ORGANISING COMMITTEE

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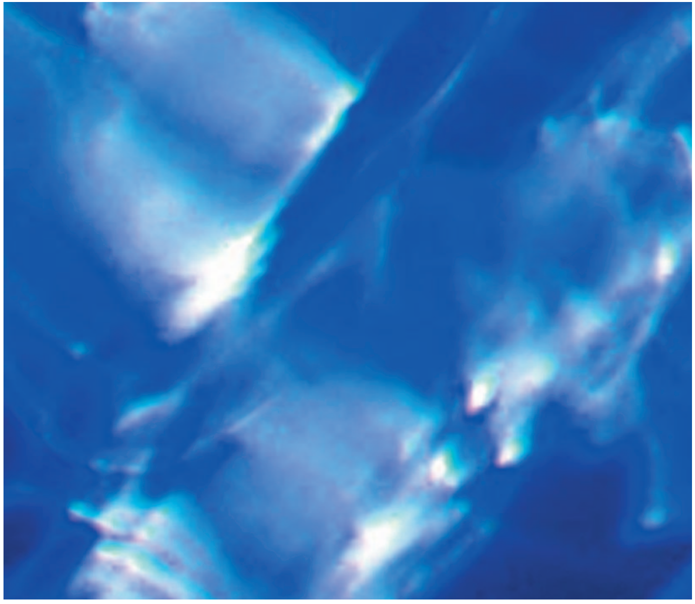
POLICY AND GOVERNANCE FOR RISKS TO REPUTATION

Report from a High Level Workshop



INTRODUCTION

It is increasingly recognised that reputation is an important valuable asset, though it does not appear in most balance sheets (except for acquisitions). Reputational capital is vulnerable and volatile, but not directly insurable.

Strategy and its implementation can have profound effects on reputation; but anecdotal and other evidence suggests that reputational issues appear only sporadically on board agendas. There is evidence too that conventional risk analysis and management techniques do not, for a variety of reasons, adequately capture risks to reputation let alone the related opportunities.

Observations such as these led John Hurrell, CEO of AIRMIC, and Anthony Fitzsimmons, Chairman of Reputability Limited, to initiate a high-level workshop to discuss policy and governance in relation to reputational risks. The event was organised by a committee drawn from AIRMIC, Reputability Limited, the Institute of Chartered Secretaries and Administrators, the Institute of Internal Auditors - UK and Ireland, GC100 (the association of general counsel and company secretaries of the FTSE100), Ince & Co and the Reputation Institute. Participants comprised mainly current and former chairmen, chief executives, company secretaries, general counsel, risk managers, internal auditors, academics and institutional investors.

The workshop focused on an overarching question and three subsidiary questions. The overarching question was:

"What questions should boards consider in deciding their approach to managing risks to their company's reputation?"

This report sets out conclusions drawn from the discussion. Time at the workshop did not allow the formal reaching of a consensus in all its details. However, having consulted the rapporteurs for each of the four questions, I believe that that this report fairly reflects the essence of the discussion and indicates the consensus that would probably have been reached had more time been available.

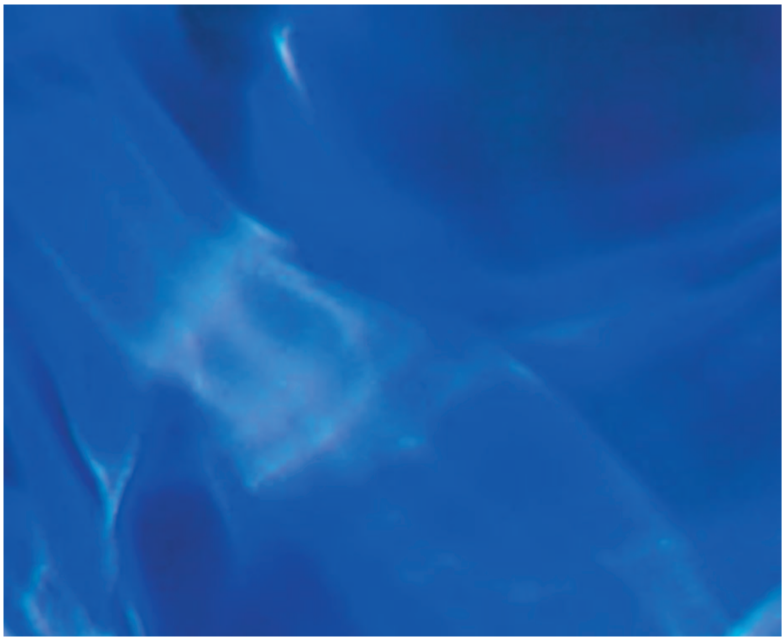
In order to encourage candour, the workshop took place under the Chatham House Rule. The only names that appear relate to individuals who have agreed to be identified.

