

# Talking Risk & Capital

By Diane Reynolds

**REGULATIONS, HIGH-PROFILE LOSSES,** the credit crunch, exchange rate fluctuations, political factors, and a growing appreciation for risk management are driving investors to demand more information from the firms in which they invest. Perhaps hardest hit by many of these factors, and therefore under the greatest pressure to disclose their risks are financial institutions. A series of surveys reveal how banks have adapted their annual reports to include more risk disclosure as they adjusted to new regulations and pushed through the beginning of the credit crunch. Using this experience as a foundation, we examine possible future directions in risk reporting by insurers, as they negotiate turbulent markets and move towards Solvency II compliance.

Can investor relations improve through better risk disclosure? If so, this would constitute an immediate shareholder value add—beyond the information itself. However, the anecdotal results are somewhat mixed. Surveys indicate that investors place significant value on risk information. For example, a recent survey by Price Waterhouse Coopers<sup>1</sup> found that respondents regarded ‘quality of compliance and risk management process’ (41 percent) and ‘transparency’ (41 percent) ahead of ‘performance’ (40 percent) when asked for the main criteria for deselecting investment providers. In contrast, AIG did not fare well in September when its financial products division began racking up large losses. Despite comprehensive risk disclosures in its 2007 annual report, its share price tumbled more than 90 percent in the wake of the losses.

Investors demand not just more information, but comparable information. Is a common disclosure road map possible? Firms and investors alike were looking to regulations such as Basel II and Solvency II for answers. Things have changed and investors are becoming more directly demanding. Ultimately, a compromise that allows the financial industry to continue operations in the short term, while ensuring a longer-term move towards greater capitalization and stability must be reached. Financial institutions are forging ahead, learning from each other to develop appropriate methods of disclosing relevant risk information to stakeholders.

One of the most public ways for a firm to disclose and discuss its risk management practices is through the annual



report. In its annual *Risk Report*,<sup>2</sup> Algorithmics surveys 100 of the world’s largest banks by reviewing their annual reports to assess how they are discussing their risks with their investors. The most recent survey examined 2007 annual reports, finding that 75 percent of banks chose to provide a separate, usually unaudited ‘risk report’ as part of or adjacent to the annual report.

In contrast, only 49 percent of banks included such a report for 2006. Of the 26 ‘new’ risk reports, many were created by simply increasing the profile of the risk-related information rather than enhancing the disclosure details. For example, by moving it into the core of the annual report as a separate “risk report” section instead of leaving it buried in various, scattered notes to the consolidated financial statements, risk information



**Diane Reynolds** is senior director of economic capital solutions with Algorithmics Inc. in Toronto, Ontario. She can be reached at Diane.Reynolds@Algorithmics.com.

#### FOOTNOTES:

<sup>1</sup> See the survey, *Transparency versus returns: The institutional investor view of alternative assets*, conducted by the Economist Intelligence Unit on behalf of PriceWaterhouseCoopers (PwC).

<sup>2</sup> Article available from [www.algorithmics.com](http://www.algorithmics.com).

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was consolidated and easier to locate. The consequences of this move from the investor perspective are two-fold: risk information is (1) more readily accessible to investors, but (2) less reliable, since it moves outside of the typical external auditor review process.

The length and level of detail in the risk report varied greatly, with banks dedicating between two and 128 pages to risk disclosure. Still, with an average length of 28 pages, or 11.2 percent of the entire annual report, dedicated to risk, the extent of the information was considerable in many cases. Although a high degree of variability in the content of the risk report was also found, the most common outline for a risk report is shown in the table.

#### Outline of a Typical Risk Report for 2007

1. Statement of solvency
2. Risk management committee structure
3. Definitions of risk(s) and capital
4. Description of material risks
5. Provisions & loan loss reserves (i.e., amounts already set aside to cover 'known' risks and prior losses yet to materialize)
6. Exposure breakdown: rating, sector, etc.
7. Risk quantified: VaR, CTE, or capital
8. Risk measurement methodologies (e.g., what is VaR?)
9. Risk attribution: business unit, country, etc.

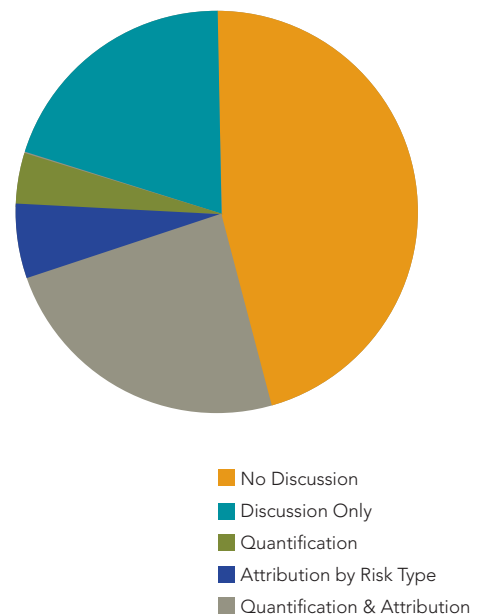
A majority of banks used their risk report to establish the link between capital and risk. About two-thirds of risk reports (54 of 75) used economic capital to describe capital requirements and quantify risks. Although the definition of economic capital varies from one institution to another, most revolve around the same key elements. Specifically, economic capital is:

- The capital required to support the risk-taking by the firm
- Meant to cover a list of particular risks
- Inclusive of diversification benefits
- Based on a confidence interval (with a number provided)—and that this confidence level is related to the rating of the institution
- Measured over a particular time horizon.

