Once a reputation is lost ...

Ulrike Raible on reputational risks in VersicherungsPraxis March 2016

It is now clear to everyone that a company's reputation is a key factor in its success as a business. Despite this, there still tends to be some hesitancy in boardrooms when it comes to introducing systematic measures to manage reputation – including the use of insurance solutions. This article looks at the possibilities and the direct benefits insurance can offer in providing protection against reputational damage for companies and their boards.

"The confidence of our clients and the public is our greatest asset, and we will do everything we can to regain that confidence." Any company publishing a statement like that will already be well into a serious reputation crisis. Be it due to a faulty component, hacking of data or misconduct, the consequences of an event that damages a company's reputation can be devastating. And it can happen to any company, be it a car maker, a food manufacturer or an airline. Years can pass before the company gets back to where it was before the event. In the meantime, millions have to be spent on PR, product improvement and marketing to restore the tarnished image.

Reputational risks in the top 10

A few years ago, reputational risks were not yet taken all that seriously in risk management, but today, in the age of the internet and social networks, customers have become an observant, critical and powerful community. Not least because of that, reputational risks now number among the top 10 global business risks. Over 800 risk experts from more than 40 countries were asked to participate in the recently published 2016 Allianz Risk Barometer. Reputational risks were in seventh place in the ranking of the 10 highest global business risks. Compared with 2015, cyber risks have moved up from fifth to third place. They too can have a huge impact on the reputation of a company. According to surveys carried out by Allianz, the reputational damage resulting from cyber attacks even exceeds the cost of the actual business interruption.

Top 10 business risks in 2016

			2015	Trend
1	Business interruption (including supply-chain interruption)	38%	46% (1)	–
2	Market developments (volatility, increase in competition, stagnant markets)	34%	NEW	▲
3	Cyber incidents (cyber crime, infringement of data protection rights, technical failure)	28%	17% (5)	▲
4	Natural catastrophes (windstorm, flooding, earthquake)	24%	30% (2)	▼
5	Legal changes (economic sanctions, protectionism)	24%	18% (4)	▼
6	Macroeconomic developments (austerity programmes, rise in commodity prices, deflation, inflation)	22%	NEW	▲
7	Loss of reputation or impairment of franchise value	18%	16% (6)	▼
8	Fire, explosion	16%	27% (3)	▼
9	Political risks (war, terrorism, unrest)	11%	11% (9)	–
10	Theft, fraud, corruption	11%	9% (10)	–

Source: Allianz Risk Barometer 2016, Allianz Global Corporate & Specialty

Still some catching up to do in risk management

Although corporate awareness of reputational risks has increased significantly, they still tend to be neglected to an extent in risk management. This has come out in current studies, such as the PR Trend Monitor Reputation Management 2015: 99 percent of those questioned stated that a good reputation was "very important" or "important" to the success of a company. However, only 58 percent had a strategy for building and maintaining a reputation. Though 45 percent reported regularly to senior management on progress with reputation, only 24 percent measured the change in reputation on a regular basis.

The reason for this huge discrepancy between expectation and reality could be the subject's high degree of complexity. This complexity leads to the fact that the responsibility for building and protecting the company's reputation lies with the board at only 48 percent of the companies surveyed. And insurance solutions are still insufficiently perceived and used as a way of limiting reputational risks.

Is reputational damage quantifiable?

A few years ago, we experienced increased demand from our clients for protection against financial loss resulting from damage to reputation, and have been offering an insurance solution since 2012. The particular challenge in developing a cover was to quantify reputational damage and to come up with measurable indicators that both define when cover is triggered and serve to calculate the actual amount of the loss. Many experts doubt that reputational damage can be reliably quantified and modelled. Most insurers offering a solution therefore confine themselves to covering costs based on defined events already insurable under other covers with occurrence probabilities they are used to estimating.

Agencies and market research companies have developed models for calculating brand value, but the values calculated vary widely depending on the method used, and the metrics are either too subjective or not readily accessible. These methods are thus not suitable for producing an objective quantification of reputational damage. Moreover, they can only be used to calculate a book value that does not directly affect liquidity, which is, however, what is urgently needed to overcome the crisis and consequently the more critical factor for clients.

