

Understanding Reputation Risk

PART IV: MEASURING REPUTATION VALUE

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"A reputation once broken may possibly be repaired, but the world will always keep their eyes on the spot where the crack was."

*-- Joseph Hall
English Bishop and satirist
(1574-1656)*

Introduction

The purpose of this series has been to describe the elements of a robust reputation risk management program with an enhancement to the quantitative framework for visualizing an organization's reputation risks. Visualization provides a key input into developing the strategy and tactics of addressing

each risk. In this Part IV of V, we add to the quantitative toolbox of our approach to reputation risk.

We started our series on reputation risk in Part I, where we provided a brief introduction to this relatively new concept and distinguished it from related concepts, like crisis management. And in Part II, we made the case that reputation risk management should be part of the strategic agenda and that every type of organization – whether corporation, non-profit or government agency -- should know who their most important stakeholders are, as stakeholders are a vital part of any reputation risk management solution.

We will conclude with Part V (coming soon) where we will pull it all together – the qualitative and quantitative aspects of reputation risk management – and apply it to several mini-case studies which we hope our readers will find useful and maybe even inspiring.

Our approach is different from what we have seen before because our philosophy is that successful reputation risk management requires a mix of art and science, quality and quantity, the objective and the subjective.

In Parts I and II of this series, we suggested that current approaches are mainly qualitative in nature. More specifically, in the “Risk Analysis” phase of risk management, inputs on the “likelihood” and “impact” of an event are determined mainly by an expert committee of insiders. Although it can be a highly qualified and insightful committee, its view will be by definition more “art” than “science” as it is the view of insiders who by virtue of where they are situated within their company can only provide an insider perspective.

It is not that we think that there is perfection to the “science” part of this equation – quite to the contrary, we fully acknowledge that the quantitative part of our approach to reputation risk will also have its flaws as everything carries a mix of objective and subjective elements. What we are saying, however, is that because of the inherently complex, ever-changing and intangible nature of reputation risk, to be as highly effective as possible, both the “quant” and “qual” sides need to be robustly taken into account and applied.

In this Part IV, we propose two supporting analyses aimed at enhancing the current methodology with some science by addressing two key questions, namely:

1. What is the *Total Value of Reputation Risk to Your Company*?
2. For each reputation risk, *what is its reputation value*?

We would like to be clear, however, that this work doesn’t answer the question of all questions – the Holy Grail, as it were: “What is the value of reputation?” What it does, however, is point to estimates based on qualitative assumptions and quantitative inputs -- qualitative assumptions set by expert committees and quantitative insights based on rigorous stakeholder research.

1) What is the Total Value of Reputation Risk to Your Company?

The Math.

Let’s now delve into some equations:

$$\text{Reputation Capital Value X Model Fit} = \text{Total Value of Reputation Risk (\$)}$$

$$\text{Where: Reputation Capital Value} = \text{Intangible Value X Reputation Capital \%}$$

Corporate reputation and the inherent risk associated with it is a part of a company’s intangible value. In order to get to our starting point of the “value of reputation”, we need to cover a few definitions, namely: “Intangible Value”, “Reputation Capital”, and “Model Fit”:

Intangible Value = Market Capitalization – Book Value

Where we use the following components based on well-accepted financial definitions:

- Market Capitalization = Stock Price x Outstanding Shares
- Book Value = Total Assets - Total Liabilities

We define **Reputation Capital** as the total sum of a company's relationships with its stakeholders (i.e., customers, partners, employees, regulators, investors, distributors, media, etc.)

Reputation Capital is a percentage of *Intangible Value*. While our view is that this percentage varies from industry to industry, for the purpose of this work, we'll adopt *The World Economic Forum's* claim. According to The World Economic Forum, on average more than 25% of a company's market value is directly attributable to its reputation (World Economic Forum, 2012). In other words, 25% of a company's intangible value is *Reputation Capital*.

"**Model Fit**" is the Adjusted-r² (i.e., how well the data fits the predictive model) from Linear Regression Model Fit whereby a set of reputation attributes is regressed on a reputation variable or construct. Examples of well-worded attributes might include:

- "Is committed to the development of its employees"
- "Provides good customer service"
- "Offers products that are responsibly made and sourced"

The data for this analysis would be derived from company stakeholder customized surveys.