The organisers would like to thank all participants for their contributions, without which the workshop would have borne no fruit. The rapporteurs made a particularly valuable contribution.

Anthony Fitzsimmons
Chairman of the Workshop

EXECUTIVE SUMMARY

1. Reputational capital is important and valuable. Boards should take deliberate responsibility for it.
2. Boards need to understand their organisation's reputation and what underpins it. This knowledge can be important in strategic decision-making.
3. Values and culture are important to safeguarding reputation. Tone has to be set from the top. Boards should ensure they are consistent.
4. Managing reputation involves managing opportunities as well as risks. Doing it well requires cooperation between all those who have relevant knowledge and skills.
5. Boards should ensure that they have structures to provide them with reliable information about reputation and risks to it. Traditional "bottom-up" risk management approaches often fail to expose important risks to reputation. Poorly designed structures can have major blind spots.
6. A reputational risk map is a useful, sometimes critically important, tool. However, reputational risk should not be considered in isolation but as part of enterprise-wide risk management.
7. Investors see reputation as an important component of value. Boards should consider reporting more explicitly on reputational matters.



THE QUESTIONS

Overarching Question:

What questions should boards consider in deciding their approach to managing risks to their company's reputation?

Underlying Questions:

Question A:

How efficiently does the commonly used specific-risk-centric approach to risk analysis capture and give suitable prominence to reputational risks? Would another approach, for example centred on reputational risk, be a useful complementary tool in identifying reputational risks more comprehensively?

Question B:

With particular reference to reputational risks but not ignoring other risks, what are the advantages and disadvantages of current hierarchical structures used within companies to identify, analyse and report on risks? Do they have potential consequences not intended by boards? And might other arrangements be better?

Question C

At board level, what is the appropriate level of NED oversight of and involvement in dealing with reputational risks, and how might this best be structured? In particular when might a risk committee be appropriate and how might the relationships between executives, NEDs, risk mangers and internal auditors best be structured?

Question A:

How efficiently does the commonly used specific-risk-centric approach to risk analysis capture and give suitable prominence to reputational risks? Would another approach, for example centred on reputational risk, be a useful complementary tool in identifying reputational risks more comprehensively?

An organisation's reputation underpins its ability to succeed. Effective risk analysis and risk management are therefore essential as regards risks to reputation. It is a responsibility of any board to ensure that sufficient focus is given to this aspect of risk management.

The traditional approach to risk mapping tends to be "bottom-up" and concentrate on risk categories (e.g. strategic, financial, product, etc.) or risks to the achievement of business plans. Analysis from the perspective of key stakeholder groups is less common and can reveal areas of risk to reputation which traditional analytical approaches may miss. It also needs to be infused with the tone that should have been set by the top.

A new type of risk map could be developed to focus on reputational risk, complementing other types of map. It would identify critical stakeholders (customers, staff, investors, regulators, communities, etc.) and reputational threats involving each stakeholder group. The group identified advantages and pitfalls associated with having a separate reputational risk map:

Advantages

1. Boards need to see the big picture but are less likely to do so without an analysis of potential risks to reputation, organised by magnitude and likelihood. A reputational 'heat map' can help boards to identify how strategies may affect reputation.
2. Reputational risk analysis can highlight possible adverse consequences that would not appear on a traditional enterprise risk map.
3. Some risks to reputation stem from failure of governance. Confidence in the management of reputational risk is only likely to be effective if the wider governance framework is right.
4. Systematic awareness of risks to reputation may improve enterprise confidence levels and facilitate informed risk taking. It does not have to cause an over-cautious environment.
5. Engagement with stakeholders, which is essential to the analysis, can help to buttress a desirable culture that emerges from it.
6. Board oversight of reputation helps a board to "set the tone from the top".
7. All stakeholders cannot be satisfied all of the time, but a reputational risk map can be a useful tool to help boards balance reputational issues.

