Reputational Risk- By Maria Ward-Brennan

Risking it all

Due to the powers of social media, business reputation can easily be damaged in a matter of hours. Increasingly companies are looking to a captive for reputational risk coverage, industry experts reveal

Over the years, more consumers are increasingly fighting for businesses to follow ethical standards. In some cases where those standards have been breached, the reputation of that firm or brand has been severely damaged. Fast-fashion companies, for example, have long been reported to use poor working conditions for staff.

It was recently reported that online fashion retailer Boohoo was discovered by an undercover reporter to be underpaying staff. This resulted in a #boycottboohoo campaign trending on social media platforms.

As a result, Boohoo shares dropped by 18 percent, and more than £500 million was wiped off the value of the fast-fashion website.

Social media has become a very powerful and vital tool for companies to promote themselves, but it's also a platform that can damage a company's reputation fast.

Reputational risk is not a new type of coverage that businesses look to add into their insurance policy but it is fast becoming a very impartial coverage due to the power of social media and the fast-moving times resulting in consumers expecting more off businesses.

Insurance policies for reputational damage generally cover the company's loss of profits and offer financial support for crisis management and efforts to restore its image. The policy provides indemnification for foregone forecast sales growth, giving a company more certainty for its planning.

But with the hardening market and the costs of traditional insurance increasing, businesses are turning towards a captive for tailored coverage.

Michelle Bradley, consulting actuary at SIGMA Actuarial Consulting Group, explains as with other non-traditional risks, there has been an increase in reputational risk being placed into captives, especially over the last two years.

Bradley says: "Analytically, the trigger and/or the payout formula seem to vary from captive to captive, and common policy traits are still emerging."

Nir Kossovsky, CEO of Steel City Re, outlines shareholders, boards, the legal community and risk managers as the four emerging trends in reputational risks he is seeing.

The first trend he states is that shareholders are claiming in securities actions that companies' reputations have been harmed and equity values are being priced lower due to a "liar's discount".

He adds: "They are also successfully advancing derivative actions claiming boards are failing to oversee and monitor reputation and, depending on the nature of a firm, the

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mission-critical business processes that create its value."

The second trend Kossovsky suggests is that boards are asking hard questions of their enterprise risk management (ERM) leadership amid the failure of current ERM strategies to anticipate and mitigate the reputation risk linked to the broadening spectrum of rapidly increasing societal, hashtag-led issues.

Reflecting on the legal community, he notes that it is integrating reputation risk mitigation strategies on a priority basis into its legal compliance and governance practices.

Finally, on risk managers, Kossovsky explains that they are requesting tactical reputation risk solutions for their captives, and are requesting strategically higher limits for reinsuring those captives.

Functions of a captive

While there is a growing insurance market for reputational risk, it is still limited when compared to traditional lines of business.

Richard Coyle, head of alternative risk at Miller Insurance, suggests captives can play a vital role in self-insuring reputational risk, allowing for the compilation of underwriting data, further aiding risk tansfer in the form of reinsurance.

Coyle suggests that a reputational risk insurance policy written by a captive must represent a commercial arms-length transaction, in order to satisfy taxations transfer pricing guidelines. The commercial insurance market can assist with this.

Peter Gerken, senior vice president of risk transfer agency and insurance at Steel City Re, explains that for both public and privately held companies, there are two complementary roles captives can play in insuring against reputation risk and they are strategic and tactical.

On the strategic role, he says: "A captive provides a valuable shorthand story. It tells key stakeholders, especially institutional investors, equity analysts, bond raters and bond buyers, that a company understands the meaning of reputation value and risk."

Gerken explains the tactical role that a captive provides accessible cash that equity investors can appreciate and value in the equity markets before, during and after a firm experiences a reputational crisis.

He adds: "A reputational crisis, defined as the behavioural economic manifestation of emotionally charged stakeholders, if left unaddressed both tactically and strategically, can quickly devolve into a liquidity crisis."

Compare the market

But is a captive more suitable to insuring against reputation risk compared to using commercial insurance? Martin Eveleigh, chairman of Atlas Insurance Management, believes that reputational risk is hard to underwrite, as it can be challenging to define suitable loss triggers.

