Rep-Risk Rocks:
Strategies to Reduce Reputational Risk at a Troubled Time

Remarks of

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I've been asked today to bring you up to date on the reputational risk front – a big challenge in a short amount of time. For years, this risk was considered a sort of last-ditch catch-all – that is, something about which a regulator complains if there's nothing concrete to criticize. However, since I spoke with you about reputational risk last year, several of the banks represented here today have had to put billions of dollars away to reserve against it. CEOs are seeing their basic ability to lead challenged when reputational risk rises, and boards are under far more pressure than ever before to be hands-on here. As a result, I think there's little doubt that reputational risk is a critical senior management challenge, and I'd today like to discuss a disciplined and accountable way to ensure your bank deals effectively with it.

When I spoke with you last year, one of you argued that reputational risk (rep-risk, for short) is no different than brand management and, therefore, not really a legal concern. Others have suggested that rep-risk is part of the amorphous "tone at the top" discussion prevalent in these corporate-governance days. In my opinion, it's neither, although both brand management and tone at the top have rep-risk impact.

Like any other type of risk management, rep-risk management is a disciplined process of risk identification, assessment, measurement – yes even that, management and when all else fails, mitigation. I'll discuss specifics of how to do each of these, but none of them can be done if there isn't a good tone at the top – concretely this means a commitment to dedicate resources to risk management and incentives that back up the top-down talk. And, without good brand management, a well-managed reputation will still have less market impact than it should and risk events will do more damage than they have to.

Is rep-risk a reality? I think so. It's not new, of course. Those of you who remember Salomon Brothers will recall a franchise brought down largely by rep-risk. Those of you dealing still with the structured financings unwinding in these post-Enron days know first hand about rep-risk and how catching it can be. Those of you who do business in Japan are learning about how quickly one bank's problem in a rep-risk prone business line – private banking – can turn a regional franchise upside down. Those of you with unregulated business lines – bond trading, hedge funds – moving into your regulated banks will learn about rep-risk if you don't already know about it. And, of course, retail lines – subprime, credit cards, etc. – are subject not only to rep-risk, but also to an array of new rules governing it.

Regulatory Rep-Risk Priorities

Regulators are very concerned about rep-risk, as those of you negotiating enforcement agreements know all too well. However, in a business based on confidence, reputation has still more profound impact, as evidence Friday when a Federal Reserve Bank of Chicago conference found it to be the biggest source of systemic risk. It's also an increasingly important component of a wide range of rules and guidances. A list of these is attached to these remarks, and the scope is daunting.

Is rep-risk a catch-all to give agencies something with which to whack your bank if they can't find anything else? Sometimes, but that doesn't diminish the power of the whack when it comes.

Rep-Risk Management Techniques

Time doesn't permit a thorough walk through of how to do rep-risk management, but let me repeat key components – modeled after all other forms of effective risk management:

- Identification – this must be done on both a franchise and line-of-business basis, on a disciplined schedule and also in the immediate wake of externalities that may raise unforeseen rep-risk concerns. Rep-risk is contagious – if one big bank gets into the headlines or – scary thought – hearings are called, everyone else of size should expect knocks at their own door. If the targeted business line is key to the franchise, preventative rep-risk management and mitigation becomes a critical franchise issue, like it or not;
- Assessment – both qualitative and, yes, quantitative. It's hard to believe, but agencies under SR 99-18 are increasingly demanding economic capital allocation for rep-risk;
- Management – not only identifying business you won't do, but how to do business with high rep-risk potential. This includes additional controls, improved disclosures, Chinese walls with business line names that separate high-risk businesses from the core franchise; and
- Mitigation – immediate, effective regulatory and government relations, assessment of litigation risk and management, PR, with crisis management if needed. Importantly, rep-risk mitigation – like all other forms – can't be cobbled together after a risk event. Mitigation resources must be in place in advance and strategies designed for different risk factors. Contingency planning exercises are essential here, and disaster preparedness on the rep-risk front is advisable to ensure that no bad news – no matter how grave – undermines public confidence to the point at which ratings change, customers pull deposits and/or assets, or regulators intervene. Banks often think themselves insulated from severe rep-risk because they are "too big to fail." This may limit rep-risk's impact in the immediate term from a market point of view, but it exacerbates it thereafter from a regulatory and political perspective. As a result, mitigation is essential, like this or not.

Also as with other forms of risk management, it's not good enough to establish a process along the lines briefly mentioned if senior management doesn't back it up, rewarding practices that conform to effective policy and validating that these policies consistently reflect corporate priorities and external realities. Specific officers need to be held accountable for rep-risk management, and it's worth considering involving nontraditional units – yours in the legal department first among them. Many critical rep-risk factors are not amendable to the traditional quantified modeling approach used in credit, interest-rate and market risk, and the qualitative understanding you have of emerging and ongoing risks is essential here.

This is, of course, a quick run-through. I know some banks are already doing much of this, but many still need to add rep-risk to the array of internal controls now subject to both bank supervisory and SEC review. Having to do this, I know, is one more burden at a time of growing overall regulatory risk. Failing to do it, though, adds to that risk – dramatically and, I think, most unnecessarily.