SPECIAL REPORT

The 21st Century Reputation Risk Hit Parade

The Positive Effect on Business

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developing ideas
LLORENTE & CUENCA

GEC Risk Advisory
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1. INTRODUCTION

Reputation risk management has become the critical executive tool of the 21st century, as it entails looking after, protecting, and developing what is becoming the most important asset for business and financial organizations of this century: their reputation.

Therefore, since reputation risks are the most important threat that needs to be addressed by organizations, it is not surprising to see reputation risks moving to the top of the list of concerns for senior managers and boards in large organizations over the last few years.

From a conceptual standpoint, reputation risks can be classified into four types –natural, leadership, operational, and environmental– based largely on where they originate from, or what other risk they may be related to (natural disasters, leadership failures, operational, or other environmental factors).

First of all, natural risks are those determined by the natural environment, and include, among others, climatic, atmospheric, or seismic events or phenomena that cannot be easily predicted by companies.

Leadership risks are those directly related to the mistakes made by organizations, and especially by their senior managers, in the decisions made about general management of the organization and its business, and as a result, in the exercise of their responsibilities as leaders of these. Leadership risks include the supervision that boards exercise –or don't in some cases– over such management decisions.

Operational risks are those that arise as a result of the production process intrinsic to the nature of each business, or in other words, to the functioning of the value chain, the supply chain, and the logistics chain of a business.

Finally, environmental risks are those where significant regulatory or legislative changes can have a decisive effect on the operating environment of a specific industry or sector.

In the 21st century, there are numerous examples in the business sector which clearly illustrate the aforementioned classification of reputation risks.

"Pressure from public opinion, interest groups, and society as a whole, called the nuclear energy business model into question"

2. NATURAL RISKS

In the case of **natural risks**, what immediately comes to mind is the disaster involving Fukushima and TEPCO (Tokyo Electric Power), the Japanese energy company that owns the nuclear plant.

The Fukushima disaster was the result of a combination of natural factors and the risks associated with leadership and the poor decisions made by the senior managers of the company (and additionally, lack of proper supervision by the board).

What is certain is that, for someone watching the events of March 2011 unfold from outside Japan, the first thing that grabs the attention is the location of the nuclear plant, so close to the sea, in a country whose inhabitants are well aware that they live in an earthquake-prone area, and in which seaquakes and tsunamis are not exactly uncommon events.

One gets the impression that this decision to position the plant so close to the sea could be related to the prevailing mentality of many 20th century companies that made decisions solely on the basis of the Profit & Loss (P&L) statement. Therefore, it is highly probable that this location was chosen due to the lower costs associated with the continuous and permanent supply of water to cool the engines at the plant. In any case, it would not be the right decision in a country with such high seismic activity.

In addition, as confirmed by several reports after the disaster took place, it seems that the decisions made by TEPCO management and the government at the time were not exactly the best.

What is clear is that this disaster not only affected the Fukushima plant, and consequently, the people living in the area, but also TEPCO, which suffered record losses after the accident took place.

However, the effect went even deeper than that, resulting in significant impact on the nuclear energy business model around the world, as pressure from public opinion, interest groups, and society as a whole, called the nuclear energy business model into question in the aftermath of the disaster.

The German government provides a case in point. The immediate reaction of Chancellor Merkel after learning the scale of the disaster was to announce the suspension of the German nuclear energy program.

However, Angela Merkel's reaction to the events in Fukushima illustrates how reputation risks can have contagion effects that have an impact, not just on the companies directly involved, but also on the business model in which they take part and compete in. Entire areas, countries, and companies within the same industry or business sector can be affected, far from where the reputation crisis first arose.

"The development of the new Information and Communication Technologies (ICTs) has exponentially increased our capacity to disseminate information"

In *The Reputation Risk Handbook*, the following observations are made about reputation risk contagion:

"The reputational impact of an event can reach well beyond its inner circle. The reach of the Snowden affair hasn't stopped with its reputational impact on the US government. By association, the US technology sector (including companies not involved in national security related technologies) has been very concerned about the reputational fallout on their competitiveness in the global marketplace, especially companies offering services in the cloud"[1].

