

Vardy, Jill

Working Paper

Reputational risk management in central banks

Bank of Canada Staff Discussion Paper, No. 2015-16

Provided in Cooperation with:

Bank of Canada, Ottawa

Suggested Citation: Vardy, Jill (2015) : Reputational risk management in central banks, Bank of Canada Staff Discussion Paper, No. 2015-16, Bank of Canada, Ottawa, <https://doi.org/10.34989/sdp-2015-16>

This Version is available at:

<https://hdl.handle.net/10419/129696>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

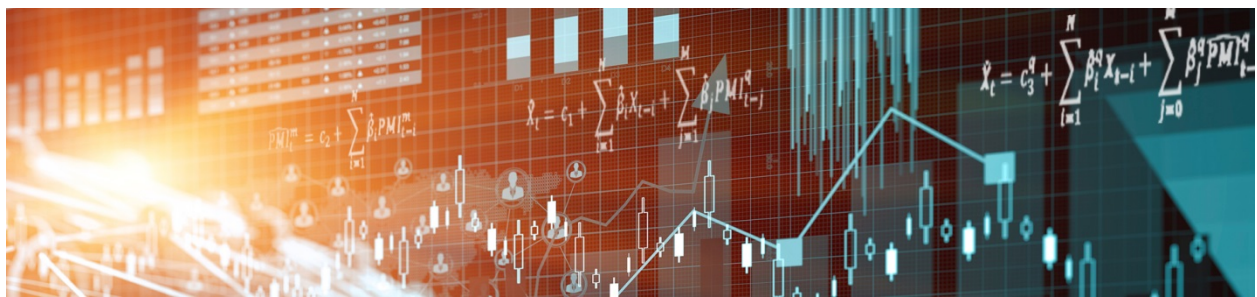
Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

Staff Discussion Paper/Document d'analyse du personnel 2015-16

Reputational Risk Management in Central Banks



by Jill Vardy

Bank of Canada staff discussion papers are completed staff research studies on a wide variety of subjects relevant to central bank policy, produced independently from the Bank's Governing Council. This research may support or challenge prevailing policy orthodoxy. Therefore, the views expressed in this paper are solely those of the author and may differ from official Bank of Canada views. No responsibility for them should be attributed to the Bank.

Bank of Canada Staff Discussion Paper 2015-16

November 2015

Reputational Risk Management in Central Banks

by

Jill Vardy

Communications Department
Bank of Canada
Ottawa, Ontario, Canada K1A 0G9
jvardy@bankofcanada.ca

Acknowledgements

The author would like to thank Michael Ehrmann, Jeremy Harrison, and colleagues in the Bank of Canada's Communications department and on its Risk Oversight Committee for their thoughtful comments on this paper. Colleagues in central bank Communications departments around the world also contributed greatly through discussions that yielded valuable insights. Any remaining errors and omissions are the author's.

Abstract

This paper discusses reputational risk in the context of central banking and explains why it matters to central banks. It begins with a general discussion of reputational risk within the broader framework of risk management. It then outlines how central banks define, measure, monitor and manage reputational risk, citing examples from central banks around the world, including the Bank of Canada. Finally, it presents a model for integrating reputational risk into policy analysis and operational planning—an “embedded communications” approach that ensures such considerations are brought into the core of central bank decision making.

JEL classification: E5, E52, E58

Bank classification: Credibility, Monetary Policy Implementation, International Topics

Résumé

Dans cet article, l’auteure examine le risque de réputation dans le contexte des banques centrales et explique en quoi celui-ci est important pour ces institutions. Elle commence par brosser un portrait général du risque de réputation à la lumière d’un cadre de gestion des risques plus large. Elle décrit ensuite de quelle manière les banques centrales définissent, évaluent, surveillent et gèrent le risque de réputation, en citant des exemples de banques centrales de partout dans le monde, dont la Banque du Canada. Enfin, l’auteure présente un modèle pour intégrer le risque de réputation à l’analyse des politiques et à la planification opérationnelle, une approche de « communications intégrées » qui permet de placer ces considérations au cœur du processus décisionnel des banques centrales.

Classification JEL : E5, E52, E58

Classification de la Banque : Crédibilité, Mise en œuvre de la politique monétaire, Questions internationales

Introduction

At a central bank policy conference a decade ago, a colleague remarked that central banks are risk averse, but they are not always risk aware. That characterization would not be accurate today. Central banks around the world are becoming more adept at anticipating and recognizing risks—the critical first step in avoiding them or mitigating their consequences should they occur.

