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# Poor Risk Disclosure? How About a Model Investors Can Use?

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**Todd R. Bault, FCAS**  
Senior Analyst

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SEE DISCLOSURE APPENDIX OF THIS REPORT FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATIONS

## A simple premise

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- Investors have little or no use for ERM
- This despite decades of development and exposure
- This despite real progress on the management side
- Why is this?

## A simple answer: CAPITAL

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- Investors want to know what will gore their ox
- For equity investors, that's a *capital event*
  - When do companies need to raise capital?
  - How much? What type?
  - Will they have to cut their dividend, and how much?
  - Or can they raise the dividend, and how much?
  - Or can they buy back shares?
- These are not boring questions to investors, they are the most important questions in the world
  - I am being bombarded with them at present!

## A firsthand report

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- I currently work as an equity analyst (9 years)
- Past life I worked in the insurance industry (12 years)
- ERM has been integral to my training in both phases
  - Helped develop capital allocation and economic return model at major insurer
  - Adapted this model for use in equity research, now a key component our valuation framework
- In addition, I even like theory and models!
- Sad truth: Some clients care about this, but not many

## Why don't investors care about ERM?

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- It's not about what makes stocks go up or down
  - Or at least, they don't know how it relates
  - Investors are very smart, but focused on what matters
  - The value of ERM to them needs to be proven
- Investors underutilize disclosures generally
  - Can only focus on so many things
  - Disclosures often seem complex or irrelevant
  - If things are working, investors tend to extrapolate
  - When things stop working, they want minute details, not boilerplate disclosures

## How to get investors to care

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- Get the ERM foot in the door *first*
  - Show investors that ERM can help predict capital events
  - Not economic capital, *real* capital, *their* capital
  - But if you can show that economic capital (or some function of it) predicts real capital events, that's your foot in the door!
  
- *Then* show the additional applications
  - Once investors have a hook into something they understand, they are more likely to think about other uses and applications
  - But not before!

## Once investors care, what then?

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- After ERM can model capital events, some immediate next applications spring to mind:
  - Capital structure: what kind of capital (including reinsurance) would be optimal?
  - Strategic valuation: What is the value of management's strategy?
  - Earnings quality: Directly address the uncertainty of profits as an issue of earnings quality
- Once investors have an application in mind, *they* can help guide desired disclosures!

# Disclosure Appendix

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# Poor Risk Disclosures: The Most Overlooked Risk

ERM Symposium

April 15, 2008

Sim Segal, FSA, CERA, MAAA  
Managing Director  
Head of ERM Service Offering, The Americas  
Aon Global