This is because the development of the new Information and Communication Technologies (ICTs) has exponentially increased our capacity to disseminate information. Above all, there has been an increase in citizen mobilization, social activism, and democratic empowerment which makes it possible to influence and put pressure on governments.

Recently, it came to light that three former TEPCO executives –Tsunehisa Katsumata, who was chairman of TEPCO at the time of the crisis, Sakae Muto, and Ichiro Takekuro, who were vice-presidents– would face criminal charges and stand trial for their alleged negligence in the Fukushima nuclear disaster. This is the first criminal case involving the utility's officials to be tried in court in relation to the disaster.

3. LEADERSHIP RISKS

In the case of **leadership risks**, let us examine the financial scandal which involved the Japanese company Olympus, manufacturer of photographic and optical equipment. The Briton Michael Woodford, one of the most promising senior executives at Olympus, became CEO of the company, starting to work in 2011 at the headquarters of Olympus in Tokyo.

Shortly after Woodford took up his position as CEO, he came upon documentation about business operations and started to get suspicious about some transactions which possibly involved fraud and tax evasion activities, such as the alleged transfer of large amounts of money to places considered as tax havens.

In response to Michael Woodford's insistence to see all the information related to this matter about which he had doubts, he only met strong resistance from the senior managers and board directors at the company in Japan.

Woodford chose the most difficult path –the one with the most personal risk to him as an exec-

[1] Bonime-Blanc, A. (2014). *The Reputation Risk Handbook. Surviving and Thriving in the Age of Hyper-Transparency*. Oxford: Dō Sustainability.

"In the open and hyper-transparent society of the 21st century, secrets are very hard to keep"

utive, but which said the most about his sense of honor– as he tried to figure out exactly what was going on in this matter. As a result of his actions, the Board of Directors removed Mr. Woodford from his position as head of the company; barely six months had passed between his promotion to CEO and his downfall.

Statements made by Woodford reveal that he had to leave the country with his family as a result of what he himself described as veiled threats against his own safety and that of his family. Once he left Japan and returned to England, Woodford continued with his public criticism of the company. In 2012, he published the book *Exposure: inside the Olympus scandal*, which recounted the events that had taken place.

Investigations revealed that Mr. Woodford's suspicions were well founded, and in fact, three of the company's senior managers have been convicted by the Japanese courts. Mr. Kikukawa, former chairman of Olympus, Mr. Yamada, former auditing officer, and Mr. Mori, former executive vice-president, were considered as those bearing the greatest responsibility for the fraud, and have thereby been sentenced to jail and banned from running businesses.

In the open and hyper-transparent society of the 21st century, secrets are very hard to keep. Although it is not within the scope of this report, it is also worth mentioning in this context cases such as those of Snowden and Wikileaks where well-kept government and corporate secrets were suddenly and irrevocably revealed to the world.

4. OPERATIONAL RISKS

Operational risks are those that affect the production and operation system of the business model itself. Again, as in the case of Fukushima, these risks are further exacerbated when combined with mistakes made by the malfeasance of corporate leaders.

The case that first comes to mind is the Toyota crisis between 2009 and 2010 in the US. This was a key moment for Toyota, as it was competing against the big US companies General Motors and Ford. It was the first time we witnessed a foreign car company gaining the lion's share of the market against the then-leaders of the US car market.

Toyota received complaints about factory defects that affected the braking system on some models, and at the same time, accidents started to happen. It became clear that the company had reacted slowly to the potentially defective products and had not ordered the immediate withdrawal of those products from the market to protect the safety of its customers.

In the end, the combined cost of legal, marketing, and increased safety measures could easily outpace the $2 billion in costs that Toyota estimated for this crisis in 2010.

"The identification and mapping of reputation risks has become an essential activity for business organizations and financial institutions"

Moreover, Toyota failed to react responsibly towards its customers and stakeholders, considering that it is a company selling consumer products with major health and safety implications.