In the years since the 2007–09 global financial crisis, central banks and other authorities have forcefully promoted the development of robust risk-management frameworks in the financial institutions they supervise or oversee. In this context, they have begun to re-examine their own risk-management frameworks. In many respects, central banks view risk in a similar way to private companies and put in place practices to anticipate, mitigate and manage the full range of risks they face. At the same time, their approach to risk reflects their unique characteristics: central banks cannot go bankrupt and they have considerable operational independence from their shareholders.

As monetary authorities around the world, including the Bank of Canada, update and overhaul their risk-management frameworks, they are advancing their monitoring, measuring and ability to manage one of the biggest risks they face in discharging their mandates—the risk of damage to their reputation as custodians of economic and financial well-being.

Reputation management has become increasingly important for central banks for a number of reasons. In countries around the world, central banks have taken on greater policy roles since the global financial crisis. In many countries, the burden to stimulate economic growth has largely fallen on the monetary authority as fiscal authorities have found their own policy tools constrained. At the same time, some central banks have assumed new or expanded mandates to regulate financial institutions and engage in macroprudential regulation. These roles carry an asymmetric reputational risk: while successful supervisory roles normally go unnoticed, failures in financial supervision can have profound and far-reaching consequences—undermining public confidence in the financial system, and in the central bank. This can, in turn, reduce the effectiveness of the conduct of monetary policy (Born, Ehrmann and Fratzscher 2012).

These more visible, wide-ranging and critical roles for central banks have raised their profile and placed them under intense scrutiny, with particular focus on their transparency and accountability. With this increased profile has come increased personification of central banks through their leaders. Arguably, this also contributes to greater risk as these individuals, whose every action is linked to the reputation of the institution, are thrust in the spotlight.

This paper discusses reputational risk in the context of central banking and explains why it matters to central banks. It begins with a general discussion of reputational risk within the broader framework of risk management. It then outlines how central banks define, measure, monitor and manage reputational risk, citing examples from central banks around the world, including the Bank of Canada. Finally, it presents a model for integrating reputational risk into

policy analysis and operational planning—an “embedded communications” approach that ensures such considerations are brought into the core of central bank decision making.

What is “reputational risk”?

The conduct of central bank policy and operations inherently involves several types of risk. These can include operational risks, such as the risk of a bank’s website crashing or a disruption in the supply of bank notes; financial risks, such as taking on new forms of collateral; and strategic risks, such as a monetary policy decision. Each of these risks can influence the perceptions of stakeholders and the broader public about the credibility and performance of the central bank, creating—for want of a better term—reputational risk.¹

There is a close correlation between a central bank’s reputation and its credibility. Credibility is tied directly to performance—it may be defined as the belief that the central bank will achieve its policy or operational objectives. In monetary policy terms, if people’s expectations are in line with the bank’s policy target, then the bank is credible.

A literature review conducted by the European Central Bank probed the link between credibility and reputation. “Credibility is defined as *the extent to which the public believes that a shift in policy has taken place, when, indeed, such a shift has actually occurred*. Reputation is generally found to be derived from that amount of credibility. A good-reputation bank is, therefore, a credible bank” (Eskenazi 2015).

However, reputation is broader and more transitory than credibility and is, in the minds of some central bank communication leaders, less directly tied to policy and operations. Reputation is driven as much by perception as performance, and it is multidimensional: each group of stakeholders will have its own view of the reputation of the central bank, based on the particular aspects of the bank’s function that is relevant to the group.

In the case of a central bank, how well stakeholders understand, support and trust the bank’s policies and operations is a key factor in upholding the central bank’s reputation. However, reputation is also influenced by the behaviour of the bank’s senior leadership, its employment practices, its transparency and responsiveness to public enquiries, its bank notes, and its emergency preparedness procedures, to name a few.

One analyst likens reputation to an item on a balance sheet: “fulfilling stakeholders’ expectations fuels (one might say ‘funds’) a bank’s reputation, but, while this is a day-to-day endeavour, the build-up of the reputation asset takes time. As an asset, reputation has a long maturity; as a liability, it comes due quickly and regularly” (Scandizzo 2014).

Like all other central banks, the Bank of Canada is exposed to a range of risks—strategic, operational and financial—that can arise from its own activities or from external forces. Since

¹ Reputational risk is not considered in most risk-management frameworks to be a primary risk; rather, it is an outcome, or a consequential risk, that arises from other types of risk. Nonetheless, the term “reputational risk” is used in this discussion paper to simply describe the risk of damage to reputation.

reputational impacts may arise from any type of risk, the Bank of Canada does not distinguish reputational risk as a risk type in itself. Reputational impact is always considered a potential consequence and thus is a major category in the impact scales the Bank uses in its risk assessments. This approach is consistent with those of most other leading central banks. It implies that reputational risks are best reduced by managing other primary risks.