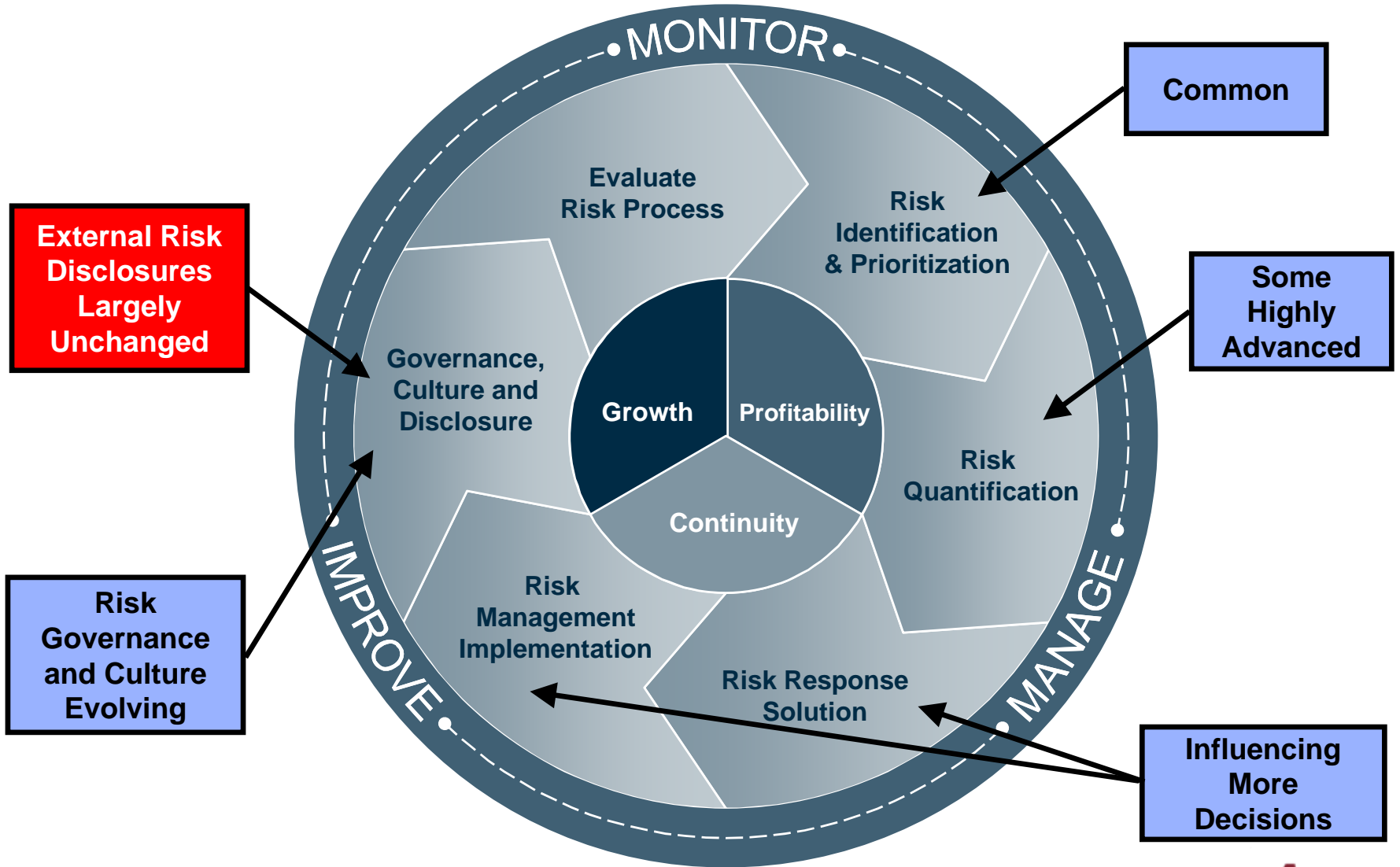


# ERM and risk disclosures

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- Primary purpose of financial statements: to disclose risks and opportunities of investing in company's stock
- Many adopt ERM to deepen understanding of key risks, including their potential impact on shareholder value
- However, most have not yet modified risk disclosures

# ERM is evolving...



# ...but risk disclosures slow to change

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- ➔ Most companies within sectors have similar disclosures, yet ERM practices vary widely
- ➔ Two potential reasons:
  - 1) Companies not yet able to disclose (MOST ARE HERE)
    - Not quantifying operational and strategic risks
    - Not quantifying risks in terms of impact on value
  - 2) Companies not yet willing to disclose
- ➔ Soon, neither reason may be acceptable

# Rating agencies

S&P ERM quote on risk management culture and governance:

