

Risk and investment conference 2012, Leeds

Risk reporting: Some preliminary thoughts
29 June 2012 meeting
Risk Reporting and Risk Management Working Party

Overview

1. Terms of reference
2. Issues and objectives
3. Theory and institutional setting
4. Prior literature – survey and critique
5. Research question
6. Sample, data description
7. Discussion of results
8. Conclusions and next steps

I Terms of reference

- Best practice Risk reporting in sector
 - to shareholders (this presentation)
 - Own business
 - regulatory
- Identify EU insurers (large, consolidated)
- Focus on current practices
- Utilise risk classification framework appropriate to sector

2. Issues and objectives

- Post crisis, changing focus of risk reporting (institutional v functional view)
- Part of broader accountability – to whom? For what? How?
- Evolving regulatory / market situation
- Viewing risk management as a process rather than starship enterprise COSO view
- Which firms are best practice? Criteria?

3 Theory

- **Good stories** – agency, incentives, reduce information asymmetry
- **Bad stories** – legitimacy, political visibility to stakeholders
- *Ugly stories* – neoinstitutional theory, hubris, instrumentalism, (fraudulent misrepresentation of underlying reality)?

3 Institutional setting;

- EU directives (insurance, MIFID, 3rd)
- COSO framework
- IFRS, ASB, SORP, auditing, actuarial standards
- Government imperatives (eg walker report)
- National variations in standards (eg German DRS 10,20)
- BASLE II/Solvency II
- FSA regulations + ABI guidance etc
- Sustainability reporting guidelines (eg IRG, ISO, WBCSD, AccountAbility, SIGMA)
- Extraterritorial regulations (eg SEC reg, credit agencies)

4a Prior literature -overview

- General literature surveys
- Industry surveys (KPMG, PwC, TW)
- Best practice reporting awards (ACCA)
- Related industries (eg Banking)
- Horing and Grundl (GPP, 2011)
 - Surveyed top 31 EU insurers
 - Period 2005-2008
 - Disclosure quality improved over time
 - Constructed index based on 45 items (market, liquidity, credit, operational, frictional risks)
 - Find disclosure quality varied with size, profits

4b Critique of Horing and Grundl

- Relied on german DRS 10 (favours allianz)
- Unable to discern results on firm by firm basis
- Risk classification framework based on COSO (vs actuarial risk classification system)
- Index comprises items that captures a mix of various stages of RM processes; i.e. did not separate adequacy of disclosure of various stages:
 - risk identification from
 - analysis of risk measurement or
 - assessment of management
- Ignored other sources than annual report
- Assumes Var is best practice risk measurement
- Dated ? (post 2008 would be of current interest)

5 Research questions

- What is extent of variation in RR practice disclosure of 'big 10' EU insurers?
- Does it improve over time eg post crisis?
- Which types of risk are subject to most disclosure?
- Benchmark to non EU (US, Asian top firms)
- Risk exposure identification, vs risk measurement, risk management disclosure?
- Narrative v numeric, quantitative
- Compliance or best voluntary practice?

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6 Sample

- Top 10 EU insurers (based on size assets under mgt);
- Study period 2008 - 2011
- Limited to allow for firm by firm comparison
- Relevant given heavy regulatory reliance on own business models
- Include bancassurers, reinsurers
- Benchmark to top 10 non EU (US, Asian) firms

No	Name	Country
1	Allianz	DEM
2	AXA	F
3	Generali	ITL
4	Zurich	CHF
5	Prudential	UK
6	Aviva	UK
7	ING	NL
8	Aegon	NL
9	Munich RE	DEM
10	Swiss RE	CHF

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6 Method

- Construct disclosure index
 - Horing and Grundl (45 items spread across 7 classes)
 - Kelliher et al framework (for top discloser)
 - Compare to US and Asian top insurers
- Analyse both by firm, by year 2008-11
- Analyse determinants of risk disclosure (incomplete)
 - Control variables (firm, institutional, incentives, corporate governance)

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Example of Horing Grundl disclosure index

Category no	Description	Max
1	Market risk	6
2	Credit risk	6
3	Insurance risk	14
4	Liquidity risk	4
5	Operational risk	4
6	Risk overview?	15
7		
	Total possible	<u>45</u>

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Method used to construct index I

1. Start with Horing and Grundl index (max 45 items broken down into 7 major categories + *strategic risk* =8)
2. Use keyword search for key items (eg 'market risk') and note no. of times used
3. Repeat for 8 categories, 4 years
4. Subtotal by risk category, total

Alternative method to construct index?