As central banks grapple with how to anticipate, mitigate and manage reputational risks, they are mirroring an effort that is taking place among financial institutions. “Setting up a reputational risk management framework is difficult when questions remain over its definition and which department should be responsible,” says Thomas Kaiser (2014) in his study on current practices in reputational risk management. Kaiser notes that different banks provide different answers to even the most fundamental methodological questions such as “Is it a risk type in its own right or just a consequential risk?” and “Is it risk management, communication, compliance or some other department that is responsible for coordinating activities around reputational risk?”

For those engaged in risk management, reputational risk has increased in importance in recent years. A 2015 Global Risk Management Survey by the risk-management consulting firm Aon plc found that damage to reputation or brand was ranked by corporations as their number-one risk, moving up from number four in 2013. Damage to reputation or brand was listed as the highest risk by respondents in aviation, banking, food processing, education, non-profit, real estate and telecommunications, all industries that have suffered high-profile cases of reputational damage to firms in recent years.

For private sector organizations, a comprehensive strategy to control reputational risk can be critical to an organization’s bottom line and its ability to rebound from a hit to its reputation. But, in a 2014 Deloitte survey of 300 executives, just 19 per cent of respondents would award their companies an “A” grade for their ability to protect against and respond to reputational risks. About 39 per cent rated the maturity of their reputational risk management programs as either average or below average.² Similar metrics have not been gathered for central banks.

Why does reputational risk matter for a central bank?

One could easily assume that the tolerance of a central bank for reputational risk is zero. However, it is impossible for any central bank to entirely avoid risks to its reputation. This is particularly true during periods of financial stress such as the financial crisis and its aftermath, when central banks around the world were called upon to conduct extraordinary policy measures to restore economic and financial stability and support the resumption of growth in their respective economies.

² See the Deloitte 2014 global survey on reputation risk at http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Governance-Risk-Compliance/gx_grc_Reputation@Risk%20survey%20report_FINAL.pdf.

A good reputation and strong credibility do, however, demonstrably improve policy effectiveness. This is true for inflation-targeting central banks in particular, whose policy credibility helps to maintain low and stable inflation. These central banks rely, to some extent, on expectations: if citizens believe the central bank's monetary policy will be effective in keeping inflation low and stable, they will adjust their expectations and behaviour accordingly, which itself reinforces the achievement of the inflation target. In contrast, when inflation expectations become unanchored from the target, because of policy or communications failure, it can be difficult to re-anchor them.³

For a central bank, credibility is also important to protect the currency from both counterfeiting and speculative runs, and to maintain or increase public support for central bank independence. The financial system's ability to rely on its central bank as an unbiased assessor of risks, provider of liquidity and lender of last resort can help the system continue to function during periods of stress and prevent idiosyncratic events from spreading into more generalized market disruption.

Of course, this does not mean that the desire to maintain the central bank's good reputation should trump the right policy decision, even when a short-term reputational hit is certain and the longer-term benefit is less certain. The opposite must be the case. For example, a policy action that surprises market participants will likely be criticized and some institutional reputational capital may be spent. However, if the policy action was deemed by the central bank to be necessary, such short-term criticism should never be sufficient to dissuade the institution from taking the required policy action. Indeed, there is a more serious risk to the central bank's credibility if it were to fail to do the right thing because it sought to avoid short-term reputational damage.

To illustrate, consider the Bank of Canada's decision to lower its key policy rate in January 2015, in the face of an economic shock caused by the precipitous fall in crude oil prices.⁴ This price decline was a major development for Canada—the only G7 country that is a major exporter of natural resources, including oil.

Market participants did not anticipate the rate decision, which had not been telegraphed by the Bank in its prior communications. The Bank of Canada had decided in late 2013 to drop its previously announced tightening bias in order to reduce market reliance on forward guidance and return the market to two-way trading. Instead of using policy inclination statements, the Bank had turned its focus to offering full transparency on the risks that the central bank is weighing in order to encourage the market to assess new information more or less as the central bank does (Poloz 2014).

³ For a case study that illustrates how difficult it was for the U.S. Federal Reserve to bring down inflation expectations during the “Volker disinflation” period of the early 1980s, see Bordo et al. (2007) at http://www.frbsf.org/economic-research/events/2007/march/monetary-policy-transparency-credibility/levin_bordo_etal.pdf.