In short, this was a reputation risk that definitely affected the company's operations. When leadership risks due to poor management decisions, and possibly poor board supervision, is added to this risk, the negative impact of reputation risk on customers, and above all, on the value of the company in the markets, becomes even greater.

5. ENVIRONMENTAL RISKS

Regarding **environmental risks**, regulatory or legislative changes can have a powerful impact on the operations of a specific company or sector.

Over the last few years, we have seen the restructuring of the Spanish financial sector leading to a seismic shift in the regulatory and operating environment of the Spanish banking system.

Long-standing Spanish institutions, such as the savings banks (Cajas de Ahorros) and charitable pawnbrokers (Montes de Piedad) have, with some exceptions, been gradually disappearing.

And that is not all. Many of their former executives are still dealing with the corporate, commercial, and criminal repercussions of their behavior while at the helm of these organizations.

Therefore, the change in the regulatory framework, along with the leadership risks associated with the behavior of many of these executives, has completely transformed this business sector, to the point that many of these organizations have literally disappeared from the marketplace.

6. IDENTIFYING REPUTATION RISKS

In the 21st century, the identification and mapping of reputation risks has become an essential activity for business organizations and financial institutions.

At the same time, the large centers for thought and analysis of the future of the world economy, such as the World Economic Forum, have created rules to identify and map global risks. The aim is mainly to identify, on the basis of two main criteria –likelihood and impact– the probability of economic, environmental, geopolitical, societal, and technological risks that could affect business organizations and financial institutions over a ten-year period, and their impact on industries and markets[2].

A brief look at the most notable cases of reputation risks of the past few decades, shows how far-reaching the consequences of poorly managed reputation risks can be.

[2] *Global Risks Report 2015*. World Economic Forum.

"At the beginning of the 21st century, we bore witness to the reputation crisis that faced the Texan energy company Enron"

UNION CARBIDE 1984

First of all, mention must be made of the incident on December 3, 1984 in the Indian city of Bhopal, where the US chemical company Union Carbide owned a plant that manufactured pesticides.

The company, in keeping with the typically economic and financial-centric mentality of 20th century business, only focused on maximizing profits, without giving a thought to the environmental and social implications of its actions. As a result, the company decided to increase the operating margins of that factory, reducing cleaning and maintenance costs, and the resources allocated to complying with the necessary safety and quality standards.

As a result of a chemical reaction, an explosion occurred, blowing the factory sky-high, and releasing a number of toxic gases that affected the inhabitants of Bhopal. According to official figures, on the night of the accident, the explosion caused the death of 3,000 people, and over the next few days, the death toll rose to 15,000 victims. This does not take into account those who suffered from chronic diseases and permanent health consequences as a result of the accident.

It is doubtful that even in 1984, this type of narrow-minded decision-making focused solely on maximizing profits with a blatant disregard for quality and safety, would have been acceptable. However, it is clear that in the 21st century, this type of behavior is totally unacceptable, and that business models built on such parameters are neither sustainable nor socially acceptable over the long term.

ENRON 2001

More recently, at the beginning of the 21st century, we bore witness to the reputation crisis that faced the Texan energy company Enron, which allegedly falsified its accounts –or in other words, the reliable and validated statements reflecting the reality of the business– to create false information and expectations in the economic and financial markets.

Again, the decisions made, strictly according to the model of focusing on the bottom line, led to the collapse, bankruptcy and disappearance of a leading energy company such as Enron, which also involved lengthy and devastating legal, criminal, and civil consequences.

As a result, the CEO of the company, Jeff Skilling, was found guilty of criminal fraud, and is still serving his sentence, although he managed to get his sentence reduced after appealing to the US courts.

In any event, the Enron case is a clear example of how the lack of consideration for reputation risk can contribute to the decline and maybe even the disappearance of a company.

> "Reputation crises not only change expectations about the future performance of companies, but also force them out of the markets"

ARTHUR ANDERSEN 2002

Related to the Enron case is the Arthur Andersen case, the company responsible for auditing Enron.