1. Disclosure adequacy of identified **primary risk exposure** using Kelliher et al. high risk classification (1/2weight of H+G index)
2. Use keyword search for key items (eg sources of identified market risk) and note no. of times used
3. Repeat for 8 categories, 4 years
4. Add an additional 1/2 point for disclosure concerning RM analysis /assessment of each primary risk exposure identified in 1

Horing and Grundl

- German focused DRS520
- Adopts standard COSO/Loach framework
- Aggregation and strategy risk not separate from operational risk
- Combines risk exposure and risk management
- condones VAR
- Overweights insurance risk (14/45 items)?

Kelliher et al

- Adopts functional perspective
- Regulatory focused?
- Separates strategy risk from other risks
- Primarily focused on risk exposure only
- Planning and control oriented
- Does not condone any performance measure

Disclosure index comparison

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Illustration of different approaches to index (e.g. market risk category= max 6 points possible)

- **Horing and Grundl**
 1. Define market risk
 2. Describe limits
 3. Describe risk mitigation
 4. Var at specified intervals
 5. Describe stress test
 6. Describe major risk classifications
- **Kelliher et al**
 - ½ Identified risk exposure
 1. Equity risk
 2. Property risk
 3. Interest rate risk
 4. Bond risk
 5. Commodity risk
 6. Forex risk
 - ½ Describe analysis/assessment of each exposure above?

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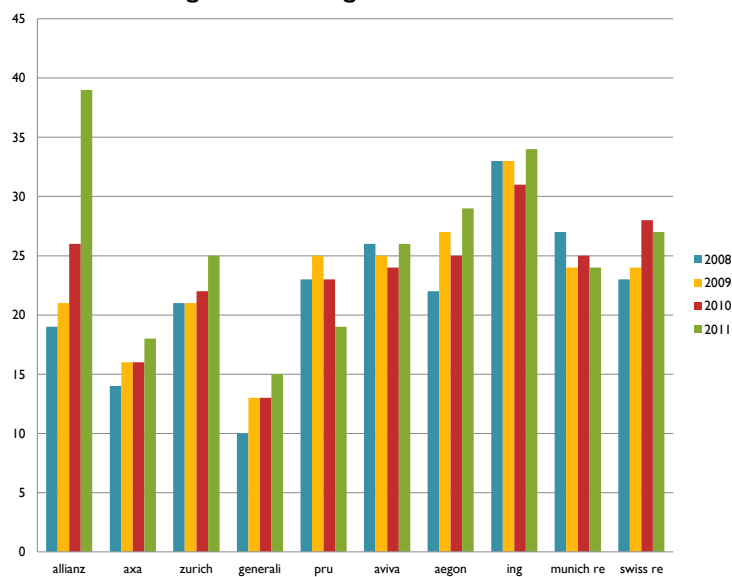
7 Preliminary Results

