THE BOND BUYER

Commentary Reduced cost of capital is the ROI of reputation risk governance and management

By Nir Kossovsky
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When Warren Buffet famously told employees at Salomon Brothers that if they lost money, he would be forgiving, but if they "lost a shred of reputation for the firm, (he) would be ruthless," he was not only setting expectations internally – he was setting them externally as well, revealing to all the company's stakeholders what type of governance and management practices and systems they could expect the firm to employ.

The implications of that linkage were significant – then and now – as it made clear that reputation risk was the consequence of failing to meet stakeholder expectations. Buffet's public sharing of that warning before a House committee showed how keenly aware he was of the enterprise-level risk posed when stakeholders – in this case including legislators and regulators – are angry or disappointed over a company's failure to meet their expectations.

By defining reputation risk this way, rather than as the risk of negative public opinion to be managed by marketing departments, the peril is measurable and manageable – as well as insurable – through the use of data analytics that are now available. Just as a physician measures the risk of heart attack without actually opening the body and examining the heart – through cholesterol levels, blood pressure and stress tests – so can we measure the risk of financial damage to companies from missed expectations —stakeholder disappointment, to be exact - through the analysis of various parametric criteria.

Applying these principles to arbitrage differences in expectations between many stakeholder communities, whose behaviors create enterprise value, and equity investors whose behaviors create equity value, we have watched our RepuSPX index of select constituent members of the S&P500 composite index outperform the S&P by 383% over the past 15 years. Could it be that reputation arbitrage, exercised with far greater diligence, is among the tactics at the heart of Buffet's successful core value strategy?

Equity markets are not alone in rewarding reputation value. Data based on analysis of how credit markets have behaved toward companies dealing with reputational issues, show that, all things being equal, the variance between great and poor reputations can alter the cost of capital by around 80 basis points.

Why is this so? Because the rating of bonds by credit analysts, the recommendations for equities by buy-side analysts, and the decision to prosecute by regulators are all social processes. All are influenced by stories, and when those stories speak to authentic systems for risk management, quality governance and compliance in terms that are simple, convincing and completely credible, there is value.

Businesses that have robust risk governance and/or enterprise risk management deployments that can be appreciated by stakeholders, including credit and equity analysts, benefit from lower costs of capital. While the income smoothing value of insurance factors favorably into analyst's confidential models, credit rating and equity recommendations remain primarily social processes. Thus, that simple, convincing and credible story-telling plays a critical role in communicating value.

Some analysts might be resistant to the idea that reputation risk is measurable, that damage due to reputational attacks is quantifiable, and that reputational warranties and defenses should figure into their calculations. But the story-telling to which we refer fulfills a very clear purpose. It is not merely the story telling of a marketing group designed to create "spin" and generate positive publicity. It is the signaling, through insurance products with real risk transfer based on the risk-bearer's analysis of corporate systems, processes and governance, that a company's reputation is strong, resilient and less likely to sustain serious damage from attacks.

Insuring reputation should be viewed in much the same way as property insurance for a town in tornado country. The expressive value of such coverage would be based on the carrier's examination of the town's building codes, early warning systems and network of storm shelters. Reputation insurance, when underwritten based on sound principles, is essentially analyzing corporate defenses against reputational tornados and attesting to their validity.

As a rough measure using spreads in March 2018 suggesting the average incremental difference between a BBB rating and an A rating on a 10-yr note approaching 60 basis points, how can any CFO not consider the potential incremental benefit of being able to include that story in their approach to analysts? How can it not add value and influence opinion?

The generalizable lesson is that there is a return on an investment in reputation risk management. And while most companies don't have spectacular opportunities for public display, their day-to-day interactions with the capital markets could be better exploited through the adoption of enterprise-wide reputation risk management strategies and the deployment of insurance products that validate the effectiveness of those practices.

Nir Kossovsky

Dr. Nir Kossovsky, co-founder of Steel City Re, is an authority on business process risk and reputational value and holds more than a dozen patents, including Reputational Value Metrics.

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