The share price could also be an indicator for listed companies. It usually reacts quickly and could therefore provide early information on losses caused by damage to reputation. However, a scandal does not necessarily lead to a drop in the share price, as something that appals consumers does not always have to be bad for investors. On the other hand, the share price is often sensitive to other factors such as the stock-market situation in far-away markets that have nothing to do with the company's reputation.

Fall in turnover as a crisis indicator

So what factors directly affect liquidity in a crisis? To answer this question, we have to look more closely at the sequence of events in a reputation crisis. The first thing that happens is generally an event that could damage the company's reputation. That might be, for example, product defects, service problems, misconduct by management, employees or celebrities used in advertising, problems in the supply chain, infringements of ethical, social or environmental principles, or mere media allegations in any of these areas. The event is followed by negative media reporting, which directly influences consumer behaviour – disappointed customers switch to competitors.

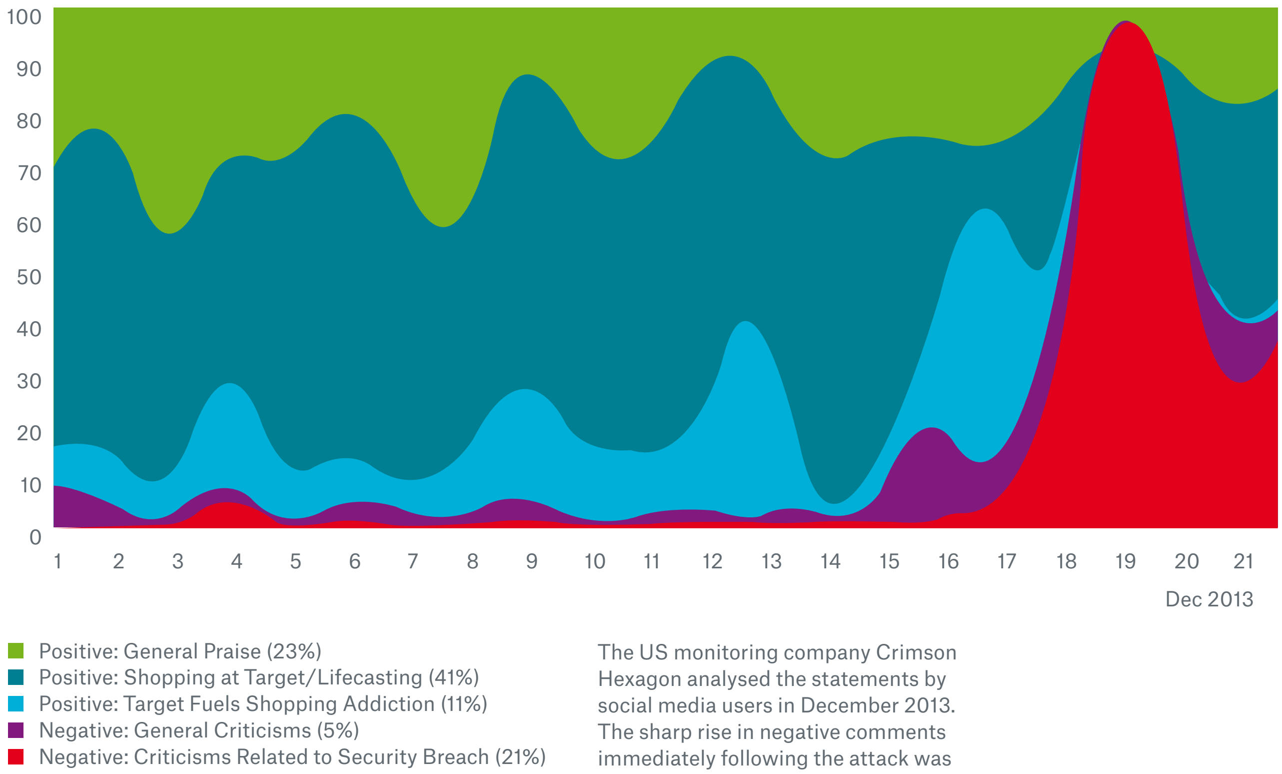
Thus, for both the company and the insurer the reputational damage is directly quantifiable via a drop in sales. Other significant factors, such as an economic crisis, seasonal fluctuations or a new competitor in the market, can easily be evaluated and taken into account in calculating the loss.

