Reputational Risk Management in Financial Institutions

Reputational risk management across the world – a survey of current practices

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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

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.

![Pie chart showing responses to the question]

- Yes: 61%
- No: 28%
- RepRisk not included in risk inventory so far: 11%

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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.
Question 4: How did you create awareness for RepRisk with employees and built risk culture? (German Study)

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>
<thead>
<tr>
<th>Stakeholder</th>
<th>Expectations (examples)</th>
<th>Potential reputational risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employees</td>
<td>Salary, appreciation, career</td>
<td>Quality issues may lead to low perception of the company</td>
</tr>
<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>
</tr>
<tr>
<td>Competitors</td>
<td>Fair play</td>
<td>Unfair competition leads to reactions by competitors</td>
</tr>
<tr>
<td>Social environment</td>
<td>CSR projects, donations</td>
<td>Misdirected CSR projects lead to negative perception</td>
</tr>
<tr>
<td>Rating agencies</td>
<td>Disclosure, communication</td>
<td>Misleading information leads to negative perception</td>
</tr>
<tr>
<td>Lobbying groups</td>
<td>Sustainability etc</td>
<td>Outsourcing to low-cost countries leads to reaction by lobbying groups</td>
</tr>
<tr>
<td>Fund managers</td>
<td>Higher share price, dividends</td>
<td>Lawsuit due to mis-selling leads to loss in trust</td>
</tr>
<tr>
<td>Regulatory authorities</td>
<td>Compliance</td>
<td>Breach of money laundering law leads to negative perception</td>
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</tbody>
</table>
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.

[Bar chart showing prioritization levels of stakeholders for global and German banks]
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.
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.

![Bar chart showing the distribution of approaches to embedding RepRisk.

Global Banks:
- Dedicated department: 40%
- In conjunction with OpRisk: 20%
- In conjunction with communication: 20%
- In conjunction with other topics: 10%
- Not yet established: 10%

German Banks:
- Dedicated department: 40%
- In conjunction with OpRisk: 20%
- In conjunction with communication: 20%
- In conjunction with other topics: 10%
- Not yet established: 10%]
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

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Question 9: How do you record RepRisk losses? (German Study)

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
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.

- 61% Quantitative (P&L impact)
- 33% Qualitative / descriptive
- 6% Not yet defined
Question 11: How did you implement an early warning system for RepRisk? (German Study)

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
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.

![Bar chart showing the treatment of reputational risk by Global and German Banks.](chart_image)
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 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.

Reputation management vs. RepRisk management

- **Prevention:** Avoiding the event from taking place
- **Reaction:** Lessening the effects of the event

**Reputation level**

- Systematic improvement of company reputation
- Target range for company reputation

**Reputational risk management**

- Target range after strategy adjustment

**Reputation management**

- Target range after the crisis
- Restoration of the company reputation

Time
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.
Question 15: In which transactions/change processes 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 projects.
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.
Question 17: Are mitigation measures being tracked/monitored? (German Study)

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.

### 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

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**Phase I**
- Extension of existing risk management instruments
- Qualitative assessment of reputational risk
- Case-by-case mitigation actions

**Phase II**
- **Value for bank management**

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**Phase III**
- Integration in all business activities (e.g., refinancing, new products)
- Integration in risk-return management