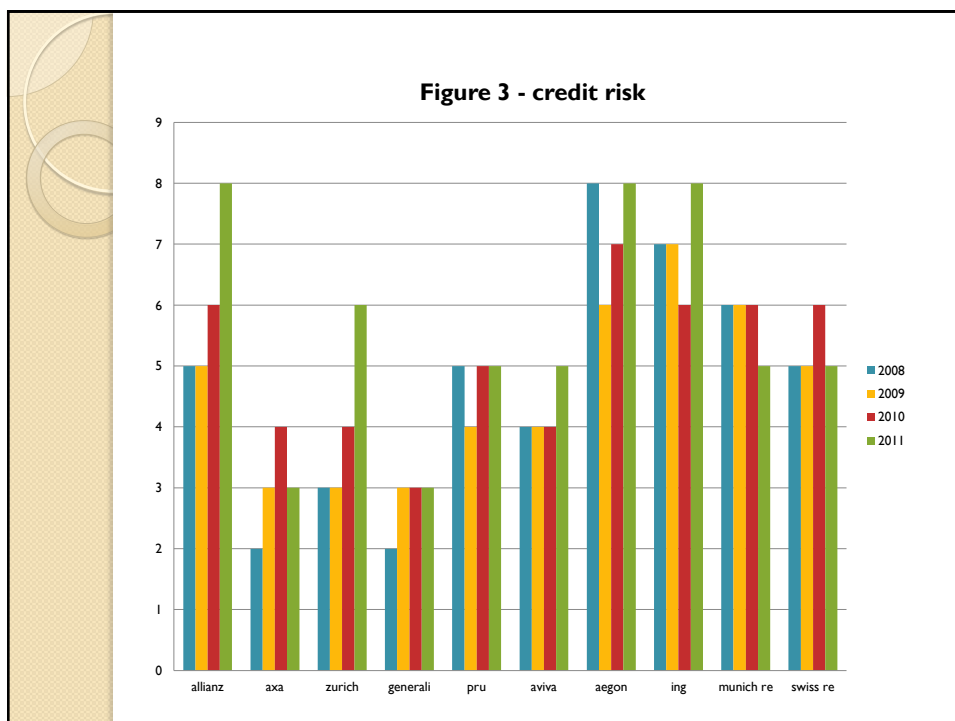
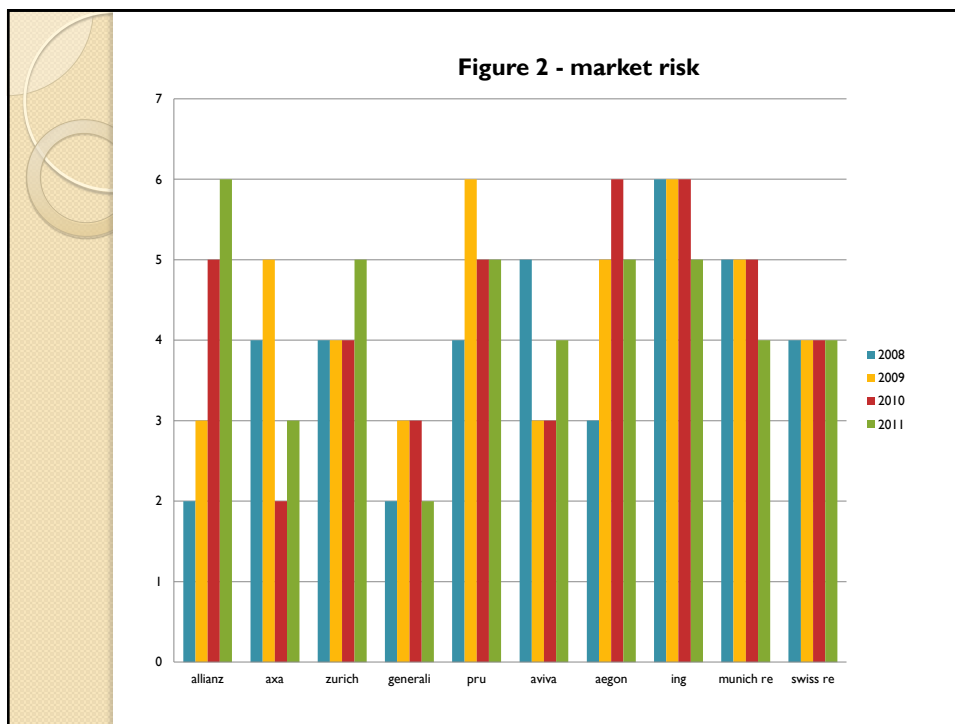
1. Graphical analysis of G+L disclosure scores in total and by risk category
2. General comments on risk disclosure by each company
3. Next steps

