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RISK MANAGEMENT AND EMPEROR'S NEW CLOTHES: THE FEAR OF REPUTATION RISK

In the post financial crisis 2008, there has seen a proliferation of non-financial risks in the financial services industry. Reputation risk has grown in prominence, with headlines around the world highlighting the importance of effective reputation risk management. Simply stated, reputation is the perceived impression that stakeholders have about how a company is managing its business processes.

Measuring the cost of reputation risk is difficult, in part because it can arise as a secondary consequence of other risks. One way in which it can be measured is through changes in market capitalisation (M-Cap) of the affected institution, which are well placed to capture the many indirect effects of reputation damage through their reflection of lost future earnings. Recently, the Indian banking industry has faced so far the biggest fraud of Rs 12,300 crore. Taking change in M-Cap as proxy for reputation risk, we found that post 1-month of the event, the decline in M-Cap is 13.2 times more than the fraud amount. Though, the positive news is that it has recovered fast and post 2-months it is now only 9.2 times of the fraud amount.

This is now much lower than the empirical evidences worldwide that show this could be as much as 20 times of the operational loss / fraud amount in some cases.

The good thing is that on the upside, following the crisis, it is not just financial institutions that are feeling the need to strengthen risk management programmes, but companies across all sectors have now strengthened risk management by embedding them in the organisational culture, with the guidance and oversight being set from the senior management/board of directors. Such risk management programmes needs to be adequately staffed, apart from sizeable investment in process-thinking and simultaneous development of a process-improvement culture.

Institutions should view risk management as an institutionalisation of best business practices, so as to anticipate risk events, minimise their impact and profit from it.

REPUTATION RISK

> *"It takes 20 years to build a reputation and five minutes to ruin it. If you think about that you'll do things differently."*
>
> *-Warren Buffett*

- In the post financial crisis 2008, there has seen a proliferation of non-financial risks in the financial services industry. Reputation risk has grown in prominence, with headlines around the world highlighting the importance of effective reputation risk management. *Alan Greenspan* once observed that, in a market system based on trust, reputation has a significant economic value. Such reputation risks may have wider
- connotations, threatening the stability of financial systems as a whole.
- Before we quantify the reputation risk, it is important to define it. Simply stated, reputation is the perceived impression that stakeholders have about how a company is managing its business processes. However, in risk management parlance, unauthorised trading may be classified as an operational risk, within the broad ambit of enterprise risk management (ERM)/risk universe (credit risk, market risk, operational risk, strategic risk etc.). Basel II defines operational risk as: *The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events*. This definition includes legal risk, but excludes strategic risk and reputational risk. More importantly, operational risk is unique as it involves a secondary impact—reputation risk that is huge, difficult to quantify and having wider ramifications as discussed. In particular, as per this definition, reputational risk arises from a negative perception on the part of customers, counterparties, shareholders, investors, etc., arising out of operational failures.
- Now the estimation part: Measuring the cost of reputation risk is difficult, in part because it can arise as a secondary consequence of other risks. One way in which it can be measured is through changes in market capitalisation (M-Cap) of the affected institution, which are well placed to capture the many indirect effects of reputation damage through their reflection of lost future earnings. Such projected shortfalls in earnings might then also need capital planning.
- Recently, the Indian banking industry has faced so far the biggest fraud of Rs 12,300 crore, which has raised a lot of concerns among different stakeholders. We endeavoured to calculate the amount of reputation risk as a fallout of that. Taking change in M-Cap as proxy for reputation risk, we found that post 1-month of the event, the decline in M-Cap is 13.2 times more than the fraud amount. Though, the positive news is that it has recovered fast and post 2-months it was only 9.2 times of the fraud amount. This is now much lower than the empirical evidences worldwide that show this could be as much as 20 times of the operational loss / fraud amount.
- However, a caveat here. The entire loss in M-Cap is not only attributed to fraud event. During the same time, RBI also came up with a new guidelines regarding the restructuring and asset quality. This is reflected in change in BSE Bankex which has declined 4.5% during 1-month, but later recovered substantially after the announcement of monetary policy.

Estimation of Reputation Risk			
Item	Date of Event	Post 1-month	Post 2-month
Market Cap (Rs Cr.)	392096	229461	279508
Change in Market Cap (Rs Cr.)	-	-162635	-112588
Fraud Amount (Rs Cr.)	12,300		
Change in Market Cap/Fraud Amount	-	13.2x	9.2x
BSE BANKEX (% Chg from Date of event)	29080	27785 (-4.5%)	28273 (-2.8%)
Memo: Change in Market Cap/Fraud Amount			
Historical Trend	**-**	**Upto 20x**	
Source: SBI Research			

- As explained, historical trends suggest that such losses could be even 20 times higher than the direct loss. It is, therefore, crucial that such operational risk events are both measured and managed by the banks to (a) reduce earnings volatility, (b) reduce the likelihood of an operational event becoming a capital event and (c) to be less susceptible to systemic problems.
- Now, the crucial question is how banks can manage this risk. The good thing is that on the upside, following the crisis, it is not just financial institutions that are feeling the need to strengthen risk management programmes, but companies across all sectors have now strengthened risk management by embedding them in the organisational culture, with the guidance and oversight being set from the senior management/board of directors. Such risk management programmes needs to be adequately staffed, apart from sizeable investment in process-thinking and simultaneous development of a process-improvement culture
- Organisations should not view risk management as merely a compliance requirement / **Emperors New Clothes**. Institutions should view risk management as an institutionalisation of best business practices, so as to anticipate risk events, minimise their impact and profit from it. Else, organisations will be in the news, but perhaps for the wrong reasons.

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ABOUT US

The Economic Research Department (ERD) in SBI Corporate Centre is the successor to the Economic and Statistical Research Department (E&SRD). The latter came into being in 1956, immediately after the State Bank of India was formed, with the objective of "tendering technical advice to the management on economic and financial problems in which the Bank has interest and which required expert analysis".

After the first reorganization of the Bank, when specialized departments like Management Science, Management Information Systems, Planning and Market Segment Departments took over the statistical work of E&SRD, the Department was renamed as ERD.

However, with the ERD team now taking on multidimensional functionalities in the area of risk management, corporate analytics, strategy and so on, who knows, the time may have come to rename it again!

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