>
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<tr>
<th>Stakeholder</th>
<th>Expectations (examples)</th>
<th>Potential reputational risk</th>
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<tr>
<td>Employees</td>
<td>Salary, appreciation, career</td>
<td>Quality issues may lead to low perception of the company</td>
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<tr>
<td>Shareholders</td>
<td>Higher share price, dividends</td>
<td>High credit losses lead to drop in share price</td>
</tr>
<tr>
<td>Creditors</td>
<td>Good risk/return profile</td>
<td>IT failure leads to loss of trust</td>
</tr>
<tr>
<td>Customers</td>
<td>Quality, service</td>
<td>Bad service reduces interest by potential customers</td>
</tr>
<tr>
<td>Business partners</td>
<td>Reliance, support</td>
<td>Erroneous contracts lead to loss in trust</td>
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<tr>
<td>Competitors</td>
<td>Fair play</td>
<td>Unfair competition leads to reactions by competitors</td>
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<tr>
<td>Social environment</td>
<td>CSR projects, donations</td>
<td>Misdirected CSR projects lead to negative perception</td>
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<tr>
<td>Rating agencies</td>
<td>Disclosure, communication</td>
<td>Misleading information leads to negative perception</td>
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<tr>
<td>Lobbying groups</td>
<td>Sustainability etc</td>
<td>Outsourcing to low-cost countries leads to reaction by lobbying groups</td>
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<tr>
<td>Fund managers</td>
<td>Higher share price, dividends</td>
<td>Lawsuit due to misselling leads to loss in trust</td>
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<tr>
<td>Regulatory authorities</td>
<td>Compliance</td>
<td>Breach of money laundering law leads to negative perception</td>
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Question 5: Which stakeholders did you prioritize within your RepRisk management framework? (Global and German Study)

The study found that only 50 percent of the G-SIBs and 60 percent of the German banks have already prioritized their stakeholders. German banks gave the highest priority to customers whereas employees only have a low priority. The survey shows that the G-SIBs have a different point of view as they categorized not only customers, but also employees and regulators with a high priority.
Question 6: How did you include RepRisk in risk committees? (German Study)

Reputational risk is of bankwide concern. Regular exchange across business units regarding actual events, potential risks as well as mitigation actions are thus very beneficial. In light of increased importance of risk concentrations and dependency structures in Economic Capital models a strong link to decision-making bodies is needed.

* e.g. executive committee, fraud committee
Possible Organizational Structure for RepRisk

Generic organizational structure

- Executive Board
- Risk Committee
- Business units
  - Unit 1
  - Unit 2
  - Unit 3
- Corporate communication
  - Public relations
  - Public affairs
  - Internal communication
- Special departments
  - Legal / Compliance
  - Human resources
  - IT
  - Marketing
  - Business management
- Risk controlling
  - Reputational risk
  - Operational Risk
  - Market risk
  - Credit risk
- Internal audit
- Risk management
- Risk control
- Audit
Question 7: How did you embed RepRisk into the organization? (Global and German Study)

There is no common approach to the 2nd line of defence for RepRisk. As reputational risks arise often as a consequential risk of operational risks, it is not surprising that the institutions try to benefit from the effects of the synergy that would occur when embedding reputational risk within the control and management of operational risk.
Question 8: How do you conduct risk identification and qualitative risk assessment? (Global and German Study)

Effective management of reputational risk should be based on systematic identification and assessment of material risk. Banks have some focus on self assessments in that regard. Linking the identification and assessment of reputational risk to the instruments used for operational risk can be an option to achieve this.

*e.g. expert opinions, interviews with Senior Management, risk inventory, media and social media screening*
Knowledge on materialized reputational risk is a key ingredient to risk management. The collection of reputational risk losses/events is currently still in a development phase at some banks. Similar to operational risk, some banks see value in external loss databases as well.

* e.g. collection of newspaper articles in OpRisk loss data base, social media monitoring

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Question 10: How did you define materiality thresholds? (German Study)

Identifying and assessing all reputational risks is neither possible nor useful. Using materiality thresholds helps to have the right focus. Only few banks have defined materiality thresholds yet, most of which are of a qualitative nature.
Early warning systems are no yet highly prioritized by the polled banks. This might be due to the immature nature of the discipline. Also resources are often not yet sufficient to cover those types of activities despite the value they might add.

