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Professional Perspective

ESG Alone Will Not Protect Corporate Reputation

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Nine out of 10 S&P 500 companies cite reputation as a material risk in public filings, according to research done by Steel City Re. This implies that most corporate boards accept that reputational risk is a peril warranting both risk management and governance oversight. The central question under consideration is whether an aggressive sprinkling of environmental, social, and governance (ESG) declarations will mitigate this material peril.

Heightened Legal and Personal Stakes

Reputation risk for more than a decade has been for businesses the "risk of risks." Today, it's also become a personal risk to corporate leadership. A record number of CEOs lost their jobs last year. The numbers are trending even higher this year, according to Challenger, Gray & Christmas, a career tracking firm. According to PWC consultancy Strategy&, financial underperformance was the second-highest reason; the number-one reason was personal reputational impairment through ethical lapses. In no uncertain terms, the personalization of accountability for corporate missteps, legally and in the court of public opinion, poses significant personal financial risk for these individuals.

Misunderstood Risks Lead to Underpowered Plans

While most companies know reputation risk is something they need to address, some still do not seem to fully understand the broad reach of this peril. As evidenced by disclosures—or the lack thereof—in their proxy statements, most mistakenly believe it is simply a byproduct of negative media coverage and that marketers will "handle it." This marketing-based approach to risk management does not give enough weight to the proximate causes of the peril that lie in operational capacity and governance. It instead leans too heavily on the aspirational image that marketers project to generate positive publicity and feelings of goodwill among stakeholders.

Which brings us to the central problem with ESG. Like its sister acronym, GRC—governance, risk, and compliance—the three concepts do not have a natural operational corporate owner. Rather, they are owned by a collective of partners. For example, environmental and social issues touch on several different enterprise silos, each with their own corporate owners. While governance is a board matter owned nominally by the corporate secretary, risk is owned by legal, treasury, or a chief risk officer, and compliance is often the domain of audit. And thus, like CSR (corporate social responsibility), the least common denominator for all is marketing. Consequently, ESG is most often reduced to scores comprising facts and figures that, like financial tables, tell a story with all the appeal of a balance sheet.

The tragedy is that storytelling could, and should, be much more robust. It is a key element of reputation risk management, which at the end of the day is a battle for the mind of the stakeholder. But to be effective, there are two key features to a compelling risk management story.

The first is process controls. Reputation risk arises from the failures of processes. The story the company tells must not only address what it's doing to mitigate that risk, but also set stakeholders' expectations.

The second is that reputational risk is an emotional reaction to corporate behavior. It is the result of angry and disappointed stakeholders. Thus, the story told must be simple, easy to understand, and completely credible—credible by virtue of the process controls, as well as properly set expectations.

These two factors comprise the key to reputation risk mitigation—and a story that earns corporate leadership the benefit of the doubt and forgiveness. The basic facts and figures of ESG metrics alone don't cut it, since they may be disconnected from the core expectations of at least some key stakeholders.

A manufacturing company located in Oklahoma, for example, that discloses the financially material risk of tornado-related disruptions in its public filings might create a board oversight committee to determine how to mitigate that risk. The company's ESG scores might be boosted in an announcement of a large investment in global climate change research, but when a tornado, both real and figurative, hits and financial losses escalate, customers, vendors, creditors, investors, and regulators aren't going to care about a company's image campaigns. Marketing—sending the correct message after a disaster or a misstep—is a tactic in risk management, but reputation overall is an operational issue linked to stakeholder expectations.

The Cost of Unmet Stakeholder Expectations

When a company fails to meet stakeholder expectations, disappointed, angry stakeholders are going to cause economic disruptions and risks to cash flows, such as:

- Creditors: Raising the cost of credit
- Customers: Buying a competitor's products
- Employees: Initiating an adverse work action
- Vendors: Impairing a supply chain
- Regulators: Initiating a regulatory crackdown

These are all repercussions of reputational crises.

Also, expectations and the definition of "stakeholders" will evolve over time, making it crucial to keep abreast of who they are and what they expect—even as companies focus on building operational strength and good governance processes.

Forging Reputational Resilience

Putting it all together, reputational resilience requires companies to have a simple and credible message that clearly and preemptively communicates their use of best operational and governance practices. The emphasis here is on practices and policies, not aspirations. Credibility requires authenticity. That means risk managers and marketers need to work together to craft strategies. Risk managers understand the nature of enterprise-wide risks, they have access to every aspect of corporate operations, and they have the internal clout to bring together resources from disparate departments within the company.

Imagine the hypothetical Oklahoma manufacturing company described above mounting a different type of ESG campaign focused on mitigating reputation risk by meeting the operational expectations of stakeholders and the economic benefit of shareholders. That would tell a far more compelling story to stakeholders that goes beyond the metrics of ESG.

Investing in innovation—for example, using environmentally sustainable sheltering solutions to protect human physical and intellectual assets—would boost both governance and social scores in the minds of stakeholders. It would show progressive governance, a prudent move to mitigate potential future disruption, as well as derivative benefits to a workforce. That would boost ESG scores, while also addressing core reputational risks.

Reputation risk management is a strategy that helps meet the expectations of every stakeholder group. Like other forms of risk management, it must address risks across the enterprise that threaten to disappoint stakeholder groups that may have a variety of interests. ESG initiatives may be important to some of those groups, but only resonate across the full array of interests when they are aligned with risk management's efforts across all business units. And of course, communications—marketing's bailiwick—is a crucial component of gauging, setting, and managing expectations.

Time is of the essence. Now more than ever, with disruptive politics affecting the corporate world and social media personalizing attacks on directors and officers, that type of coordinated approach—melding the storytelling that marketers do so well with the proven principles of enterprise risk management—can provide both resilience and protection from future reputational crises.