⁴ The Bank of Canada was one of 20 central banks that announced monetary policy stimulus measures in the first two months of 2015 to counter the effects of a slump in oil prices and stagnant growth.

Media and market reaction to the January 2015 rate cut was swift and negative, calling the decision “a flat-out shocker” and “a surprise that went off like a bomb in financial markets.” However, in the face of what turned out to be two quarters of declining gross domestic product, the decision to lower the key policy rate must today be regarded as the appropriate one, despite the criticism that it generated. In this case, as in all others, the decision to adopt the right policy stance will always outweigh any short-term reputational impact.

Who plays a role in defining reputational risk?

Many players influence the reputation of a central bank. Some of them are internal—leadership and staff—and many more are stakeholders and observers who are interpreting the central bank’s actions and outcomes.

Clearly, the governing or policy council typically has the biggest influence—it is their governance and policy decision making that is at the heart of public perceptions of the central bank. The Governor, Chairman or President plays a critical key role here. He or she is the public face of the institution and comes to personify its reputation. This has become even more evident since the global financial crisis, when central bank leaders moved from somewhere in the middle of the business pages to the vanguard of public policy efforts to restore growth. This increased profile for the heads of central banks is one reason why skill as a public communicator has become one of the essential qualifications for the job.

Behind the public face of the central bank’s leader are all of the internal policy and operational leaders whose conduct and communication play a role in the bank’s reputation. This is why, for example, it is critical that reputational risk be managed in close coordination with those responsible for business continuity. Ineffective management of emergencies or critical incidents is one of the easiest ways to squander a central bank’s reputation.

Central bank employees also help determine an institution’s reputation through the quality of their research and analytical work, their contributions to the field of central banking knowledge and their conduct. While staff mistakes or misconduct rarely trigger a serious operational or financial risk at a central bank, their impact on the bank’s reputation can be important. Central banks, including the Bank of Canada, mitigate the risk of these events with robust conflict of interest and code of conduct guidelines for their staff, and with swift and transparent responses to contraventions of these guidelines should they occur.

Governments also influence the reputation of their central banks. Consider the public disagreement between former Bank of Canada Governor James Coyne and Donald Fleming, the Canadian Minister of Finance in 1961. Their dispute, which eventually led to Coyne’s resignation, caused significant public discussion about the relationship between the country’s government and its central bank, with one newspaper calling the dispute “a soiled page in our history.”⁵ The six-week dispute, which became known as the Coyne Affair, prompted amendments to the *Bank of Canada Act* to enshrine operational independence for the Bank in

⁵ *The Ottawa Citizen*, 12 July 1961.

its conduct of monetary policy. This strengthening of the Bank’s institutional framework ultimately enhanced the Bank’s ability to conduct an effective monetary policy that is, and is perceived to be, outside the influence of the government of the day.

While the Coyne Affair was the only example in the Bank of Canada’s history of a public fight between the governor and Canada’s government, there have been other public and well-documented disagreements between central bankers and their governments. These disagreements are often painful. But their outcome, in many cases, serves to enhance the reputation of the central bank by reinforcing public perceptions of its independence from political interference. As the European Central Bank’s first president Wim Duisenberg said of the German central bank’s resistance to political pressures, “The Bundesbank is like whipped cream. The harder you beat it, the stiffer it gets” (Berger 1997).⁶

Since reputation is also vulnerable to the perception of failure, not just to failure itself, it is largely determined by external audiences—central bank watchers, market participants and the general public. Financial analysts, economists and other information providers engaged in social media all help to uphold (or call into question) the reputation of the central bank.

The media are the most frequently evident of these external audiences and the ones that usually receive the most attention, because the media are instrumental in determining the success of central bank communications. Most central banks rely heavily on the media to get their key messages out to the public. The media also act as a filter, deciding which central bank statements they will distribute. Part of their job, too, is to interpret policy decisions, to comment on the central bank’s performance, and to reflect third-party views of what the monetary authorities say and do (Vayid 2013). For these reasons, financial or economic journalists covering central banks are the audience on which bank officials are often intensely focused. This is hardly surprising, since media outlets have broad reach and provide an immediate and very public feedback channel through which bank staff and observers can gauge outside perceptions of the bank’s performance. In this way, media coverage provides an ongoing means by which to monitor the bank’s reputation.

In fact, the feedback channel is so alluring and instant that it is easy to attach too great an importance to media coverage of the institution—particularly coverage in social media. The role of media monitoring in managing reputation will be discussed in more detail later.