***“Regarding external communications... compliance with regulatory standards is often insufficient.”***

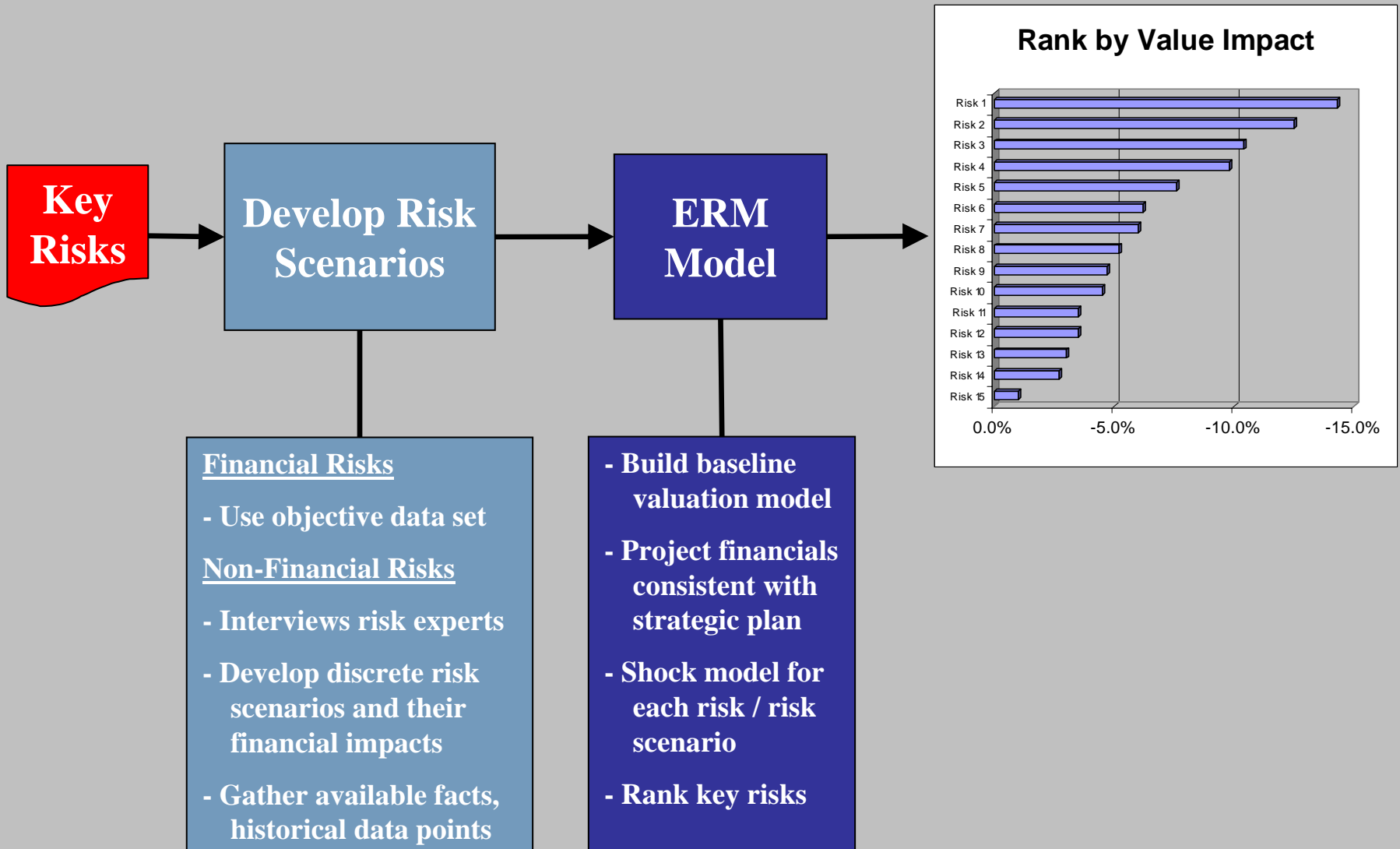
The screenshot shows a document from Standard & Poor's RatingsDirect. The header includes the Standard & Poor's logo and the date November 15, 2007. The main title is "Criteria: Request For Comment: Enterprise Risk Management Analysis For Credit Ratings Of Nonfinancial Companies". Below the title, it lists the Primary Credit Analyst (Steven J. Dwyer) and Secondary Credit Analyst (David Inguen). A "Table Of Contents" section lists: Proposal Summary, Scoring ERM, Background, Standard & Poor's Experience With ERM Analysis, Ratings Impact, Related Articles, and Response Deadline. The footer contains the website URL www.standardandpoors.com/ratingsdirect, a page number 1, and a copyright notice for 2007.