An Example.

Company X has three stakeholders: customers, suppliers and employees, an Intangible Value of \$5 billion and a Model Fit of 60%.

If we apply the following formula:

Reputation Capital Value X Model Fit = Total Value of Reputation Risk (\$)

(\$5B (Intangible Value) X 25% (*Reputation Capital* %)) X 60% (Model Fit) = \$750 Million

As a result, the *Total Explained Value of Reputation Risk* among all three stakeholders would be \$750 Million.

Additional advanced analytics could further determine the *Total Value of Reputation Risk* by stakeholder. This analysis is beyond the scope of this brief.

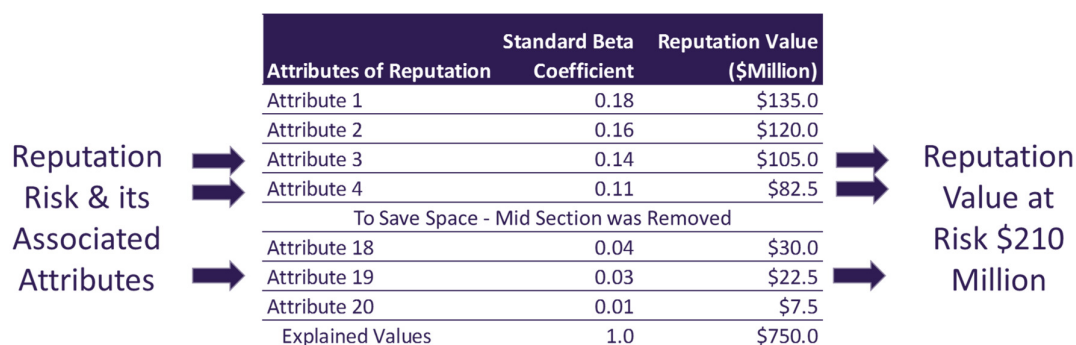
The next step is to leverage this figure to further understand the reputation value at risk for each reputation risk. More concretely:

2) For each reputation risk, what is the reputation value?

Let's assume that our reputation model had 20 attributes with a *Total Explained Reputation Risk Value* of \$750 Million. To estimate the value of a specific risk (e.g., perception of poor customer service), the *Explained Reputation Risk Value* would be multiplied by the regression Standard Beta coefficient (i.e., a measure that explains what each attribute contributes to explaining the dependent variable, in our case, reputation). In other words, the *Total Explained Reputation Risk Value* would be distributed across each attribute by the multiplied value of the regression Standard Beta coefficient.

Attributes of Reputation	Standard Beta Coefficient	Reputation Value (\$Million)
Attribute 1	0.18	\$135.0
Attribute 2	0.16	\$120.0
Attribute 3	0.14	\$105.0
Attribute 4	0.11	\$82.5
To Save Space - Mid Section was Removed		
Attribute 18	0.04	\$30.0
Attribute 19	0.03	\$22.5
Attribute 20	0.01	\$7.5
Explained Values	1.0	\$750.0

Next, each reputation risk would be mapped to two or more attributes. An internal company expert committee would determine if one or more particular attributes apply to a specific risk. For example, the specific risk of the perception of poor customer service would be mapped to three reputation attributes for a total reputation value at risk of \$210 million (see below).



Additional analysis would further determine:

- What estimated budget is needed to mitigate this risk?
- If such an amount is invested, what is the ROI?

These analyses are beyond the scope of this brief.

Conclusion

In this Part IV of our five-part series, we have taken a bold leap forward in presenting quantitative inputs to developing a more complete framework for understanding reputation risk.

As we have emphasized throughout this series, we don't believe that either the quantitative or the qualitative sides of reputation risk analysis can stand-alone. We are also very cognizant that each of the qualitative and quantitative sides of this "equation" has limitations. We are convinced, however, that the combination of a well thought through combined approach of the "quant" and "qual" aspects of this complex and evolving topic – reputation risk – offers the best way forward for a holistic, strategic and practical solution to the dilemma many companies and other organizations are facing on this topic today especially in the financial sector where entities are facing demands from multiple regulators to quantify their reputation risk.

In our final Part V, we will demonstrate how this all fits together by showing you how our approach applies to several actual case studies.

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