Measuring the reputational impact of central bank risks

A critical step required for effective reputational risk management is to establish—or aggregate—the tools that will be used to identify and monitor reputational risks. This set of tools will allow for an early warning system to identify emerging risks and provide the information needed for post-mortem analysis and identification of lessons learned.

⁶ For a comprehensive study of the reputational effects of the Bundesbank’s disputes with the German government during its early days, see Berger (1997).

Measurement of central bank credibility and reputation is different from that of typical corporations. Indicators such as market share, stock price and industry rankings do not apply to monetary authorities.

When measuring the credibility of central banks, authorities have generally focused on monetary policy and have followed three approaches: observing the dependence of inflation expectations on actual inflation, noting the degree of disagreement among professional forecasters and estimating the responsiveness of inflation expectations to news. All of these measures should be small if the central bank is credible (Eskenazi 2015).

All the measurement techniques listed above revolve around some measurement of inflation expectations, which, as European Central Bank (ECB) research points out, are largely derived from financial markets (as almost all market products may encapsulate some pricing based on inflation expectations). These techniques do not measure the credibility the central bank has accrued from its other key functions. That is why central banks also use other performance measures, such as counterfeiting rates and operational availability of their clearing and settlement systems.

While these measures tell us a great deal about the effectiveness of the central bank, they cannot directly capture the reputational impact of the central bank's communication. Therefore, more complete measures of reputation must involve a better understanding of external perceptions, of both the media and the broader public. That is why many central banks seek other gauges of reputation—involving some qualitative assessment of public and stakeholder opinion or other measures of the effectiveness of the central bank's communications.⁷

Central banks consulted for this discussion paper, for example, all have some form of media analysis devices that they describe as useful, if imprecise, measures of their reputation. Media analyses are the tools with which communicators are most comfortable and familiar. Communications departments understand the drivers of traditional media, as well as the rules and journalistic standards under which traditional media operate. They also have some, albeit limited, ability to influence the relationship: the journalists and media outlets generally have a pre-existing relationship with the central bank or can be interacted with if required.

This is less true of social media. The relative anonymity, immediacy and ability to spread information (or misinformation) rapidly make measuring social media unreliable and prone to immediate and outsized reactions or “noise.” However, central banks recognize that social media provide direct feedback from their public and therefore routinely monitor it. In late 2014, the Bank of Canada conducted a survey of 12 central banks and international

⁷ In May 2015, the Reserve Bank of New Zealand (RBNZ) published the findings from its first external stakeholder engagement survey, which suggested the more transparent the central bank becomes, the more it risks jeopardizing the certainty that is valued by the stakeholders—a dilemma that RBNZ Communications Head Mike Hannah calls “the paradox of transparency.” See Hannah (2015) at http://www.rbnz.govt.nz/research_and_publications/reserve_bank_bulletin/2015/2015may78-4.pdf.

organizations on their methods for monitoring social media. The survey results showed that this activity is largely done by members of the digital media/web team or by the media team. Respondents identified Twitter, blogs, Facebook, YouTube and LinkedIn as the most relevant social media to monitor. Most respondents monitor social media continuously, using third-party software, and produce regular reports that are shared with senior management. For many of the organizations surveyed, monitoring social media is a way to identify incipient trends in order to tailor and adjust communications strategies. A few also mentioned that the monitoring helps them understand how they are viewed by the public. While “noisier” than traditional media, social media serve as a useful early warning system to gauge perceptions of central bank communications.

At the Bank of Canada, real-time social media monitoring occurs each time the Governor holds a press conference. During the press conference, senior communications staff monitor tweets by the main journalists who cover the Bank, as well as by known market commentators who are reacting to the Governor’s answers. This information helps communications officers quickly and proactively correct any misperceptions or provide additional context after the event, before the journalists submit their stories for publication.

Other measures of reputation used by central banks are focused on key stakeholders. For example, the Bank of England logs and monitors the numerous parliamentary enquiries it receives. Several central banks, including the Bank of Canada, use regular opinion polling to track shifts in public awareness and opinion. To augment this work, some central banks have developed more comprehensive approaches to stakeholder relations. Both the Bank of England and the Bank of Canada have recently established Stakeholder Relations groups to improve the coordination and consistency of their engagement with non-media external stakeholders.

Ultimately, there will be no perfect metric for gauging the reputational outcomes of risk events. As noted by Steinhoff and Sprengel (2014), “a rather qualitative and expert-based approach fits best, since many reputational risks cannot be expressed by numbers. The gut feeling should be adhered to and indeed prioritised.”