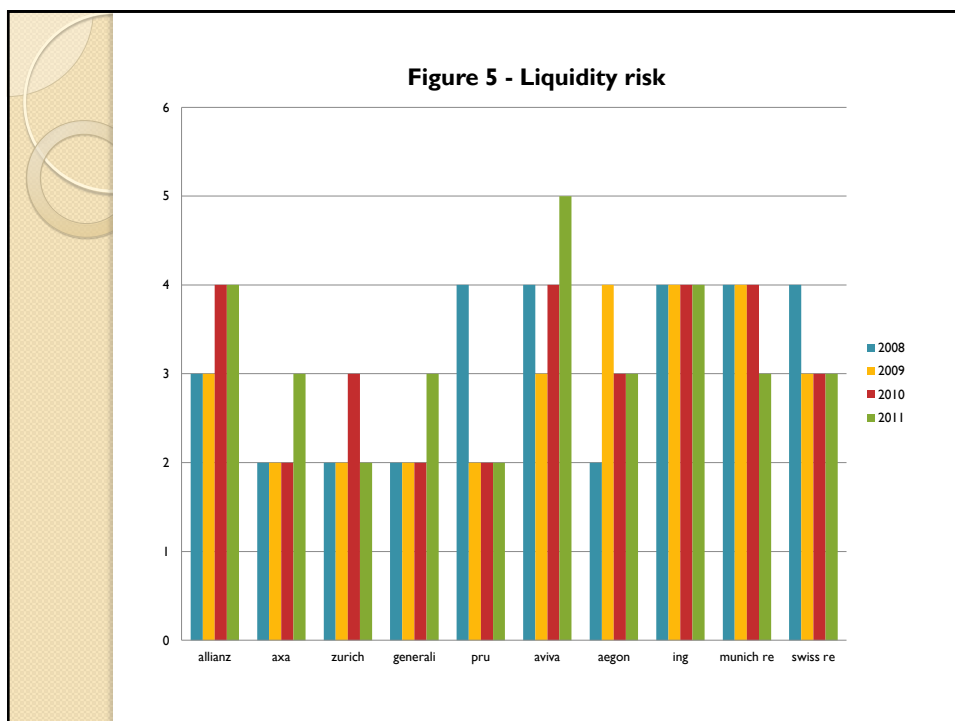
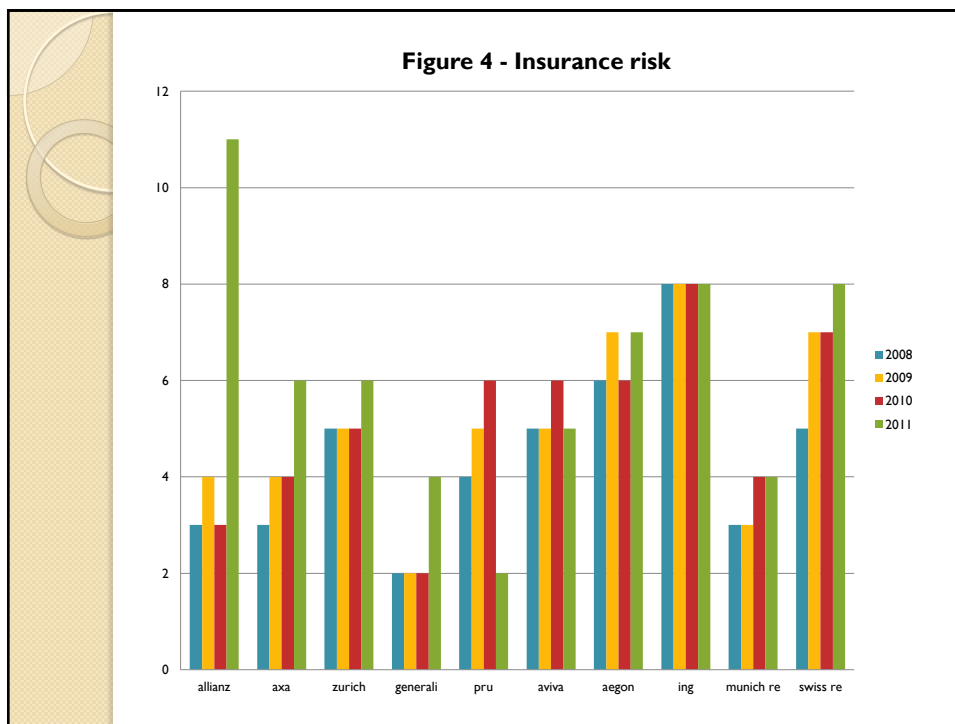
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