



SANFORD C. BERNSTEIN & Co., LLC

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

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A simple premise

- 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

- 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

- 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?

- 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

- 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?

- 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

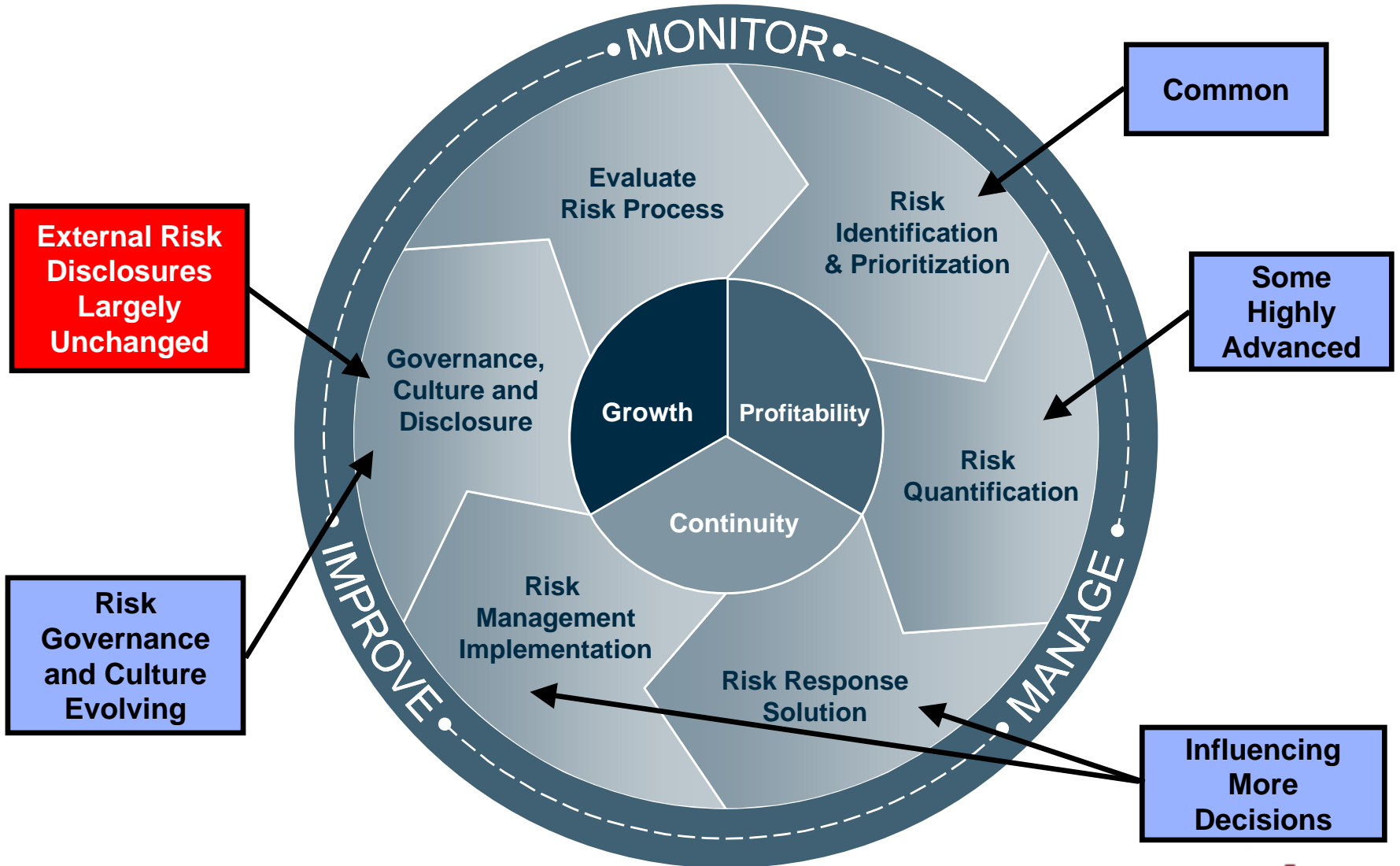
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Head of ERM Service Offering, The Americas
Aon Global



ERM and risk disclosures

- 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

- ➔ 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.”