Significantly, 30 firms (up from 19 the previous year) went beyond definitions and discussions to actually quantify economic capital. Of those 30, six (five last year) stated an overall capital requirement, four (three last year) provided an attribution of capital across risk types, business lines and/or geographical centers, and 20 (11 last year) provided both types of information.

Not only were more banks discussing economic capital, more detailed information was also provided. For example, Commerzbank not only allocated its economic capital by risk type, it supported the distribution of economic capital with stress tests and scenarios analyses for each risk type, then compared stressed economic capital to available capital. If this seems a sophisticated strategy, keep in mind that AIG also provided stress test information in their 2007 report.

#### Talking Economic Capital



One area where there was little change was in terms of comparing economic capital requirements to a benchmark of available capital or funds. Unlike measures of regulatory capital which can be compared to shareholder equity, economic capital is a forward-looking measure of risks on an economic basis. It is counter-intuitive to compare

“A standard liquidity-based benchmark for economic capital, such as cash & equivalents, may emerge from the crisis of autumn 2008.”

a book value to an economic measure, leaving the identification of a suitable benchmark in question. As IFRS moves firms inexorably toward mark-to-market of assets, a more suitable benchmark may become available. Given the events of the autumn of 2008, however, one might also consider a more liquidity-based benchmark such as cash & equivalents.

How did insurance firms compare to banks in 2007 reporting? Taking Great-West Life as an example, we found six pages devoted to identifying and defining a wide variety of risks in an easily-identifiable risk report addressed under the management discussion in the annual report. In contrast, Manulife Financial, the parent company of John Hancock, devoted only two pages (of 124) to defining and quantifying interest rate, reinsurance and credit risks in Note 7 to its financial statements. Like many banks, there is of course other risk information available in the report—it is divided across several, variously labeled notes.

Other insurers surveyed included Sun Life (risk report, three pages) and All State (17 pages spanning four separate sections). These examples illustrate the variety in reporting details, methods and locations. Arguably, the variety itself obscures the risk information by making it more difficult for investors to compare firms. This admittedly small sample also showed distinct similarities between insurer reporting in 2007 and bank reporting in 2006.

Looking more closely into the earlier AIG example, we found that AIG dedicated 25 pages to risk in a clearly labeled section; but embedded it in section 7 of their 10-K filing. Rather than addressing risk in the core 50-page report, one had to search through the section-by-section contents to locate it. (Although one must note the standard location of risk in 10-K filings.) More extensive than other insurers reviewed, the risk information included definitions of key risks, an overview of the management processes and even a discussion of economic capital model enhancements (no quantification).

Clearly, the length of the risk report is only a crude metric of the extent to which risks are reported. Other issues such as the scope and quality of the information take precedence. Further, while the concept of ‘gathering together’ all of the risk information into a central location is appealing, it may not be practical. Many accounting standards (e.g., IFRS 7) and regulations reference or require the disclosure of risk measures or practices. Some of the details must be audited and/or impose strict rules on referencing of unaudited information. These competing requirements create complexity in the design of a risk report.

The CRO Forum<sup>3</sup> addressed this issue in its November 2008 paper, “Public Risk Disclosure under Solvency II.” In an effort to promote market discipline they proposed a principles-based standard for risk disclosures that would provide harmonized reports to stakeholders, thereby reducing negative surprises and permitting comparisons across firms and across time. The five key principles included (1) group disclosure as a reference, (2) leverage of financial reporting, wherever feasible, (3) materiality, (4) appropriateness of disclosures to the risks faced and audience and (5) comparability of solvency, based on Solvency II standards.

In discussing materiality, the CRO Forum stated “Risk disclosure should include the specific definition of materiality used by the undertaking [firm] and a description of the material risks faced by the undertaking, the governance framework for managing these risks, and the relationship between risk and capital.” In other areas, quantitative disclosure is encouraged, and stress testing deemed essential.

#### FOOTNOTES:

<sup>3</sup> See <http://www.croforum.org/>

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From a practical perspective, the CRO Forum also presented a template for risk disclosures accompanied by an example. These items are well worth examining in detail. As a summary, the outline proposed by the Forum for risk disclosure is presented in the table below.

**CRO Forum Risk Report Template**

## Risk Overview

- Risk Governance Framework—organization, controls, and policy
- Risk Overview—material risks, solvency assessment, mitigation

## Risk assessment by risk category

- Quantitatively assessed risks: non-life underwriting, life & health underwriting, market, credit, and operational risks
- Qualitatively assessed risks: liquidity, strategic and reputational risks

## Capital adequacy management

- Internal capital adequacy
- Regulatory solvency

## Required capital for major solo entities

Generally, this proposed outline tracks well with the more detailed risk reports provided in 2007 annual reports. By

creating a standard template, information will be easier to locate and compare. Within the detailed outline provided in the paper, there are also guidelines as to the measures firms are expected to disclose for quantifiable risks—something that is currently high non-standard.

Certain questions remain open, however. For example, stress testing is not addressed. Rather, there is a statement that Solvency II is expected to produce a common set of standard stress tests to serve as reporting benchmarks. While this might be the case, Basel II regulations do not as yet include standard stress tests, instead leaving it to each institution to tailor stress tests to its own particular circumstances. Perhaps a combination of common and customized stress tests will emerge as a standard, however, some care must be taken not to create too high a burden.

We have already seen some significant changes in the extent of risk reporting amongst large banks and leading insurers. Risk management, already high on the budget agenda based on regulatory compliance considerations and gaining momentum in the popular press through the growing credit crunch, rogue trading, rumors of downgrades & growing spreads, then actual defaults and downgrades, took center stage in September and October 2008 as market turmoil escalated. However, questions remain as to what new standards of best practice for risk disclosure may emerge from this latest market lesson in risk management. The CRO Forum has taken an important step along this path. ♦