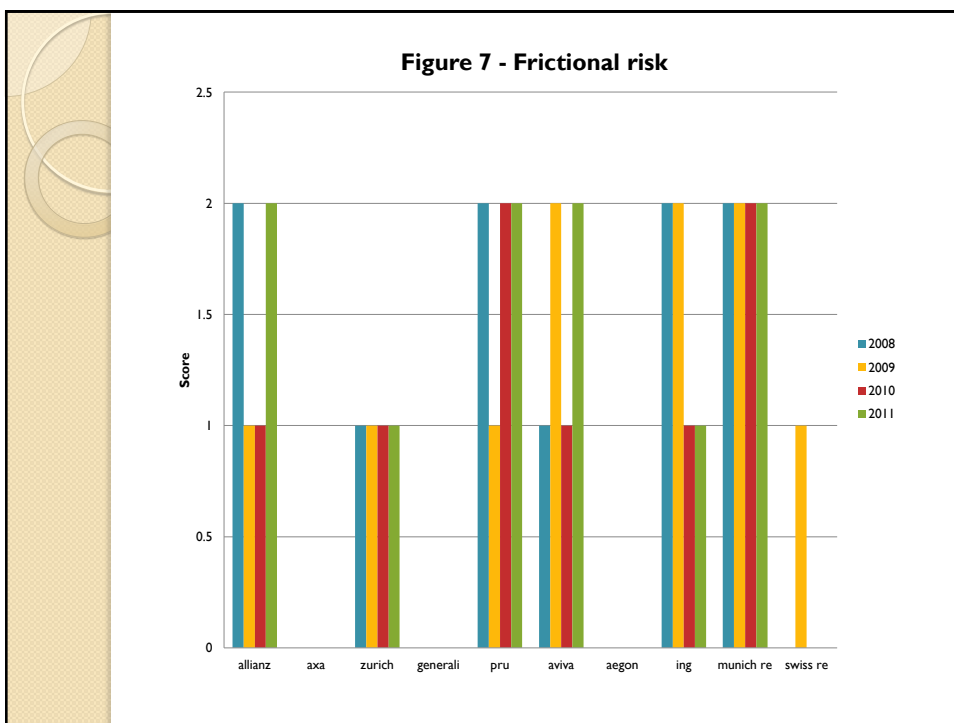
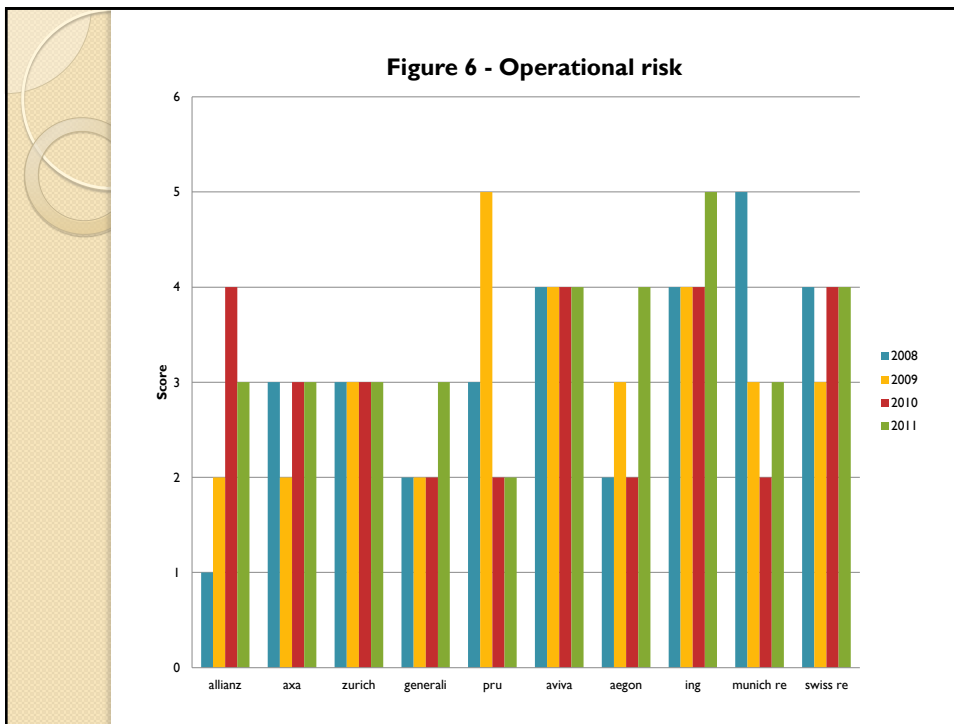
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