* e.g. new product process, media screening
Question 12: How did you consider RepRisk in the risk bearing capacity concept? (Global and German Study)

In general, material risks have to be included in a bank’s risk bearing capacity concept. Otherwise their exclusion has to be properly reasoned. The global study shows that the G-SIBs consider reputational risk as an individual buffer, but most of them have no explicit model in their risk bearing capacity. In contrast, German banks do consider reputational risks to be part of an overarching buffer.
Question 13: How did you include RepRisk in Stress Testing? (German Study)

Stress tests for reputational risk is not yet a prioritized topic in the polled banks. As reputational risk typically materializes in other risk risk types (mainly business risk, liquidity risk and operational risk), including reputational risk in the stress testing of those risk types is probably the most straightforward way of implementation.
Preventing and reacting to events that affect public opinion are part of reputational risk management.
Question 14: How did you include RepRisk in risk management/mitigation? (Global and German Study)

The reputational risk management framework should focus on active management/mitigation of those risks. The majority of the German banks declared that they have defined the roles of dedicated organizational units whereas only 10% of the G-SIBs have any such defined roles, however the inclusion of reputational risk within risk management is explicitly planned in particular. Those institutions who are planning to extend their reputational risk framework intend to enhance the role of the decentralized operational risk manager, or to include reputational risk management within crisis management.

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<thead>
<tr>
<th></th>
<th>Global Banks</th>
<th>German Banks</th>
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<tr>
<td>Defined roles of units</td>
<td>60%</td>
<td>10%</td>
</tr>
<tr>
<td>Enhanced role of OpRisk</td>
<td>20%</td>
<td>0%</td>
</tr>
<tr>
<td>Inclusion in crisis</td>
<td>40%</td>
<td>80%</td>
</tr>
<tr>
<td>No formalized management</td>
<td>20%</td>
<td>0%</td>
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Question 15: In which transactions/change process did you explicitly include RepRisk? (Global and German Study)

Managing reputational risk can both occur on a portfolio level as well as on single processes or transactions. The latter enables banks to shape their business and transactions in a risk mitigating way. The survey revealed that the focus at the time it was conducted was on new product processes, credit business and outsourcing of course due to concrete regulatory requirements. Furthermore, the G-SIBs pay high attention to trading businesses, service providers, and corporate development projects.
Question 16: How do you report on RepRisk to Senior Management? (German Study)

Results of the identification and assessment of reputational risks as well as mitigation measures should be reported to Senior Management on a regular basis. Most polled banks focus on overarching risk reports and ad-hoc reports.
Tracking mitigation actions and their lifecycle in a database supports judging their effectiveness as well as to ensure the actual implementation. Due to the limited maturity of the topic it is somewhat surprising to see more than a third of the polled banks having such measures in place.
Conclusion

■ The management and controlling of reputational risks at the time of writing is in an early phase of development and there are different points of view concerning governance, methods and processes.

■ Setting up a reputational risk management framework is difficult when questions remain over its definition and which department should be responsible.

■ The results of the survey show that a significant number of institutions already systematically integrate reputational risk into their overall risk management, or have started to develop a risk management framework.

■ In terms of establishing a methodology for reputational risk management, the obvious approach is for banks to utilise the tools and instruments created for operational risk management and to modify them accordingly, as demonstrated in several other chapters of this book.

■ Firms should take advantage of the learning curve from operational risk – it took operational risk eight to ten years to become a relatively mature discipline, but by using existing toolsets it should probably take reputational risk less time to mature.
The methods and processes of reputational risk management could be introduced gradually.

### Possible implementation of Reputational Risk

**Reputational risk as a risk type of its own**
- Clear roles and responsibilities
- Establishment of dedicated methods and processes
- Comprehensive qualitative and, where applicable, quantitative assessment
- Systematic mitigation actions

**Analysis of all interdependencies**
- Extension of the instruments
- Consideration of the (financial) impacts of actual reputational events on other risks, e.g., liquidity
- Integration in all business activities (e.g., refinancing, new products)
- Integration in risk-return management

### Value for bank management

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<tr>
<th>Phase I</th>
<th>Phase II</th>
<th>Phase III</th>
<th>Time</th>
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**Reputational risk as a consequential risk**
- Extension of existing risk management instruments
- Qualitative assessment of reputational risk
- Case-by-case mitigation actions
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**Corporate reputation** is understood as the sum of perceptions and assessments of all relevant stakeholders of a company. Reputation means in other words, the degree of social esteem, a company enjoys for medium or long term.

### Management of Reputation

- Already established in the banking industry
- Voluntary activity aimed at maintaining and/or improving reputation in order to secure business
- Primary usage of methods from communication science (e.g. media response analysis, issue management),
- Primary task of strategic planning, corporate communications, etc.

### Management of Reputational Risk

- Systematic approaches for RepRisk management are in their infancy
- Regulatory pressure to implement RepRisk management as part of Pillar II/MaRisk requirements
- Systematic process of the definition, identification, assessment and mitigation of reputational risk
- Risk control as coordinator for activities across business areas and specialist departments
**Definition & description of Reputational Risk**

### RepRisk Definition (HVB Group)

Reputational Risk is defined as the risk of a negative P&L effect caused by adverse reactions of stakeholders due to their altered perceptions, which can in turn be triggered by the materialization of a primary risk.