Until 2002, Arthur Andersen was one of the largest auditing companies worldwide. Its misdeeds in terms of its audit responsibilities vis-à-vis Enron led to its demise as well.

Founded in 1913 by Arthur Andersen and Clarence DeLany under the name of Andersen, DeLany & Co, in 1918, the company changed its name to Arthur Andersen & Co. Arthur Andersen was said to be a man with a very strict code of ethics and strong principles, on which he based his firm's corporate culture. "Think straight and talk straight" became the motto of the firm.

The company was one of the largest accountancy firms in the world, and at the same time it became a type of quasi university or business school, training executives who would then be hired by other companies to run them.

However, in 2002, the firm, as auditor of Enron Corporation, was involved in a scandal related to the alleged destruction of documentation belonging to Enron in the weeks prior to its breakdown and which demonstrated the irregularities the company had been involved in.

The auditing firm was fined $500,000 for obstruction of justice in relation to its handling of Enron documents and was deprived of its license to audit companies for five years, thereby being unable to exercise one of its main functions, which led to it practically disappearing from the market and collapsing like a house of cards in a matter of weeks.

Later in 2005, the Supreme Court reversed the conviction of Arthur Andersen, concluding that the evidence of guilt in 2002 was too vague. However, it was too late because the firm could no longer recover from its enormous reputation crisis.

In this manner, reputation crises not only change expectations about the future performance of companies, but also force them out of the markets.

BP DEEPWATER HORIZON 2010

A more recent event would be the environmental crisis caused by the explosion of the oilrig owned by BP, *Deepwater Horizon*, located in the Gulf of Mexico. The accident took place on April 20, 2010 and caused what is considered the largest oil spill in the history of the US.

Five years after the disaster, BP is still paying the price for its poor management of the incident. In fact, the current CEO of BP is not the same person who was in charge at the time of the disaster, since this reputation crisis also meant a changing of the guard for the high-level executives at the company.

"The reputation economy and reputation itself as an asset have economic and financial consequences on the performance of companies"

As a result of that incident, BP saw its stock market value fall by $90 billion, and it set up a $20 billion fund to satisfy claims, in addition to the legal disputes about who should receive compensation payouts.

If we add up all the money being spent on the legal processes, the loss of state contracts due to the decision of the US Environmental Protection Agency (EPA), the reduction in sales and the damage to its reputation, the cost just keeps rising, and at the writing of this paper, the ballpark figure was around $54 billion for all costs and fines resulting from this disaster.

This goes to show that the reputation economy and reputation itself as an asset have economic and financial consequences on the performance of companies. In addition, the EPA cancelled the contracts it had with BP and gave instructions to all US federal agencies not to contract with BP.

However, the most interesting thing about this decision is the powerful argument used by the EPA to stop BP from obtaining new federal contracts, which can be summarized in four words: "lack of business integrity".

In other words, for the EPA, the decision was not made on the basis of the traditional criteria that used to determine the contracting of services or purchase of products, which were mainly price and quality. The EPA cancelled the contract with BP because it thought that the company lacked integrity in managing and operating its own business, and therefore should not be hired by the US government.

This is a clear example of the extent to which we live in a reputation economy, where the supposedly intangible asset of organizational reputation also has an effect which is just as tangible as that of any other asset.

BARCLAYS 2012

Another paradigmatic case is that of the British Barclays bank, one of the banks allegedly involved in manipulating the London Interbank Offered Rate (Libor), used as a global benchmark for short-term interest rates.

Bob Diamond was Barclays' chief executive at the time when several alleged misdeeds were identified within the bank, and in his attempt to resist the growing pressure from public opinion and stakeholders, Mr. Diamond became the visible face of the institution during the investigation into the bank's business practices.

The crisis was untenable for the bank itself and its Board of Directors, and in July 2012, a week after the bank was fined a record amount for its attempt to rig the Libor rates, Mr. Diamond resigned. Mr. Diamond said he resigned because he did not want to damage the bank's reputation further by staying:

"The current leaders of Barclays want to rectify what has happened, and in fact, they have created the position of Chief Ethics Officer"

"The external pressure placed on Barclays has reached a level that risks damaging the franchise; I cannot let that happen"[3].