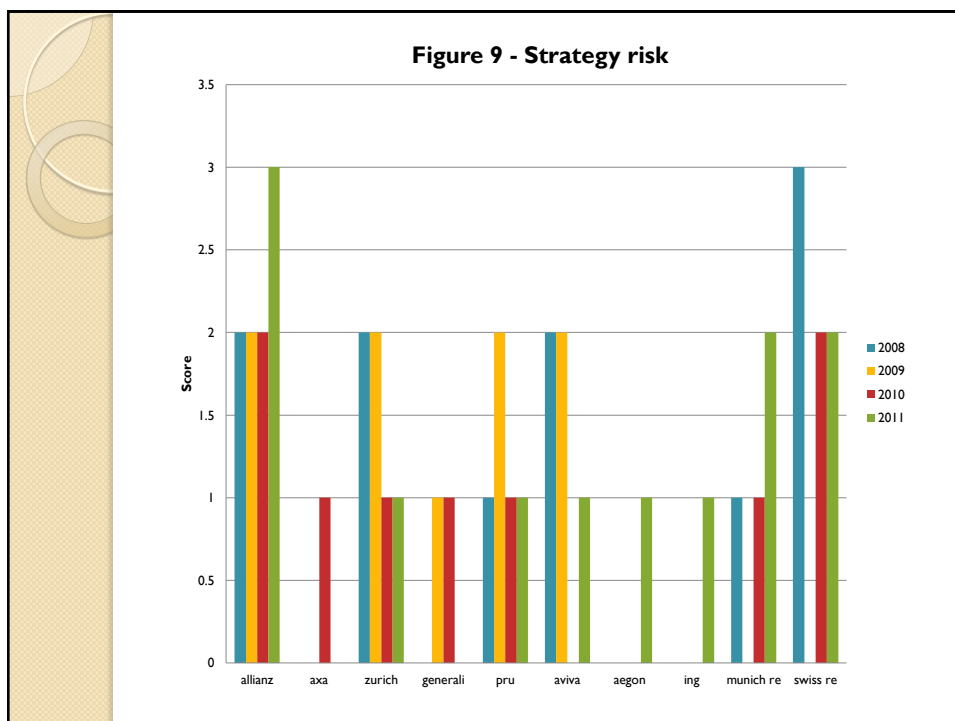
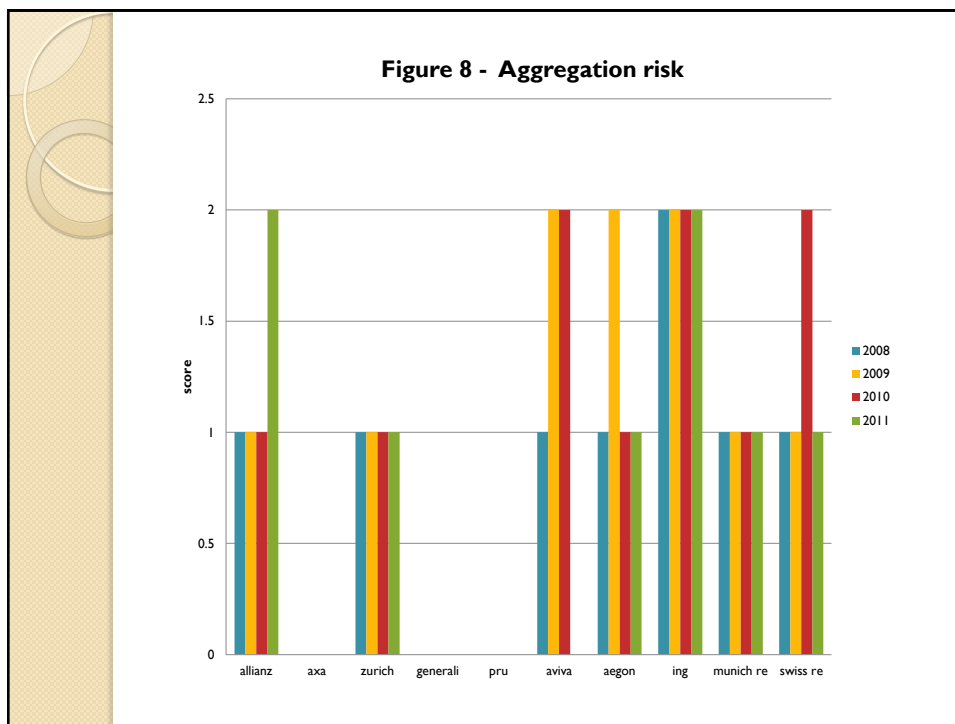
Figure I - Horing +Grundl total index