How to evaluate and govern

Developing reputational risk governance follows three different stages. The first and simplest approach is decentralized and fairly implicit, with policies and guidelines serving as the basis for compliance, and communications as the way to react. In this stage, no coordinated function or systemic reputational risk toolkit exists.

In the second stage, a responsible role for reputational risk is established to consolidate all activities within a coordinated framework. Reputational risk becomes part of the institution’s risk strategy, stakeholders are defined and a reputational risk committee is created.

In the third and most advanced stage, reputational risk management is embedded in the main business processes. The framework is supported by tools that allow a view on future trends and lessons learned from the experience of others. The framework is managed centrally and the

strategy is to anticipate reputational problems and minimize them (Steinhoff and Sprengel 2014).

The most effective frameworks are buttressed by codes of conduct, staff guidelines and documentation of processes. In cases where events occur that are not covered by the established processes, there needs to be a clear and straightforward decision-making and approval process to allow for swift response and timely communication. In all cases, a standard reporting mechanism must be in place to capture the decisions made and lessons learned. Finally, a clearly articulated risk culture that is understood by central bank staff is key: everybody in the institution plays a role in reputational risk management.

Who “owns” reputational risk

The question of who is responsible for coordinating the management of reputational risks is complicated to answer. Since reputation is an outcome of all of the traditional categories of strategic, operational, financial and other risks, it fits under the mandate of the Chief Risk Officer. However, managing the institution’s external reputation is often seen as the responsibility of the Communications department. This is not only the case in central banks: one-third of German banks surveyed by KPMG in late 2013 and early 2014 embedded responsibility for reputational risk in their Communications departments (Kaiser 2014). On matters of risk to the internal reputation, this responsibility is often held by the institution’s Human Resources function, working in tandem with Internal Communications.

This shared ownership of reputational risk makes it clear that it must be managed within a comprehensive risk-management framework. Steinhoff and Sprengel (2014) identify roles for the board of directors, the strategic leadership, corporate communications, the compliance group and the risk control office.

One way some companies have found to make reputation a holistic process within the company, while also avoiding organizational conflicts, has been to establish a “Reputation Council” that brings together all those in the company with responsibility for reputation. So far, this model has not been adopted by central banks.

The Bank of Canada’s approach to reputational risk

Along with many other central banks, the Bank of Canada has been examining and overhauling its enterprise risk management (ERM) framework and describing the risks it is prepared to take or accept to achieve its mandate and strategic goals. The Bank strives for a risk culture that encourages open communication and transparency on all aspects of risk management. Employees are empowered to speak up when they believe the Bank is operating outside of its risk appetite or, conversely, when innovation is being stifled by risk aversion.

The Bank classifies risks into the three risk types—strategic, operational and financial—and identifies key risk areas within each of these types. As previously noted, all three types of risk are viewed in the context of their ability to generate reputational impacts.

To identify, mitigate and manage these risks, the Bank of Canada follows a “Lines of Defence” model, which distinguishes among three groups (each representing a line of defence) who play a role in effective risk management. The first line of defence is composed of the business units that “own” and routinely manage day-to-day risks to their areas of responsibility. The second line of defence, which includes the Bank’s Chief Risk Officer and its Risk Oversight Committee, sets standards for control, compliance and risk management. It advises and challenges the first line and monitors risks, providing regular risk reports to the Bank’s senior leaders and Board of Directors. The third line of defence provides independent assurance on the state of risk management and includes internal audit and other independent assurance providers. These lines of defence exist within the Bank’s ERM framework and are supported by policies that ensure that reputational issues are managed in a consistent way.

The tools for managing reputational risk likely already exist in all central banks, although they are of most value when aggregated inside an effective ERM framework. Making the framework understood and usable requires a clear definition of reputational risk and an approach for managing risks when they arise. Several central banks have created risk appetite statements that give high-level guidance on acceptable risk taking, including how to consider potential reputational impacts in decision making. An effective risk appetite statement helps a central bank’s staff anticipate, mitigate and manage the risks that could undermine its ability to fulfill its mandate, while providing the necessary scope to do groundbreaking research and improve operations and business practices.

An embedded approach: Integrating reputational considerations into analysis and planning

A good ERM framework provides the necessary tools for any organization to assess and manage its risks. However, ERM is not sufficient to manage the reputational risk that may arise from external opinions of the institution that may be independent of any risk event. That is because, as discussed above, reputation is determined not only by performance, but also by the external perceptions and comprehension of audiences and stakeholders. Therefore, effort must be made to improve external understanding and reduce the information asymmetry between an institution and its stakeholders: the larger the asymmetry, the more relevant the role that reputation plays in the success of a policy action or operation.