Pitfalls

Using separate reputational risk heat maps could create a celebrity culture for reputational risk which overshadows traditional enterprise risks and distorts priorities. Reputation should not be considered in isolation.

There is a danger of creating a new bureaucracy around analysis of risks to reputation.

Conclusion

A reputational risk map is a useful addition to existing controls. For some types of business, it is absolutely critical. However, reputational risk should not be considered in isolation but as part of the enterprise-wide process of risk governance.

Reported by John Hurrell/AIRMIC and Ivor Godfrey-Davies/HSBC

Question B:

With particular reference to reputational risks but not ignoring other risks, what are the advantages and disadvantages of current hierarchical structures used within companies to identify, analyse and report on risks? Do they have potential consequences not intended by boards? Might other arrangements be better?

The status quo

Larger organisations inevitably have hierarchies. Whilst these have developed for good reasons, their existence can give rise to functional or departmental silos, which may fail to share information and result in issues "falling into the gaps". This is particularly so for reputational issues, where the full implications emerge only from an overarching view.

In most large organisations, there will be a person or team responsible for managing risk. The seniority of the head of risk management varies but it may be a board member or a direct report to an executive director. Some also report to the audit committee chairman.

However, there is rarely a single person or team responsible for reputational issues. Different teams (e.g. risk, PR, executives, boards) handle different aspects. They may not form a comprehensive view of the risks nor communicate effectively either with one another or with the rest of the organisation.

The lack of clear reporting on reputational issues makes it harder for the board to see that their policy decisions have been implemented as they intended.

A hierarchical system can however be empowering if well defined and resourced. It helps risks to be managed close to the point at which risk is taken. It also allows for clear accountability and reporting. However, specialists and those close to a particular risk may be unable to see the whole picture.

It seems that risks to reputation are often not explicitly defined to be within the risk management function. If they are, they may receive inadequate attention, especially if reputation is seen as 'just another risk area'. Risk managers may also feel inhibited in reporting frankly on risks which emanate from higher up the hierarchy. As a result, an incomplete view can be reported up the organisation. A false sense of security may develop from the fact that responsibility for the risk has been formally (but in fact ineffectively) delegated. This can lead to decision-making on false assumptions right up to board level.

Possible improvements

Management of reputation should involve looking at reputational opportunities and risks in a holistic manner, from board level down through the whole organisation. This will not happen by accident. A good solution will include the following improvements to typical hierarchical structures.

1. Responsibility for management of reputation and risks to it should be specifically allocated to a suitable individual or small team.
2. Develop a top-down understanding of risks to reputation and enhance it with strong cross-cutting communication at all levels.
3. Ensure that risk management teams have communications and PR knowledge; and that reputation managers understand risk management.
4. Identify problem areas in culture, values, personal behaviour and risk-awareness, and take remedial steps where needed.
5. Enhance stakeholder engagement.
6. Review the hierarchy regularly. Is it still fit for purpose?

7 Mixed messages from leaders are confusing at best and can be dangerous. Tone needs to be set, clearly and consistently, from the top.

8 Enhance compliance and create or reinforce measures to counter tolerance of non-compliance.

9 Carefully align both overt and implicit incentives to safeguard reputation and mitigate undue risk-taking. This needs constant monitoring.

10 Learn from risk management failures but do not over-react as this can have adverse consequences including a reluctance to report future failures.