He explains: "Claims adjusting is also complex as loss of revenue may be caused by several factors, of which the reputational event is just one. A captive may offer broader policy language and, within reason, a faster and more sympathetic approach to dealing with claims."

Bradley says that placing a reputational risk into a captive allows the parent company to address crisis events directly related to and as identified by the parent.

"Due to the parent-captive relationship, this type of risk placement gives the parent company additional freedom in determining the parameters of the policy. The crisis events that lead to reputational harm may differ significantly across industry segments, so this type of customisation is a key component of its usefulness," she adds.

Attraction boost

Reflecting on if there has been an increase in interest around using a captive to insure against reputation risk, Coyle reveals that Miller Insurance are currently reinsuring several captives writing reputational risk into the Lloyd's market.

He notes that more captives are enquiring about the possibilities to self-insure reputational risk and manage exposure utilising reinsurance.

He said they expect the number to keep on growing as the word spreads about the ERM benefits of managing reputational risk in this way.

Bradley points out that they are seeing an increase, especially over the last two to three years.

Also agreeing, Kossovsky suggests that they are seeing an increase: "We are also seeing treasurers appreciate both the tactical and strategic value of employing a captive to help address reputation risk."

Risk hurdles

Examining the challenges around insuring this type of risk, Denise Williamee, vice president of corporate services at Steel City Re, outlines four hurdles they help their clients overcome.

Williamee suggests that the firm's board must acknowledge that 21st-century reputation risk is an enterprise peril comprising the behavioural economic consequences of emotionally charged stakeholders that can manifest with breathtaking speed enterprise-wide, and highlights "it's not a marketing problem".

She continues: "A board with this mindset will challenge its ERM apparatus to rethink in terms of stakeholder expectations while monitoring reputation risk with the same diligence as other enterprise risks both qualitatively and quantitatively."

Additionally, Williamee explains that an enterprise management team empowered by the board to function as an integrated reputation group (IRG) needs to work with each of the operational silos, gather enterprise-wide intelligence on stakeholder expectations and match them against actual corporate capabilities.

"The IRG must determine the best communications, operational and financial strategies to address any gaps. This is where captives and commercial insurances become partners critical to moving-forward solutions," she notes.

Williamee also highlights that risk managers desiring to finance reputation risk within a captive and/or reinsure face three practical quantitative challenges – frequency, severity, and triggers – where the consequences for error invite heightened regulatory scrutiny.

According to Bradley, for many emerging risks, the lack of unique historical loss data is generally the most significant challenge.

She explains: "In many cases, losses pertaining to a specific emerging risk don't exist in a company's loss history, and even if historical events have occurred, the data may not have been captured in a usable format."

"If no unique data is available, industry data is often used – but finding data relevant to a specific company or industry may also prove difficult. When projecting losses for most risks, a loss rate is applied to an exposure base," she continues.

Bradley adds that depending on the risk being analysed, defining or deciding on an appropriate exposure base may provide additional challenges.

Meanwhile, Coyle comments that parametric solutions can be used as a way of overcoming the challenge of the quantification of a company's reputational value.

The future

With the number of companies using a captive to insure against reputational damage increasing over the last few years, should the industry expect to see these figures increasing?

Bradley explains that SIGMA Actuarial Consulting Group is seeing a large increase in the use of captives for recently emerging risks.

This year, 2020, has also displayed the effect of several 'crisis' events that could affect company reputation.

"The combination of these events, as well as the continually hardening market, will likely lead to more firms using captives to address both reputational risk and other, similar risks," she comments.

As companies' balance sheets continue to be more heavily weighted to intangible versus tangible assets, Coyle believes that reputation is perhaps a company's most valuable asset and with today's social media and 24-hour news, it could be destroyed in a matter of minutes.

"It is therefore natural to seek ways to manage reputational risk. Self-insurance coupled with reinsurance to manage exposure should be at the forefront of every CFO/risk managers mind, particularly for companies heavily reliant on their reputations to trade successfully," Coyle adds.

Eveleigh explains that Atlas has been insuring this type of risk in captives since it was formed in 2002, and although clients have always understood it, "they are now more worried about it and quicker to cover the risk in their captive".

Finally, Williamee suggests that over the next five years, reputation risk coverage will complement directors and officers liability insurance in all the firms whose enterprise risk management apparatus qualifies them for coverage. ■