Applying this theory to central banks suggests that, in addition to managing risks to a policy or operational decision, a central bank can mitigate reputational risk by ensuring that its stakeholders and observers understand why the decision has been taken.⁸ This requires clear

⁸ Research that examined the impact of clear communications on media reaction to ECB rate announcements found that if the ECB decisions surprise markets and there is little informational content during the subsequent press conference, then the tone in the media turns negative; in contrast, the tone in the media does not turn sour if the press conference following a surprise decision is informative. See Berger, Ehrmann and Fratzscher (2011).

and comprehensive communication of the central bank's objectives and the actions it will take to achieve them. In terms of monetary policy, this means effectively explaining to observers the bank's reaction function, including the specific information that is taken into account when a policy decision is made, and the process by which this information is reviewed and assimilated by the bank's decision-makers. This transparency has the added benefit of reducing market uncertainty about the Bank's monetary policy rules and its reaction to economic data or new disturbances.

That's not to say that market uncertainty should be eliminated entirely. If the central bank is credible and has managed to make its reaction function well understood, market participants can still come to different conclusions about the optimal evolution of policy rates, based on their own assumptions about the current state of the economy. That generates the two-way trading that is the desired steady state of markets.

In some cases, central banks have sought to reduce information asymmetries and market uncertainty through forward guidance, which we define as indications that the central bank gives to markets about its intentions regarding interest rates and the factors it will take into account when setting them. This can extend to explicit conditional commitments about the future path of interest rates. The Bank of Canada temporarily exercised this form of guidance in the wake of the financial crisis, to good effect (Vayid 2013). Its current position is that, while forward guidance clearly removes a key source of uncertainty from the marketplace, it is a tool that should be used only in extreme circumstances, such as when interest rates are at their effective lower bound, as a form of additional stimulus to return the economy to equilibrium and inflation to target.

"Forward guidance works by taking certain possibilities off the table," Bank of Canada Governor Stephen S. Poloz has argued (Poloz 2014). "This is tantamount to giving the market a one-way bet. The market responds by positioning itself around that one-way bet, with consequences for other markets that the central bank desires. It is natural that much of this market positioning will be leveraged, the more so the longer the forward guidance is in place. One should not be surprised, therefore, that markets will see some significant volatility when they perceive that the central bank is preparing to change its guidance: the volatility of a return to two-way trading is the future price of successful forward guidance today. That does not invalidate the use of forward guidance, but it underscores that the lunch may not be entirely free."

Forward guidance is a good example of a policy whose effectiveness relies on clear communication. A recent case study of the experiences of the central banks of Canada and Sweden during 2009 highlights some of the challenges and potential risks associated with forward guidance. It concludes that if such guidance is not clearly communicated, it can produce an effect that is the reverse of the desired stimulus (Charbonneau and Rennison 2015).

In the case of any new or untested policy, there is a greater risk of reputational impact because the information asymmetry is high. Reducing the asymmetry, and the risk, requires a pre-established communications strategy that provides information and context for the new action. A good example of this was demonstrated by the Reserve Bank of New Zealand (RBNZ) when it

introduced New Zealand’s new macroprudential policy regime in May 2013. Like any new policy framework, this one required a comprehensive communications plan to build understanding of its objectives and operation.

“Several steps were taken to ameliorate possible downside risks,” the RBNZ reported (Bascand and Gordon 2014). “We set the scene for these measures in a number of on-the-record speeches and in remarks at press conferences, and in Monetary Policy Statements and Official Cash Rate statements expressing our concerns with easier lending standards and house price inflation. We consulted with banks and published analyses of the potential impact of the measures, as well as comparisons with regimes in other countries. Following their introduction, we provided assessments of the impact, rationale and objectives in further speeches, media interviews, and in the November 2013 and May 2014 Financial Stability Reports.”

This kind of embedded communications thinking is critical for reducing the risk of information asymmetries—both externally and internally. The goal should be to integrate communications strategy at the very beginning of discussions of policy and operations.

Role of Communications

The communications function will always be responsible for routinely monitoring how the bank is perceived by the public, which means it is well-suited to anticipate, identify and advise on the reputational impact of existing and emerging risks.

The Bank of Canada seeks to embed communications strategy into all major policy and operational discussions. The Bank’s Communications Department (COM) works with the Bank’s Governing Council to draft its policy interest rate announcements, all public speeches, and all major policy and corporate communications. But its role extends more deeply and begins at an earlier stage: COM leadership has a seat at the table on the Bank’s Monetary Policy Review, Financial System Review and Senior Management committees—meaning communications considerations are integral to policy discussions and deliberations from the outset. Indeed, COM is routinely invited to participate in discussions of any new corporate or policy initiatives.