# Shareholder expectations

- Two similar firms lose 25% of their value, triggered by same event
- Shareholder or employee litigation

Company A	Company B
Standard risk disclosures	Enhanced risk disclosures
26 <sup>th</sup> risk discussed; no particular logic in ordering of risks	10 <sup>th</sup> risk discussed; based on ranking key risks for potential impact to shareholder value
Not much content; risk not highlighted as a major risk	Robust content, including strong tone regarding impact
Company surprised at magnitude of impact	Magnitude not a surprise, based on range of scenarios quantified
Board / management may be more at-risk	Board / management more secure; performed primary fiduciary responsibility. Shareholders made informed decision

# Quantifying / Ranking on Value Basis



## For more information, contact:

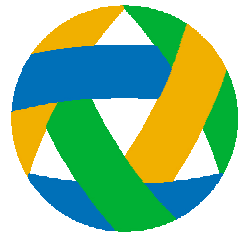
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Sim Segal, FSA, CERA, MAAA

Managing Director

ERM Service Offering Leader, Americas

917-699-3373 (m)



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**Poor Risk Disclosure:  
The Most Overlooked Risk**

ERM Symposium  
Chicago, April 15, 2008

Basil Rabinowitz, ASA, PhD  
SVP, Actuarial and Strategic Analysis



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## Reasons for Poor Disclosure

- **Disclosed Risks are Irrelevant**
- **For Relevant Risks**
  - **Poorly Communicated**
  - **As Yet Unidentified**
    - **Poor ERM**
    - **Hidden**
  - **Threat Perception Underestimated**
  - **Integrity - Conflict of Interests**



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# Communications

- **Up / Down within the Company**
- **Senior Management / Board**
- **External Stakeholders (Analysts, Rating Agencies, Regulators, Shareholders ....)**
- **Clearly Articulated**



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# Obfuscation

$$\ln\left[\lim(1+1/z)^z\right] + \left[ \sin^2x + \cos^2x \right]$$

$$= \sum (\cosh y)^* ((1-\tanh^2y)^{0.5})/2^n$$



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## Articulate Clearly

- **Lotto - pick 6 winning numbers from 54**
  - **Odds are 1 in 25,826,165**
- **Pick One Dime from a stack of Dimes**  
**21.7 Miles high**
- **A commercial Jet flies at an altitude of**  
**about 6 miles high**



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## Articulate Clearly

- In NY Lotto - pick 6 winning numbers from 59
  - Odds are 1 in 45,074,474
  - Stack of Dimes is 37.8 Miles High
- For MegaMillions
  - Odds are 1 in 135,145,920
  - Stack of Dimes is 113.4 Miles High



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## Close the Loop

- **Disclosures - Herd Mentality**
- **Map the Disclosure List to Basic Categories**
- **Assign Oversight by Category to Board Subcommittees**
- **Communicate Regularly and Clearly**



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# Culture

- **Involve the Risk Experts - the Troops in the Trenches Understand the Danger Best**
- **Analogous to Purchasing a House**
- **Monitor Perceived Threat - Elevate and Disclose Appropriately**
- **Conflict of Interests - Cultivate Risk Culture - Integrity - Tone from the Top**



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# Conundrum

- **The Better the ERM, the Less the Perceived Value**
  - **Terror Threat**
  - **Eastern Airlines Flight 855 - L1011**
    - **Out of Miami 5/5/83**
    - **3 Engines**
    - **$P(\text{Single Engine Failure}) = 1/10,000$**



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## Model Risk

- **Appropriate Granularity / Speed**
- **Temper Results with Good Judgment**
- **Long Term Capital**