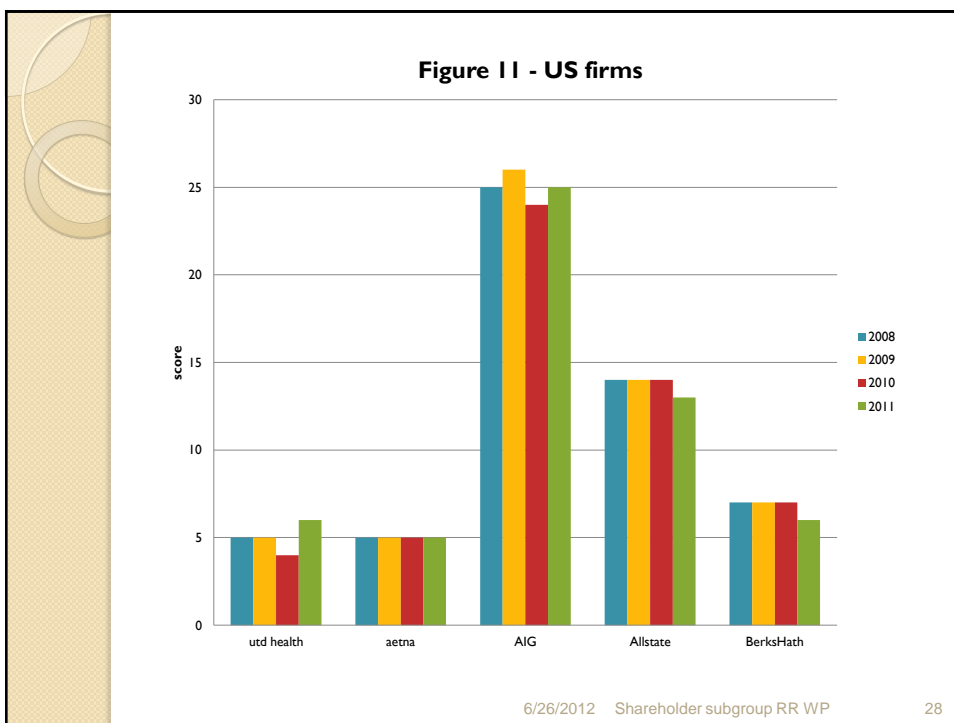
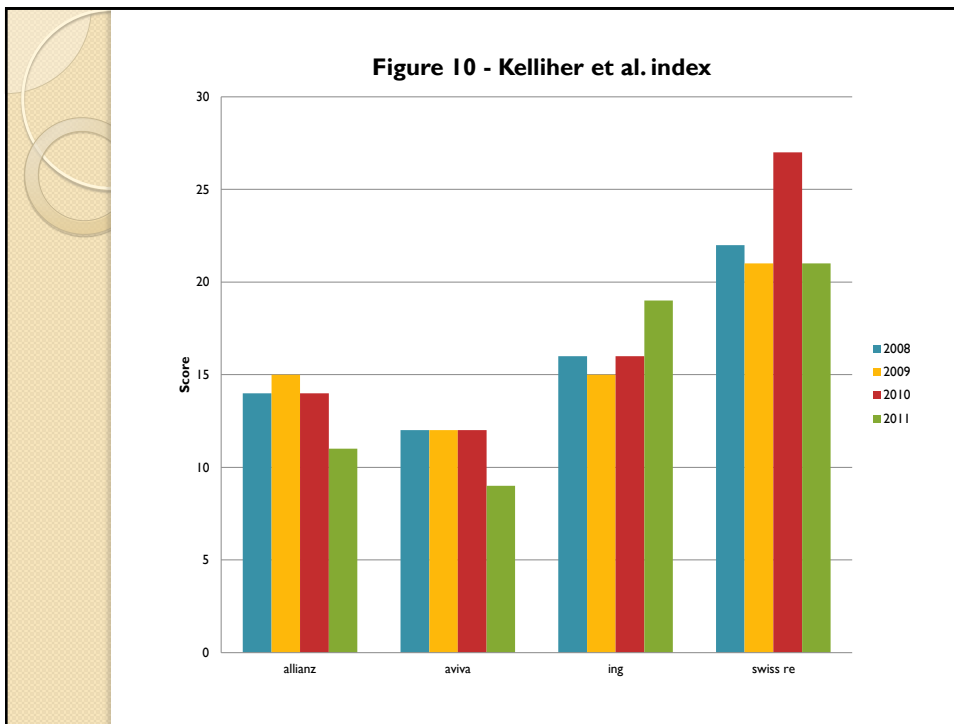