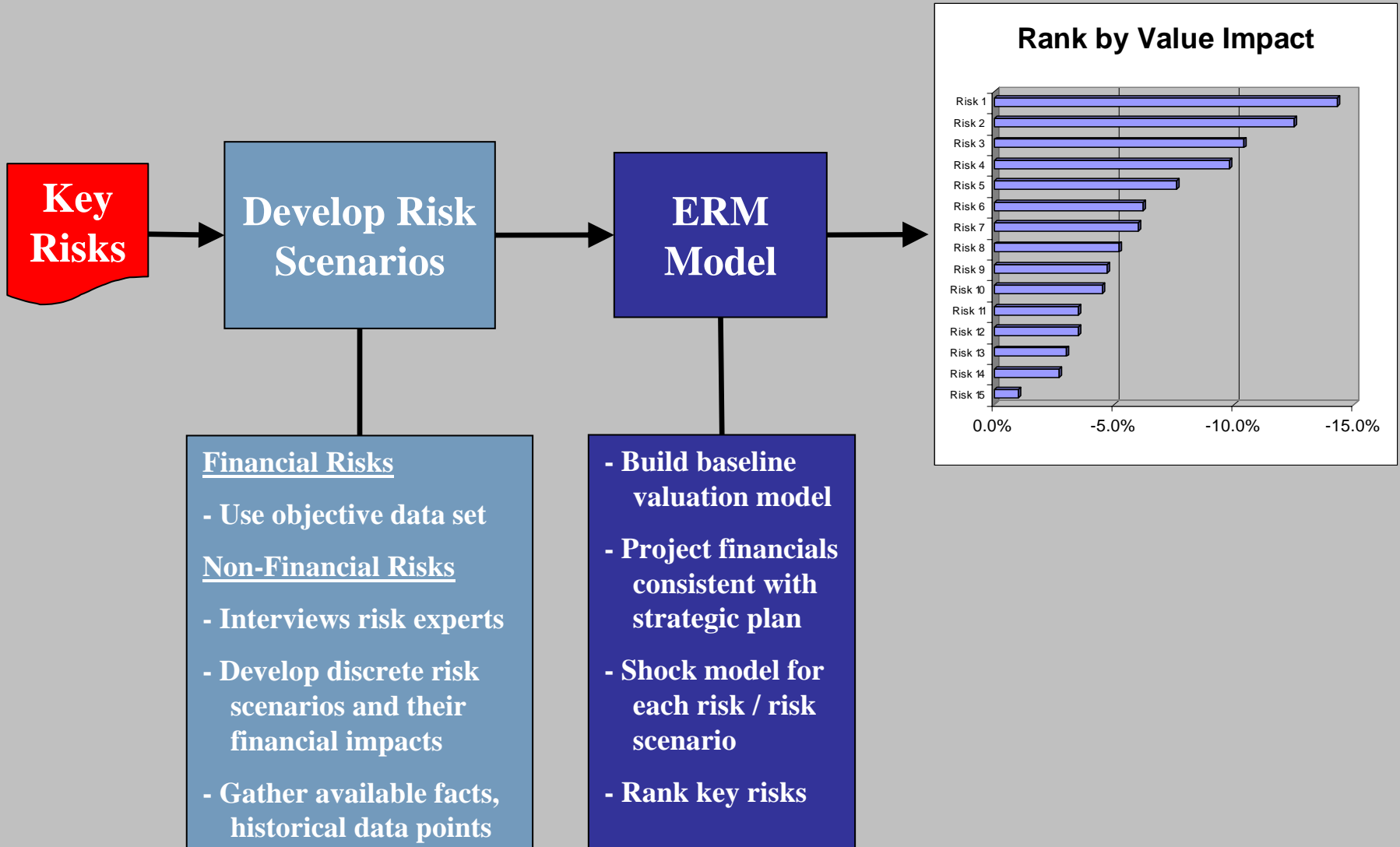
The screenshot shows a document header with the Standard & Poor's logo on the left and 'RATINGSDIRECT®' on the right. Below the logo is the date 'November 15, 2007'. The main title of the document is 'Criteria: Request For Comment: Enterprise Risk Management Analysis For Credit Ratings Of Nonfinancial Companies'. Below the title, it lists the Primary Credit Analyst as Steven J. Dwyer and the Secondary Credit Analyst as David Inguen. A 'Table Of Contents' section follows, listing items such as Proposal Summary, Scoring ERM, Background, Standard & Poor's Experience With ERM Analysis, Ratings Impact, Related Articles, and Response Deadline. At the bottom, there is a footer with the website 'www.standardandpoors.com/ratingsdirect', a page number '1', and a copyright notice '© 2007 S&P Global Ratings'.

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 th risk discussed; no particular logic in ordering of risks	10 th 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



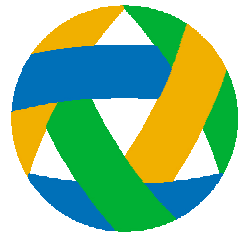
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**Poor Risk Disclosure:
The Most Overlooked Risk**

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**