On taking over the running of the bank, the new Group Chief Executive of Barclays, Anthony Jenkins, made public statements which showed a clear contrast to the practices of previous years.

Mr. Jenkins said that over the past 20 years, the bank had been too aggressive, too focused on the short term, too removed from the needs of consumers, customers, and society in general. He also acknowledged that Barclays was not immune to the impact that these trends had on the bank's operations. He specifically stated that Barclays suffered reputational damage in 2012 as a result of this incident[4].

The current leaders of Barclays want to rectify what has happened, and in fact, they have created the position of Chief Ethics Officer, with maximum responsibility in ensuring that all of the bank's business practices comply with the ethical standards expected from a financial institution of this caliber. This shows how the income statement of company governance and ethics can have a key impact on the performance of business organizations and financial institutions.

7. THE BIG PICTURE OF REPUTATION RISK

One could continue to look for and find a wide variety of other reputation crises and risks. As mentioned above in relation to Barclays, in the words of the Financial Secretary to the Treasury, Greg Clark, the Libor rigging scandal was an extremely serious matter, motivated primarily by greed.

Three large banks –RBS, Barclays, and UBS– are trying to limit their civil and criminal liability with regard to this matter. RBS reached an out-of-court settlement for $612 million, Barclays reached an out-of-court settlement for $450 million, and UBS reached an out-of-court settlement for $1.5 billion.

8. CREATING SHARED VALUE

If we specifically refer to the impact of the Great Recession on the reputation of banks with their stakeholders, it is worth mentioning films like *Inside Job, Margin Call and Tower Heist*. Those films show that, regardless of what the courts decide, the verdict of public opinion may be quite different and more negative, and this opinion is not merely limited to demonstrators or movements such as Occupy Wall Street, Occupy the City, and 15 M in Spain.

On the covers of major publications like *The Economist*[5],

[3] Statements made by Bob Diamond. *The Telegraph*. July 3, 2012.

[4] Statements made by Anthony Jenkins. *Financial Times*. February 12, 2013.

[5] *The Economist*, July 7, 2012.

"The sophistication of the stakeholders and interest groups does not stop there"

world opinion leaders have made a clear and strong point about the poor reputation of certain industries and institutions, which still have a long way to go in being accepted by people and institutions that are building their business models around the concept of creating shared value.

However, the sophistication of the stakeholders and interest groups does not stop there. We are also seeing increasingly sophisticated pressure by companies in how they structure their business model.

STARBUCKS 2012

Starbucks in 2012 is a good example. Starbucks has built its business model not only around its range of products and services and the emblematic surroundings that its facilities offer customers, but it has also established a philosophy of well-being, health, nutrition, and respect for indigenous communities as a priority for its supply chain for the products that it serves to its customers. However, Starbucks recently saw the entire model on the verge of collapse.

At a time when in Europe there is serious debate about the contribution that the public and businesses make to meet state-provided social services costs and to deal with the high rates of debt that exist in each country, Starbucks has found itself responding to questions about its tax contribution to the countries where it operates. This is an issue that other major multinationals like Google and Apple are facing as well.

Even if these companies comply with the current legislation about transfer pricing regulated by the tax system in force for large multinationals, there is increasing social pressure for such legislation to be socially acceptable.

In other words, the public is demanding that large multinationals also contribute to the markets where they operate. And that they do so in such a way that does not avoid their legal and social obligations to make tax payments by devising financial and tax engineering mechanisms that allow them to divert profits from one market to another through transfer pricing. Such is the importance of this topic that, in meetings of the G20 and the G8, it has been at the top of the agenda for regulators.

THE INTERNATIONAL RETAIL INDUSTRY & RANA PLAZA

The extension of company principles and practices throughout the entire supply chain, beginning from the extraction of raw materials, also deserves a special mention.

The case of the textile workshops in Bangladesh, where the collapse of a building caused over a thousand deaths in one location alone (Rana Plaza), led some international textile companies to react quickly.