The decline in turnover has a direct effect on the company's cash flow, and hence on the funds it has available to repair the damage to its reputation as quickly as possible. Such unplanned expenditure and losses have to be funded from reserves or can be covered by insurance.

The power of the new media

A spectacular case illustrating the typical sequence of events when reputation is damaged was the cyber attack on US retailer Target in December 2013. Brian Krebs, an IT security expert known for his reliable sources and accurate revelations, claimed that Target had been the victim of hackers. In the first two days following the announcement of the attack, the monitoring company Crimson Hexagon counted almost 600,000 tweets on the cyber attack on Target. A few weeks after Krebs' revelations, the company was forced to admit that hackers had indeed stolen up to 40 million credit and bank data records and another 70 million names and addresses. The loss of customer confidence and the associated damage to Target's reputation significantly affected the company's results, with Target reporting a 46% fall in profits for the fourth quarter of 2013 compared to the previous year.

The Target hacking incident – what the social media thought



The US monitoring company Crimson Hexagon analysed the statements by social media users in December 2013. The sharp rise in negative comments immediately following the attack was striking. December.

What form can a reputational damage cover take?

An insurance policy covering reputational damage can be designed along the lines of the above sequence of events, for example with cover triggers as follows:

- Trigger 1: An incident that could adversely affect the company's reputation occurs.
- Trigger 2: The media pick up the issue and report negatively on the company.
- Trigger 3: Customers lose confidence and sales fall.

The triggers can be individually tailored to the client's requirements. Either all operational triggers can be covered, or cover can be limited to defined incidents of particular relevance for the company. For example, a food manufacturer operating only in certain markets could take out a policy covering only product defects (Trigger 1) or limited to certain media and markets (Triggers 2 and 3).

An insurance covering reputational damage generally covers the company's loss of profits and offers financial support for crisis management and efforts to restore its image. The policy provides indemnification for forgone forecast sales growth, giving a company more certainty for its planning. The insurer verifies the sales forecasts by comparing them with performance to date. Reputational damage resulting from cost savings leading to lower quality, fraud or other intentional acts is, of course, not covered.

What are the benefits of insuring against reputational damage?

An insured company has a better chance of surviving a crisis with the lowest possible financial damage. The analysis of the potential risk scenarios with the insurer often in itself leads to an improvement in risk management. If a claim is made, the funds received via the insurance can be used to restore the company's reputation. The circumstances under which the funds are payable and the amount depend on the needs of the client. A cover that pays for marketing measures is appropriate if such measures are sufficient to restore reputation. An insurance that covers loss of profits is advisable if a company wishes to be free to decide how it goes about restoring its reputation.

Contacts

Christian Höft
Tel.: +49 89 38 91-68 23
choeft@munichre.com

Martin Will
Tel.: +49 89 38 91-82 86
mwill@munichre.com

Companies generally know best what action needs to be taken to steer the business model back onto the path to success and to be prepared for the future.

The board's obligation

Target parted company with both its CIO and its CEO. The board has an obligation to ensure that appropriate systems to identify reputational risks and avoid damage are in place, including media monitoring as well as risk management and crisis communication. These enable threatening developments to be identified at an early stage. If the percentage of negative reports rises dramatically, a company needs to act quickly, but nevertheless carefully consider each step. Communication plays a crucial part in limiting the impact of a crisis, and it is essential for a company to be prepared in advance.

The board also has an obligation to ensure that effective provision for dealing with reputational damage, should it occur, is already in place. Taking out insurance cover can constitute such provision. In the event of losses, the board is then able to demonstrate that it has been prudent in dealing with reputational risk and has acted in the company's interest.

© 2016
Münchener Rückversicherungs-Gesellschaft
Königinstrasse 107, 80802 München, Germany

Picture credits
Front page: dpa/Picture Alliance/Abaca,
p. 4: Fotostudio Meinen, Munich

Münchener Rückversicherungs-Gesellschaft (Munich Reinsurance Company) is a reinsurance company organised under the laws of Germany. In some countries, including in the United States, Munich Reinsurance Company holds the status of an unauthorised reinsurer. Policies are underwritten by Munich Reinsurance Company or its affiliated insurance and reinsurance subsidiaries. Certain coverages are not available in all jurisdictions.

Any description in this document is for general information purposes only and does not constitute an offer to sell or a solicitation of an offer to buy any product.