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Measuring and Managing Reputational Risk

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Reputation has moved to the top of the agenda for many CEOs and senior executives. What used to be "nice to have" is now increasingly considered as a core asset that needs to be protected and managed. Reputational damage can hurt a company in many ways. Take the example of Wal-mart. Over the last two years, Wal-mart has been the subject of negative news coverage on topics ranging from environmental and labor concerns to allegations that Wal-mart has negative net effect on local communities. These accusations (whether true or false) have already had an impact on Wal-mart's business performance. According to a leaked internal study, about 2-8 percent of shoppers have taken their business elsewhere because they were no longer comfortable shopping at Wal-mart stores. Perhaps more importantly, Wal-mart has encountered increased resistance to opening new stores, especially on the West Coast and the North Eastern region of the United States. As a consequence Wal-mart's stock price has been depressed over the last two years.

An important lesson from the Wal-mart case and related cases is that a company's reputation (even among customers) is only partially shaped by direct experiences with the company. In other words, perfect execution at the typical "touch points" with customers is not sufficient for building and maintaining an excellent reputation. Third parties, especially the media, play an important role in shaping customer perception. In particular, there are three core difficulties in managing corporate reputations:

- Lack of **control.**
- Limited **credibility.**
- Overwhelming **complexity.**

Control. Companies cannot directly control the messages received by third parties. Consider the example of a credit card company. If a customer is unhappy with a late-charge, a customer services representative can directly engage with the customer on a one-on-one basis and rectify the situation, e.g. by waiving the fee or at least explaining its rationale. In contrast, if the *New York Times* runs an article detailing the alleged abuse of late fees among credit card companies the company cannot reach all the readers of this article, certainly not among potential customers.

Complexity. Customers usually do not understand the complexity underlying certain business decisions. As a consequence they will form their own beliefs on whether the company's behavior was appropriate or not. In many cases they will rely on heuristics and rules of thumb when forming an opinion about a company. Social and cognitive psychologists have demonstrated that risk perception is subject to various biases and so-called "framing effects." For example, customers will overestimate the risk to themselves if they empathize with the reported victim of allegedly improper business practices. Food safety concerns are a prime example of such processes. Adult female customers, for example, will be measurably more concerned for their own well-being if they read an article about a child being injured than, for example, a middle-aged male.

Credibility. When third parties (e.g, journalists or scientific experts) play a role in shaping a company's reputation, companies need to realize that in many cases their own credibility is much lower that that of the experts. In the competition over a company's reputation, companies are at a disadvantage compared to scientists, doctors, even non-governmental organizations and many government actors. Moreover, which third parties have the high credibility varies from country to country. In Northern Europe, non-governmental organizations have some of the highest credibility scores. This is not true in Japan or the United States where some government agencies (e.g, the FDA) have more credibility with customers. Companies need to understand that what works in one market may not work in another. During the introduction of genetically modified food, Monsanto successfully used the FDA to overcome customer concerns about food safety in the U.S. market. A similar strategy in the European market, however, dramatically back-fired because the Ministry's reputation had previously been damaged after it mismanaged the occurrence of Mad Cow Disease in the United Kingdom.

These few examples point out that reputation management not only can be extremely challenging, but can affect the core assets of a company, especially if maintaining high levels of trust among customers, regulators, investors, or other stakeholders is necessary for sustained business success. It follows that reputation management should not be relegated to functional specialists such as the legal or PR department. In many cases reputational challenges have their origin in ordinary business decisions such as market entry (Monsanto), marketing (credit cards) or product design (sub-prime lending). Once reputational challenges have reached the desk of the corporate counsel they frequently have reached crisis proportions. It is therefore much better to integrate reputational considerations into the day-to-day business decisions of the managers that run the business.

To successfully manage reputational challenges companies need to develop three core capabilities:

- A functioning **early warning system**.
- Ongoing **measurement** of the reputation of the company, its markets and products
- Rapid **situational assessment** by issue, product, and market.