Core Stakeholders are customers, employees, shareholder(s), regulators, rating agencies and creditors.

Reputational Risk can appear as a knock-on effect triggered by another risk type (primary risk), as a risk type of its own, and as a trigger for other risk types.”

### RepRisk Management

RepRisk Management: is defined as the implementation of appropriate systems & procedures aiming on prevention of RepRisks and to prevent a decline of the bank's reputation not only focusing on P&L effects.
The RepRisk Management Framework covers a part of the interactions between the business, specialist functions and crisis management, some of which are coordinated/facilitated by RepRisk Control.

- Crisis Management: already existing, no direct involvement of Risk Control in case of crisis
- Specialists are part of RepRisk Management (evaluations, votes)
- Business: is the main operative responsible for RepRisk Management within the set framework (1st line of defense)
- Op- and RepRisk Control: Responsible for framework, risk control and reporting (2nd line defense) including concept for RepRisk Framework

Petra Merl, Head of Operational and Reputational Risk, HypoVereinsbank, 30.06.2015
Overview HVB approach

Requirements

Part of firmwide risk strategy

Implementation of a RepRisk Control and extended processes for identification, measurement and reporting

New policies/ ZAD RepRisk

RepRisk definition and categories, Stakeholders

Top Risks
RepRisk Council cases

Preventive and reactive mitigation, action tracking

RTB*: Self Assessments, Senior Mgmt Interviews – CTB**: NPP transactions, SPV, projects -- stress testing.

Single case assessment, action tracking

Identification & Measurement

RTB* | CTB** | Stress Testing

ARGO-ART (IT system)

Governance

Strategy

Definitions & Structures

Reporting

Mitigation

Petra Merl, Head of Operational and Reputational Risk, HypoVereinsbank, 30.06.2015

* Run the Bank
** Change the Bank
Governance structure – follows closely existing OpRisk structures

**Reputational Risk Council**

**Strategic decisions & framework changes**

**Management Board**

**Risk Committee**

### Business Divisions & Competence Lines
- Commercial Banking
- Corp. & Investment Banking
- CEO
- Global Banking Services
- CRO
- CFO

### Specialist departments
- Corp. Sustainability
- Legal
- Compliance
- Tax
- Country Risk
- Equator Principles Desk
- Others (e.g. HR, IT)

### CMR4
- Responsibility for Methods, Tools, Processes & Reporting for
  - Reputational Risk
  - Operational Risk

### Internal audit
- Corp. Sustainability
- Legal
- Compliance
- Tax
- Country Risk
- Equator Principles Desk
- Others (e.g. HR, IT)

### Enhanced role for OpRisk Managers (ORM)

### Risk Management (1st line of defense)

### Risk Control (2nd line of defense)

### Audit (3rd line of defense)

*Petra Merl, Head of Operational and Reputational Risk, HypoVereinsbank, 30.06.2015

*including RepRisk decisions concerning NPP, projects, outsourcings and SPVs
Core and other stakeholders

- Stakeholders can be divided into those affecting the P&L directly and those impacting the P&L indirectly by influencing Core Stakeholders.
- HVB’s RepRisk Management focus is on Core Stakeholders.
- Regulatory RepRisk definitions (Basel & CEBS) also focus on Core Stakeholders.

**P&L**: core stakeholder reactions might negatively affect the bank’s P&L.

**Core Stakeholders**: changed perceptions and consequent reactions could directly affect the bank’s P&L.

**Other Stakeholders**: could affect the core stakeholders’ perceptions, and thus could have an indirect P&L effect.

Petra Merl, Head of Operational and Reputational Risk, HypoVereinsbank, 30.06.2015
Causal chain from primary risks to RepRisk P&L effect

Materialization of Primary Risk
- Credit Risk
- Operational Risk
- Market Risk
- Liquidity Risk
- Business Risk
- Strategic Risk*

Core Stakeholders
- Customers
- Employees
- Regulators
- Shareholders
- Rating Agencies
- Creditors

Other Stakeholders
- Media
- Equity Analysts
- Government
- Civil Society etc.

