Reputation based cooperation in the ESIA process

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Abstract

Environmental and Social Impact Assessment can be regarded as a cooperative interaction between the project proponent, the financial institution, and the public that is affected by a project. While the question why individuals cooperate is subject to intense research across disciplines, reputation has turned out to be a principal mechanism. The underlying reason is that a loss in reputation can be costly, because individuals neglect others with a low reputation as cooperation partners. We briefly illustrate the general importance of reputational mechanisms with examples across species. Building up on this, we highlight that reputation is a critical mechanism involved in the ESIA process. First, financial institutions implemented the ESIA standards as part of their risk and reputation management strategy. Secondly, reputational mechanisms are involved in various respects during the ESIA process. We discuss the implications of our analyses in the light of current evolution of corporate reputation management and with regards to efficient ESIA process management.

Introduction

The ESIA, as required by financial institutions, is a largely novel approach to sustainable project realisation. To some extent this approach turns standard procedures upside down, as it calls for a pro-active collaboration attitude on the part of the project proponent, including early consultation of stakeholders by means of a participative process. Pro-active assessment and communication of likely impacts is required, which also should acknowledge cultural differences, local minorities and vulnerable groups. This whole approach is in contrast with the view that economically efficient project realisation depends on a top down approach that focuses on immediate and direct economic costs and gains only. But what are the reasons for this development?

The approach taken in the ESIA can only be fully understood when realising the reputational consequences involved. This is because the underlying reason for why financial institutions implemented the requirements involved in ESIA is that it is seen as part of the risk and reputation management strategy (Coulson and Dixon 1995). If the negative consequences resulting from a project on the environment are not adequately communicated and discussed with the involved stakeholders, this can overall become more expensive, both in terms of financial loss and loss of reputation (Horta 2002; Dümke 2007). Associated risks may involve costly interruption of project execution, strikes or protests, or loss of investor confidence due to unfavourable media attention. On the other hand, financial institutions regard the potential positive consequences of an ESIA as a gain, due to enhanced acceptance of the project by local communities and governments and due to image improvement involved in demonstrating good corporate citizenship (IFC 2009).

Reputation drives cooperation: from fish to humans

Basic research in experimental economy and evolutionary biology over the last three decades highlighted that reputation is a central feature of cooperation (Alexander 1987; Bergmüller et al. 2007). This can nicely be illustrated with the example of cleaner fishes. Marine cleaner fish (*Labroides dimidiatus*) feed on parasites they find on the body surface of other reef fishes (so called “clients”)). To obtain this cleaning “service”, clients visit cleaner fish at their stations (Grutter 1999), hence both clients and cleaners profit from cooperation. However, cleaner service can be either good (removal of parasites) or poor (cleaner bites client). When clients obtain a poor service, they leave the cleaner station to obtain a better service elsewhere. Reputation also matters: when clients queue for a service they can observe the interaction of the cleaner with another client. Watching clients are more likely to leave a cleaning station when they observe that the current client obtains a poor service (Bshary and Schäffer 2002). As a result, cleaners are more likely to provide a good service (with fewer bites) when they are observed by others (Pinto et al. 2011). This example demonstrates that reputational mechanisms are a general feature underlying cooperative behaviour across species and, assuming that cleaner fish are not conscious about what they do, the mechanism acts, even though the interacting parties may not be aware of it.

In humans, a number of controlled lab experiments showed that individuals are more cooperative when their behaviour is monitored by others (Wedekind 2002; Milinski et al. 2002; Milinski et al. 2006). Even abstract cues of being watched such as images of eye-like spots have been found to enhance cooperative behaviour. For instance, people invested more time and money in public goods in the presence of images of “observing” eyes (Bateson et al. 2006; Francey and Bergmüller in press). Hence, reputational mechanisms seem to be so efficient that even abstract cues are treated as a real observer, suggesting that reputational effects are cognitively robust evolved psychological mechanisms that were of critical importance throughout human evolutionary history.

Reputation essentially describes what we know (or believe to know) and feel about other individuals or groups (Frith and Frith 2006). While a good reputation generates trust which translates into credibility and reliability, a poor reputation can be costly, because individuals neglect others with a low reputation as cooperation partners. A reputation of unreliability and of providing false information can have substantial negative feedbacks on the cheating party. Even rumour or gossip about incredibility can have strong negative effects. The reason is that few emotions have comparable strong effects as those resulting from betrayal. A breach of agreement favours strong impulses such as grudge and vengeance which are opposed to the commitments required in social and economic transactions (Finkel et al. 2002).

Corporate reputation management

Reputation has long been recognized to be a key element in economic decision making (Dümke 2007). As reputation is a form of intangible capital, companies compete for the best reputation (Fombrun and Shanley 1990; IFC 2009). Enhancing brand value is thought to be a critical factor of economic transactions and consumer decisions. The reason is that corporate reputation has been estimated to contribute substantially (more than 50%) to a company´s market value (Gaines-Ross 2008).