In an embedded approach to reputational risk management, the role of COM is to assess the reputational impact of proposed activities on a rough matrix that takes into account the central bank’s risk appetite and measurement tools. The approximate scale of this matrix could be along the following grades: brief attention on social media; short-term negative press in domestic media; negative press in domestic as well as international media; negative views expressed by financial market participants in their reports; sustained public reaction; and, most severely, a monetary policy transmission mechanism that is disrupted because the Bank’s credibility has been seriously damaged. Account must also be taken of the negative impact on employees’ interests, which can have pervasive and lasting effects on employee morale and operational effectiveness. COM then works with the Bank’s leadership to advise on, and coordinate the development of, communication strategies to manage the reputational impact.

To be sure, an embedded communications approach will never eliminate all the reputational risk in the function of any central bank. There will always be unforeseen impacts and reputational implications of events. Moreover, eliminating risk (reverting to the risk aversion of which central banks were suspected a decade ago) should never be the goal, since informed risk taking is crucial to the effective conduct of forward-looking policy and operations.

In the end, the most effective way to manage the reputational implications of the risks to which central banks are exposed is by employing a two-pronged approach. The reputational impact of risk events are best managed through a comprehensive and well-understood ERM framework, bolstered by clear and responsive communications. The reputational impacts of misperceptions and information asymmetries are best reduced through embedded, and effective, communications. Together, these approaches will help to ensure that central banks maintain the degree of risk awareness and public credibility they need to act in the best interests of their citizens.

References

- Bascand, G. and S. Gordon. 2014. "Innovation and Risk Management: Insights from Executive Management at Statistics New Zealand and the Reserve Bank of New Zealand." An address delivered to the New Zealand Institute of Chartered Accountants, Wellington, New Zealand, 24 June.
- Berger, H. 1997. "The Bundesbank's Path to Independence: Evidence from the 1950s" *Public Choice* 93 (3): 427–53.
- Berger, H., M. Ehrmann and M. Fratzscher. 2011. "Monetary Policy in the Media." *Journal of Money, Credit and Banking* 43 (4): 689–709.
- Bordo, M., C. Erceg, A. Levin and R. Michaels. 2007. "Three Great American Disinflations." Available at http://www.frbsf.org/economic-research/events/2007/march/monetary-policy-transparency-credibility/levin_bordo_etal.pdf.
- Born, B., M. Ehrmann and M. Fratzscher. 2012. "Communicating About Macroprudential Supervision – A New Challenge for Central Banks." *International Finance* 15 (2): 179–203.
- Charbonneau, K. and L. Rennison. 2015. "Forward Guidance at the Effective Lower Bound: International Experience." Bank of Canada Staff Discussion Paper No. 2015-15. Available at <http://www.bankofcanada.ca/wp-content/uploads/2015/11/dp2015-15.pdf>.
- Eskenazi, M. 2015. "Reputation and Credibility for Central Banks: A Brief Literature Review." Internal document of the European Central Bank.
- Hannah, M. 2015 "Being an Engaging Central Bank" Reserve Bank of New Zealand *Bulletin* 78 (4) (May 2015): 3–4.

Kaiser, T. 2014. "Reputational Risk Management Across the World: A Survey of Current Practices." In *Reputational Risk Management in Financial Institutions*, edited by T. Kaiser and P. Merl, 185–203. London: Incisive Media.

Poloz, S. S. 2014. "Integrating Uncertainty and Monetary Policy-Making: A Practitioner's Perspective." Bank of Canada Discussion Paper No. 2014-6. Available at <http://www.bankofcanada.ca/wp-content/uploads/2014/10/dp2014-6.pdf>.

Scandizzo, S. 2014. "An Asset-Liability View of Banks' Reputation." In *Reputational Risk Management in Financial Institutions*, edited by T. Kaiser and P. Merl, 21–35. London: Incisive Media.

Steinhoff, C. and R. Sprengel. 2014. "Governance as a Starting Point for a Reputational Risk-Management Process." In *Reputational Risk Management in Financial Institutions*, edited by T. Kaiser and P. Merl, 205–225. London: Incisive Media.

Vayid, I. 2013. "Central Bank Communications Before, During and After the Crisis: From Open-Market Operations to Open-Mouth Policy." Bank of Canada Working Paper 2013-41. Available at <http://www.bankofcanada.ca/2013/11/working-paper-2013-41>.