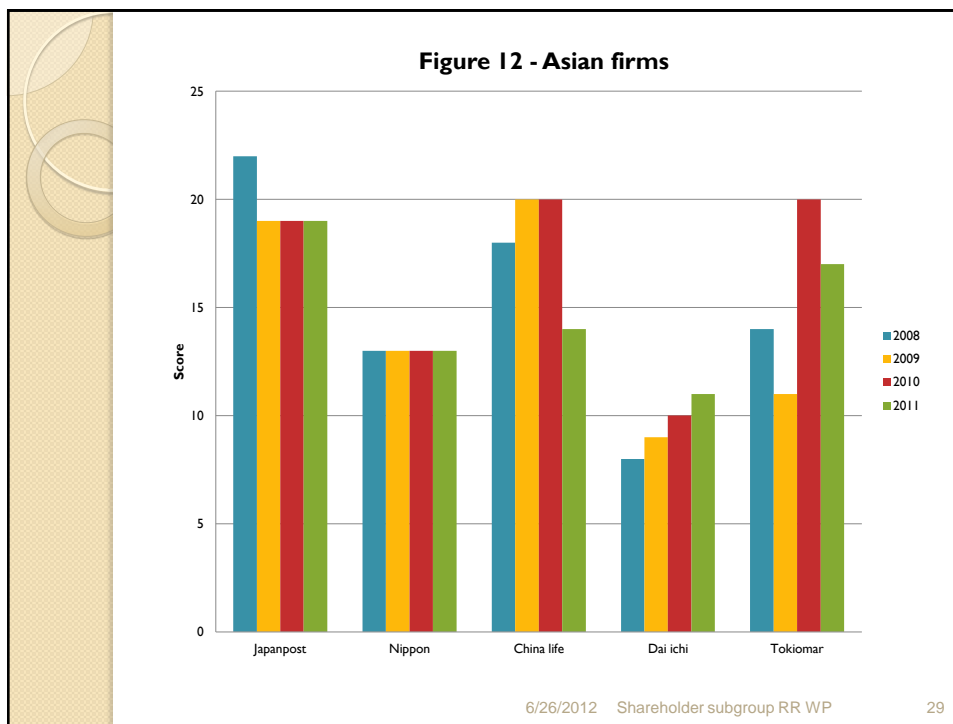












7. I Summary of overall trends – graphical analysis

- Total disclosure highest for Allianz lowest for Generali
- Trends improve over time
- Best disclosure for market risk
- Worst disclosure for aggregation risk
- Continental insurers better disclose financial risks
- UK firms: Aviva is consistent over time; Pru reduced
- EU firms disclose more risk information than US, Asian firms
- Kelliher et al alternative classification relevant only for high quality compliers/disclosures under H+G

8 Conclusions

- Horing and Grundl disclosure index is subjective and can lead to confusion between 'compliance' and voluntary practices?
- EU insurers generally disclose more information, especially about non-financial risks, than US or Asian firms
- Some improvement over time
- Alternative Kelliher et al. risk classification system may lead to better analysis

8 Next steps

- Analyse determinants of risk disclosure quality
- Link to best practice reporting for own business and regulatory purposes
- Develop comparisons with non EU
- Help profession develop position on risk reporting