"In the Reputation Economy, companies have to earn the social license to operate"

They focused on finding high-quality and socially acceptable solutions not only for themselves and their employees, but also for those who worked with them at the first, second, or third level of the supply chain.

THE PROXY SEASON & EXECUTIVE PAY

The list continues. The "Shareholders Spring" phenomenon questioned the role of companies, for example in relation to the remuneration of executives.

In March 2013, the Swiss activist Brigitta Moser-Harder mobilized Swiss public opinion through the open and democratic Swiss system that makes it possible to hold referendums, to win 68% of the votes in favor of the popular initiative against abusive executive salaries.

This phenomenon has also spread to the European Union. The Belgian parliamentarian Philippe Lamberts argued in the European Parliament that for bank directors within the EU, there should be limits on the amount of variable incentives earned for meeting their targets in relation to their fixed remuneration.

9. CONCLUSION

In short, in the Reputation Economy, companies have to earn the social license to operate. Not the administrative license granted by governments and regulators, but the license granted by stakeholders, in accordance with the five P&L statement model, which requires simultaneously developing the dimensions of economic profit, governance and ethics, environmental protection, commitment to talent and looking after employees within organizations and any others forming part of their value chain.

In this context, it is not surprising that, as mentioned above, reputation risks are increasingly at the top of the agendas of senior management of large companies.

Proof of this is the AON's biennial *Global Risk Management Survey*[6], which gathers the responses of 1,418 risk decision-makers from 28 industry sectors in 60 countries and identifies the most important risks faced by the corporate world.

As shown in the table below, for the first time since 2007, damage to brand and reputation has been ranked as the top risk in 2015. And as the research points out, reputation has switched from being defined as "priceless" or as an "intangible asset" to being defined as having tangible value and as an asset which exerts a direct impact on the company's bottom line.

In addition, in Deloitte's *Exploring Strategic Risk*[7] study, which surveys more than 300 executives

[6] *Global Risk Management Survey.* AON 2015.
[7] *Exploring Strategic Risk.* Deloitte 2013.

"Ultimately, it is a question of generating economic value by means of generating social value"

around the world to find out their perceptions about strategic risks, reputation is again cited as the strategic risk with the greatest impact. Furthermore, from the responses obtained, it appears that the age of social media and hyper-transparency is having a major impact on reputations and reputation risk. This is because companies have lost control over the transmission of the information that affects them, and therefore there is an increased risk that stakeholder perception of companies will be affected.

In short, and in keeping with *the 2014 Annual Reputation Leaders Study*[8] by the Reputation Institute, 65% of business leaders say that reputation management is a top priority for executives and the Board of Directors, up from 56% in 2013.

And 78% of business leaders interviewed agree that we live in a world where who you are as a company is directly tied to business success.

Finally, referring to the article that Michael Porter and Mark Kramer wrote in the *Harvard Business Review* of January-February 2011, companies that want to succeed have to evolve towards a model of creating shared value, where the process of creating value is fully integrated into the model of competition and business, generating benefits for the economy in relation to cost and investment, but at the same time generating benefits for society and value for communities.

Ultimately, it is a question of generating economic value by means of generating social value.

[8] *Playing to Win in the Reputation Economy. 2014 Annual Reputation Leaders Study*. Reputation Institute. June 2014.

Top 10 critical business risks

RANKING	2013	2015
1	Economic slowdown / slow recovery	**Damage to reputation / brand**
2	Regulatory / legislative changes	Economic slowdown / slow recovery
3	Increasing competition	Regulatory / legislative changes
4	**Damage to reputation / brand**	Increasing competition
5	Failure to attract or retain top talent	Failure to attract or retain top talent
6	Failure to innovate / meet customer needs	Failure to innovate/meet customer needs
7	Business interruption	Business interruption
8	Commodity price risk	Third-party liability
9	Cash flow / liquidity risk	Computer crime/hacking/viruses/ malicious codes
10	Political risk / uncertainties	Property damage

Source: *Global Risk Management Survey*. AON 2015.

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