Reported by Jackie Cain/IIA and Paul Batchelor/Crown Agents

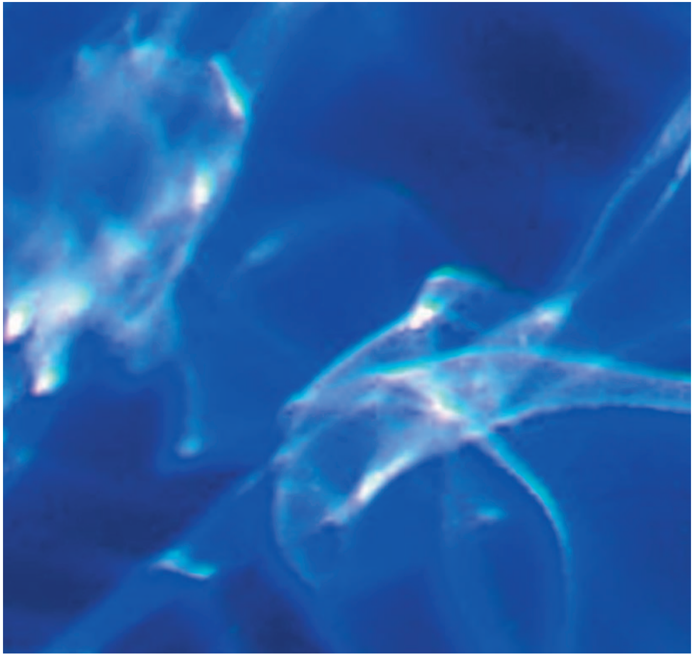
Question C:

At board level, what is the appropriate level of NED oversight of and involvement in dealing with reputational risks, and how might this best be structured? In particular when might a risk committee be appropriate and how might the relationships between executives, NEDs, risk mangers and internal auditors best be structured?

Behaviour is more important than structures. There is no "one size fits all" solution for effective risk or reputation management.

The board and NEDs have a central role in identifying and overseeing management of key risks – in particular "forward looking" risks that will not emerge from "bottom up" processes – and in foreseeing possible reputational implications. But the most influential role for the board is to set the tone and culture for the organisation as a whole.

The key is getting the right people on the board in



the first place and ensuring they are encouraged to challenge constructively in the boardroom. They need an opportunity to learn about the business and engage outside it. It is important that the chairman encourages these activities.

There is a limit to what NEDs can achieve in the limited time they have available, so it needs to be used effectively. Structures should be designed accordingly. So, for example, in complex companies a risk committee may be necessary. In others the audit committee may be appropriate. The important thing is to get the right people in the room together.

Likewise, responsibility for actual management of risk should remain with the executive, not with the board. It is important to have a clear process for determining which issues are escalated up the line and to the board; and when. Equally, the board should not see the use of committees or delegation to management as excusing them from their ultimate responsibility for reputation and risks to it.

Investors want evidence that the board has a grip on risks. Evidence of dynamism is comforting; some boards just repeat the same list of risks every year. Investors present did not have views on the merits of different structures but would like to understand what they were.

Reported by Nick Gould/Ince & Co and A. Nonymous

Overarching Question:

What questions should boards consider in deciding their approach to managing risks to their companies' reputations?

Risk taking is core to running successful businesses, not intrinsically bad. This applies as much to risks to reputation as to other risks. Risks to reputation currently appear to be a 'Cinderella' area. Some of these suggested questions will be more important during a transition to a more proactive approach, but most will retain their importance.

1. Do we understand how reputation relates to our strategy and the "why are we doing what we are doing?" including implicit as well as explicit assumptions?
2. Do we understand what underpins our reputational capital?
   - How do we ensure that NEDs are sufficiently well informed?
   - Will we spot opportunities that arise from this understanding?
3. Can we be confident that our risk management system will rigorously capture all the important risks to our reputational capital?
   - Have we explicitly allocated responsibility for reputation and risks to it?
   - Is our governance structure for reputational questions fit for purpose?
     - Does it have blind spots?
     - Do perverse incentives reduce its effectiveness?
   - Does it seek out and listen to internal and external stakeholders?
4. Is our boardroom behaviour right?
   - What tone do the chairman and CEO set within and outside the boardroom?
   - Are we open-minded and do we avoid 'groupthink'?
     - How do we make sure?
   - Do we see issues from the perspective of external stakeholders as well as internal perspectives?
   - Does the way we look at risk encourage short term thinking and vice versa, e.g.
     - Are some risks ignored because "it won't happen on my watch"?
     - Is the quarterly analyst briefing structure affecting behaviour?
   - Do we lose our inherent sense of risk when we go into the boardroom?
5. Would greater disclosure to shareholders be an opportunity?
6. How often should we revisit these questions?

Reported by Anthony Fitzsimmons/Reputability and David Wilson/ICSA