Early Warning System. In many cases reputational challenges have their origin in areas not frequently monitored by companies. For example, a data privacy issue may first be voiced in an obscure engineering conference and not raised again until it reached main-stream media. In many cases, companies can completely avoid or at least mitigate reputational crises by changing business practices, stakeholder outreach or through detailed communication plans. But developing such responses takes time, the one thing companies do not have once an issue has reached crisis proportions. In retrospect the warning signs could have been identified but they never reached the key decision-makers. Moreover, in many cases issues that turned out to be enterprise-critical were not even identified as potential risks; they never made it onto the radar screen. As "unknown unknowns" they never could be integrated into a proper risk management framework.

This is the value proposition for investing in early warning systems. This may range from informal monitoring of various media sources over proactive stakeholder outreach to the development of an internal issue anticipation group. Of particular promise is the use of information technology in this area. Many of my clients have benefited from using tools from computational

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> “Reputational Management not only can be extremely challenging, but can affect the core assets of a company ...”

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linguistics and artificial intelligence to identify and monitor emerging issues. Conceptually, the idea is closely related to the concept of "open source intelligence" in the area of national security. The idea is that in the context of emerging issues, the shortcoming does not rest in the lack of information but in too much information. Unfortunately, much of the information is never aggregated to actionable intelligence. The "dots" were present, but not connected.

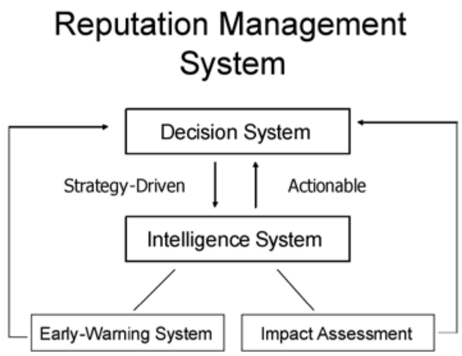
Measurement. What gets measured gets managed. While financial and operational risk can now be (largely) quantified, this is not the case for reputational risk. If companies engage in any measurement at all it is largely based on surveys or focus groups which make it difficult to obtain enough reliable data for a proper quantitative analysis.Two things are lacking: operational measures (similar to, customer satisfaction scores in marketing or quality measures in manufacturing) and financial measures that connect reputational with financial performance. Again, the sophisticated use of information technology provides a potential remedy.

As discussed on page 21, media coverage heavily influences the perception of customers and other stakeholders. While measuring their beliefs directly may be prohibitively costly and impractical, we can measure the opinions expressed in the media and third-party sources. This can be accomplished by using computer algorithms that are trained to identify positive or negative opinions using technologies not too dissimilar from a sophisticated spam filter. The effect of this approach is to generate quantitative data about a company's reputation that can then be further analyzed.

For example, companies can compare the reputations of a given product in two different markets, measure reputational challenges over time, and assess whether a particular strategy has "moved the needle." Once such measures have been developed, they can be connected to a company's financial performance using standard event study methodologies. This allows an integration of reputational risk with other risk types.

Situational Assessment. Once critical issues have been identified and their impact measured, managing such issues requires rapid and reliable situational assessment. For example, in many cases issues are "owned" by only a few journalists. Also, journalists frequently rely on the same group of experts that are then repeatedly quoted. Companies need to understand who is an "ally" or an "opponent." Of course, the list of opinion leaders, gate-keepers, etc. is both issue-and market-specific and therefore requires ongoing monitoring.

Given that the importance of managing reputational risk is no longer much in doubt, companies need to develop appropriate processes and capabilities. The following figure summarizes the key components of an effective reputational risk management system.



However, even if companies develop appropriate decision systems—and many do not—there is much less appreciation of the need to create intelligence systems that allow a quantification of reputational risk. Yet, the many reputatutional crises suffered by corporations today make the need for such a system only too apparent. ✦