An essential feature of corporate reputation management is demonstrating credibility by reliable commitments. This involves investments of time and energy in building up trusting relationships with stakeholders such as customers or partners. Moreover, signals that communicate the commitment to refrain from any cheating options are important. For instance, brand value can emerge from a commitment of producing high quality goods and services. Another key measure to underpin credibility is transparency and admittance of external control. For instance, labels such as “organic food” can underpin their credibility by allowing external auditing companies to perform quality checks on products and performance standards.

Why reputation management is not trivial

While reputation management is of critical importance, it tends to be underrated due to several cognitive constraints and biases that prevent accurate judgment of issues that trigger reputational effects. We wish to highlight some issues for. A key factor for why reputational effects are often underrated is that they concern intangible assets. In contrast to tangible assets (money, goods, production facilities), reputational value is hard to measure and reputational effects are difficult to deal with. Due to this, reputational consequences often become most apparent when the positive effects of good image suddenly disappear, hence, when it is already too late. One important bias involved is negative reputation bias, which is the assumption that a negative reputation due to actions that deteriorate valuable relationships (e.g. deceiving) can easily be outweighed by a similar amount of positive actions (e.g., cooperative communication). However, the opposite is the case. Building up a good reputation takes much time and energy, but this effort can be damaged easily by relatively small negative effects. Warren Buffet coined this the following way: “It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you’ll do things differently”. Another bias involved is loss aversion (Kahneman et al. 1991), which is the observation that people tend to attribute a higher value to something they posses compared to something they do not. Building and keeping a good reputation typically requires investments (i.e. giving away something that one does possess) for a return that may, or may not come about due to a gain in reputation. An example is that the requirements involved in stakeholder engagement demand that a project proponent informs and involves all stakeholders proactively (i.e. before they ask for it). Loss aversion may cause reluctance to invest in reputation. Communication bias is the fallacy that reputation is only about good communication (public relations). However, effective reputation management involves commitments that lead to actions which can than adequately be communicated. For instance, sole communication about stakeholder involvement without corresponding actions is likely to have opposite than desired effects. Group (corporate) reputation management involves the additional challenge that individual actions affect group reputation (they are generalized). Hence, a bad reputation of one member of a group (a politician or an employee) translates into poor reputation of the whole group (all politicians, the company). Likewise, group reputation feeds back on group members (Dutton et al. 1994). Finally, reputation typically has multiple dimensions. For instance, a company typically has a reputation in different realms such as economic performance, reliability, quality, communication or sustainability. A good reputation in one context (e.g. economic performance) can be in conflict with reputation in another (e.g. sustainable project realisation). Current corporate reputation strategies seek to remove such conflicts by the idea that sustainable project realisation is a means for enhanced performance (IFC 2009).

Implications of reputational effects for an efficient process of ESIA

Within the ESIA process reputational effects are of key importance at different levels. These can be separated in effects on the reputation of (a) financial institutions and (b) that of project proponents.

(a) Reputation of financial institutions

By means of the ESIA process financial institutions seek to enhance their reputation which is considered as one major pillar of economic performance. Financial institutions can protect their reputation by demanding improvements to project planning or by not to financing projects with adverse impact on social and environmental issues. This is because any significant negative effect that is not accounted for and adequately mitigated during the ESIA process, ultimately redounds upon the financing bank as negative reputation.

Understanding reputational effects for financial institutions can be difficult for the personnel of the credit user. For instance, stakeholder engagement requires a pro-active information and participation process (IFC 2012) which has not been common practice by many practitioners before the introduction of ESIA. Therefore, efforts need to be made so that employees of the credit user can understand the generalisation effects their actions have on other companies and that the requirements implemented by financial institutions are ultimately a conflict prevention strategy of financial institutions to enhance cost efficient project realisation.

(b) Reputation of project proponents

i. Perspective of financial institutions

Reputational effects also act among the project proponent and the financial institutions. For instance, the decision not to implement an ESIA in the screening phase despite of likely impacts may negatively affect the reputation of the project proponent. Likewise, inappropriate stakeholder engagement in the scoping phase or downplaying of expected impacts during impact assessment have potential to trigger reputational reactions from lenders.

Another issue is ambiguous communication between the credit user and the financial institution. This might arise, for instance, due to internal conflicts of interest on the side of the project proponent during project planning and realisation. Appropriate conflict and communication management can help to mitigate conflicts thereby facilitating clear communication.

ii. Perspective of stakeholders

Experience has shown that a top down approach to project realisation without appropriate stakeholder involvement can lead to substantial costs such as interruptions of project execution and unfavourable media attention. As local stakeholders typically base their actions (cooperation or resistance) upon the communication and cooperation attitude of the project proponents, it is in the own best interest of a company to pre-emptively avoid potential conflicts by means of a pro-active communication and participation strategy. For instance, in the planned new construction of the main train station in Stuttgart, Germany (“Stuttgart 21”), a top down approach of project proponents led to considerable resistance in the population, caused severe and expensive delays in start of construction, and triggered displacement of the ruling political party by the Green Party.

Conclusion

Reputational effects are one of the main driving forces concerning efficient implementation of environmental and social impact assessment. However, the effects of reputation are often unknown or underestimated by the involved parties due to their intangible nature and their indirect effects. Sensitising collaborators for the reputational effects involved in the ESIA process can help to facilitate the process in various respects, thereby enhancing efficient and sustainable project realisation.

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