Reputational risk management: A key determinant of competitive performance

When WorldCom collapsed in 2002, its investors lost billions – and so did shareholders of Citigroup. Markets punished the financial giant for its part in the financial scandal. Citigroup had risked its reputation by developing a web of intimate business relationships with the fraud-ridden telecoms firm.

Citigroup equity analysts had been apparently writing reports on WorldCom for Citigroup customers, while at the same time the financial services group had been advising WorldCom's board on strategy. Citigroup also lent money to WorldCom, issued and underwrote WorldCom securities and advised its pension fund. Citigroup's asset managers held a large chunk of WorldCom shares. Citigroup even lent money to private businesses run by WorldCom's head, Bernie Ebbers – now serving a 25-year sentence for fraud.

Modern financial groups such as Citigroup are particularly vulnerable to issues of reputational risk, says INSEAD visiting professor Ingo Walter, who's also a professor at New York University's Stern School of Business.

The bigger the range of services that financial companies provide, the bigger the economies of scope. There are undoubtedly synergies and probably bigger profits. But there is also a greater risk of conflicts of interest, more temptation for aggressive managers to break the rules—and greater damage to a firm's reputation if there's a scandal.

"Corporate governance is a good part of it," Walter says. When customers flee, compliance costs rise and investors' perception of the risk associated with their shares increase, and poorly functioning boards are often to blame.

"They are after all the representatives of the shareholders and owe a duty of care and a duty of loyalty to them. When these duties are neglected due to inattention or misplaced board loyalty to management, reputational problems can easily arise. The results are usually bad for shareholders."

The average annualised loss from a "reputation-sensitive" event could be around 7 per cent, or US$3.5 billion, according to initial findings of a pilot study Walter conducted together with Gayle De Long and Anthony Saunders. The researchers looked at the losses to shareholders in banking and financial services firms from 49 such occurrences between 1998 and 2005.

Counting the costs

Assessing the damage to reputation takes a lot of data. "First the reputation-sensitive events have to be identified in terms of precisely when they become known to the market," Walter says. "Then the share price impact has to be determined. Then the financial costs have to be identified and discounted to the time of the announcement. Whatever shareholder losses are not accounted for by financial costs represent pure reputational losses."

Consumer companies have lots of experience of dealing with crises that affect their reputation. For example, in 1997 Mercedes was caught off guard when its new A-class car embarrassingly rolled over during a test to simulate being hit by an elk. In 1990, Perrier recalled millions of bottles of its water after traces of benzene were found in the product.

Good business schools teach students about these cases and the ways they can be avoided and dealt with when they do occur. No one wants to drink tainted water or drive an unstable car. Replacing the product swiftly is an obvious solution to help rebuild trust – savvy managers can even improve the company's or product's reputation by dealing skilfully with reputation-related crises.

But such solutions aren't necessarily applicable to financial firms with similar troubles. "Perhaps a point of distinction is that financial firms as a whole may be more reputation-sensitive than non-financial businesses, because clients' switching and contracting costs may be lower, so that market discipline may be tougher," says Walter. "Plus, they are always working with other peoples' money."

Prevention and regulations

So prevention seems all the more important for reducing reputational risk in the financial sector. Regulation is one approach. Walter notes this often runs in cycles: public outcry after a scandal or crisis prods watchdogs to snarl and politicians to rush through tougher rules. Then the industry earns public trust again, the environment changes and then there's a round of deregulation and red-tape slashing. To be followed by another crisis … and so on.

The bursting of the dotcom bubble certainly shook up the regulators in the US. New York attorney general Eliot Spitzer (now the state's governor) took on some of Wall Street's biggest names. He sued under New York law and extracted massive settlements from investment banks, commercial banks, mutual fund companies, insurance companies and insurance brokers in connection with a broad range of offenses ranging from rigged IPOs and kickbacks to misleading research and fiduciary violations. Spitzer may have been politically motivated, but he was effective and helped kick the watchdogs of the financial system into action.

But the American approach has its drawbacks. It relies on rules and cross-regulation between federal and state agencies and self-regulatory organisations, along with civil and criminal litigation, Walter says. The Securities and Exchange Commission (SEC) has a patchy record as a watchdog: "[the system] falls well short of delivering a cost-effective level playing field for all financial market participants and could do with a thorough redesign," he adds. "Sensible rethinking of the rules of the game and how they are applied could provide the proverbial 'free lunch' – greater financial stability and efficiency at lower cost.

'Good guys finish first'

"On the whole, I have a lot of respect for the UK Financial Services Authority, which relies on a combination of market discipline, fitness and properness, and principles-based regulation, and combines them with substantial sector expertise to deliver a solid – though not perfect – regulatory environment at reasonable cost and a high level of global competitiveness."

Training is another way to prevent financial firms taking risks with their reputations and their shareholders' capital. "As an economist, I was taught 'the business of business is business', although even Adam Smith and Milton Friedman acknowledged that business is conducted in a social context and has to maintain its social legitimacy," Walter says.

"Convincing MBA students of this is no small task. The challenge is to prove them dead wrong – that managing social and professional responsibility issues and reputational risk is a key determinant of competitive performance and that, at the end of the day, good guys finish first."

"Most of the time I succeed. But the challenge never ends."

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