Stakeholder Perceptions

Stakeholder Impact/Reaction
- RepRisk Events are used as basis for stress tests on least liquidity and business risk
- Examples
  - Customers withdraw deposits
  - Counterparties lose trust and cancel agreements
  - Rating Agencies downgrade rating
  - Increased number of lawsuits due to media coverage

P&L Effect
- Mainly affected Primary Risk Types:
  - Liquidity Risk (e.g. refinancing problems)
  - Business Risk (e.g. decline in sales)

*and other risk types

Petra Merl, Head of Operational and Reputational Risk, HypoVereinsbank, 30.06.2015
# RepRisk identification tracks

<table>
<thead>
<tr>
<th>Identification &amp; Measurement</th>
<th>Embedded Mitigation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Micro-Perspective</strong></td>
<td></td>
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<tr>
<td>Transaction-oriented</td>
<td></td>
</tr>
<tr>
<td>&quot;CTB&quot;</td>
<td></td>
</tr>
<tr>
<td>(Change the Bank)</td>
<td></td>
</tr>
<tr>
<td>Business Transactions (incl. M&amp;A)</td>
<td></td>
</tr>
<tr>
<td>Special investments (e.g. SPV)</td>
<td></td>
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<tr>
<td>Outsourcing</td>
<td></td>
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<tr>
<td>New Product Process</td>
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<tr>
<td>Projects</td>
<td></td>
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<tr>
<td><strong>Macro-Perspective</strong></td>
<td></td>
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<tr>
<td>Ex-post Mitigation</td>
<td></td>
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<tr>
<td><strong>Portfolio-oriented</strong></td>
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<tr>
<td>&quot;RTB&quot;</td>
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<tr>
<td>(Run the Bank)</td>
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<tr>
<td>Self Assessment</td>
<td></td>
</tr>
<tr>
<td>Senior Management Interviews</td>
<td></td>
</tr>
</tbody>
</table>

Petra Merl, Head of Operational and Reputational Risk, HypoVereinsbank, 30.06.2015
Run the Bank Process - RepRisk Management Process

Identification & Assessment
OpRisk Manager & Risk Owners
RepRisk Control & OpRisk Manager

Consolidation & Documentation
RepRisk Control
OpRisk Manager & Risk Owners

Basics | Actions RepRisk Management | Analysis/Reporting | Data entry
--- | --- | --- | ---
Questionnaire | Self Assessments | Senior Management Interviews | Data Entry IT system (ARGO-ART)

Petra Merl, Head of Operational and Reputational Risk, HypoVereinsbank, 30.06.2015
Self-Assessment Process - basics for classification

1. Estimation of the intensity of the stakeholder's reaction (expectation)

<table>
<thead>
<tr>
<th>Generality parameter</th>
<th>Customer's</th>
<th>Creditors</th>
<th>Rating Agencies</th>
<th>Employees</th>
<th>Regulators</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Operative earnings</td>
<td>Refinancing rates</td>
<td>Downgrading</td>
<td>Fluctuation rate / hiring costs</td>
<td>Measures &amp; sanctions</td>
</tr>
<tr>
<td>Low</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medium</td>
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<tr>
<td>High</td>
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</tbody>
</table>

2. Estimation of the occurrence probability (expectation)

<table>
<thead>
<tr>
<th>Probability</th>
<th>Low</th>
<th>Medium</th>
<th>High</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>unlikely</td>
<td>possible</td>
<td>likely</td>
</tr>
</tbody>
</table>

3. Total RepRisk impact

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Change the Bank Process - process scheme

Source
- Business transaction, e.g.
  - credit application
  - payments
  - Project finance
- Other transaction, e.g.
  - New product (NPP)
  - Outsourcing project
  - Other project
  - SPV
  - M&A

Preparation of the RRC request
- The Proponent (Business manager Product manager Project manager)
  - fills request form (case description, RepRisk issues) &
  - adds attachments if needed

Risk assessment & vote
- The Specialist
  - adds the result of the risk assessment,
  - determines the case grading acc. to the threat potential &
  - votes pro or con

Decision making and communication
- Completed RRC Request
  (+attachments, if necessary)
- RepRisk Council Decision
- UCG Committee (NBO issuance)
  - Upward escalation in defined cases or in cases with group-relevance

Communication of the decision to all involved parties

Process coordinated and controlled by RepRisk Control unit

Petra Merl, Head of Operational and Reputational Risk, HypoVereinsbank, 30.06.2015
<p>| | |</p>
<table>
<thead>
<tr>
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<tbody>
<tr>
<td>1</td>
<td>Introduction</td>
</tr>
<tr>
<td>2</td>
<td>Overview about the book</td>
</tr>
<tr>
<td>3</td>
<td>Reputational Risk Management across the world</td>
</tr>
<tr>
<td>4</td>
<td>Reputational Risk Management at UniCredit Bank</td>
</tr>
<tr>
<td>5</td>
<td>Discussion</td>
</tr>
</tbody>
</table>
Contact details

Prof. Dr. Thomas Kaiser
Director
Financial Risk Management
THE SQUAIRE
D-60549 Frankfurt
ThomasKaiser@kpmg.com
T +49 69 9587 6283
F +49 1802 11991 3234
M +49 174 300 7198

Petra Merl
First Vice President
Head of Operational and Reputational Risk
UniCredit Bank AG
+49 89 378 27615
petra.merl@unicredit.de