

Risk Reporting - The Long View

Some things take time. I've been involved for the last two years in an IFOA project looking at the introduction of new corporate risk reporting guidelines. The Financial Reporting Council (FRC) kicked off the project to improve reporting in March 2011. As of January 2016 only a small handful of companies have reporting under the new guidelines with the first disclosures for most companies taking place over the next few months.

In this article I'm going to cover three topics;

1. A summary of the new requirements introduced by the FRC
2. A detailed look at how risk reporting of one company, Grainger plc, has evolved over the last decade. The company has been chosen as one of the first to produce a detailed long term viability statement as now required by the corporate governance code.
3. The role actuaries could play in helping develop better risk management outside of the insurance industry

1. FRC Code and Guidelines

The FRC introduced the most recent version of the UK Corporate Governance Code and Guidance on Risk Management, Internal Control and Related Financial and Business Reporting in September 2014. The requirements came into force for UK Listed Companies for year ends starting on or after 1 October 2014. For most companies the first set of report and accounts under the new guidelines will be published in the first half of 2016.

The new guidelines introduce a hierarchy of risks as illustrated in Figure 1.

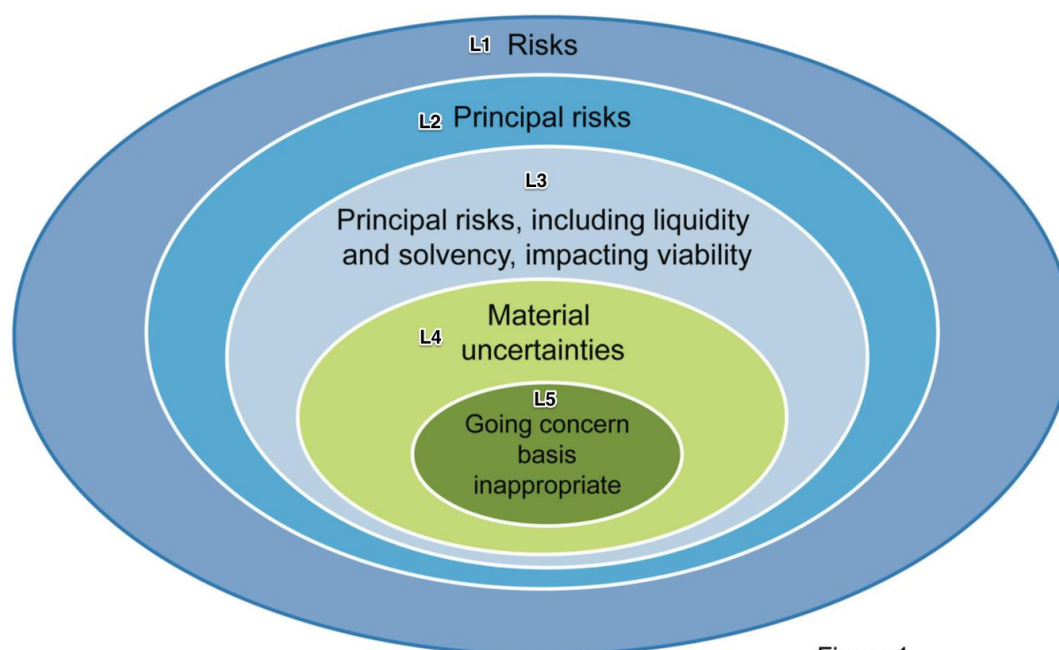


Figure 1

Companies have a wide range of risks (Level 1) that need to be managed and the FRC emphasises the importance of good risk management processes that need to be owned by the board. These risks will range widely in impact and likelihood. It is only the Principal Risks (Level 2) that need to be reported to shareholders in the annual report and accounts. Typically this will be in the range of say 6 to 20 risks. A good disclosure will set out the nature of the risk including an indication of likelihood and impact and what the company is doing to mitigate the risk. Ideally the reporting will give some sense of the current status of the risk – is it growing in significance? Have there been recent developments in relation to the risk?

Some risks are so significant that they could impact on the ongoing viability of the company (Level 3). Risks that could impact on liquidity and solvency need to be considered. A major new element to the FRC guidelines is a requirement to carry out a long term viability assessment and to make a related disclosure in the report and accounts. It is up to each firm to decide the period of the long term assessment but commonly adopted periods are in the range 3 to 5 years. Good disclosures will highlight those risks that are so significant that they might challenge the long term viability of the company.

Whilst some risks could challenge the long term viability under an adverse scenario there may be some risks (Level 4) that are already endangering viability and that represent material uncertainties to the ability to prepare accounts on a going concern basis. This is an area where the FRC has beefed up requirements so as to avoid the situation, like with the banks in the financial crisis, where accounts gave no clear indication that there were significant risks to the viability of a business.

Companies are required to adopt the going concern basis of accounting, except in circumstances where management intends to liquidate the entity or to cease trading, or has no realistic alternative to liquidation or cessation of operations (a Level 5 situation). Accordingly, the threshold for departing from the going concern basis of accounting is a very high hurdle, as there are often realistic alternatives to liquidation or cessation of trade. This will even be the case when material uncertainties related to events or conditions that may cast significant doubt upon the company's ability to continue as a going concern have been identified. These are the sorts of uncertainties that should be disclosed at Level 4.

Under the previous requirements there was generally good reporting of Level 2 risks and it was obvious when a company had reached Level 5 but there was little reporting of the more severe risks to company viability (Level 3 & 4). With the new Code and Guidelines there should be greater clarity on the most material risks that may previously have been hidden within relatively bland and sometimes generic Level 2 disclosure.

The previous Level 2 disclosures will typically have required firms to maintain an effective process for risk identification and ongoing management of those identified risks. The new requirements will require more focus on the impact

and likelihood of risks, business modelling and stress and scenario testing – areas where actuaries have considerable experience.

2. A Decade in Risk Disclosures

Changes from year to year in risk disclosures are generally gradual. It is interesting however to take a longer term perspective and so by way of illustration I examine how risk disclosures have changed over the past 10 years at one company. I have chosen Grainger plc as an example because they are one of the small number of companies that have already complied with the new FRC Code and Guidelines. It is also an example, in my view, of a high quality implementation of the new guidelines. Grainger plc is a private rented sector landlord.

The overall size of the accounts has increased from 104 pages in 2005 to 176 in 2015. Risk disclosures have increased from just 77 words in 2005 to 2360 words in 2015.

In 2005 the description of risks was minimal. The full section is given below.

Risk review

Major risk relates to state of housing market, linked to interest rates and general economic environment. Risk minimised by:

- Portfolio is geographically widespread, reduces cluster risk
- Portfolio spread across property types and values, reducing exposure to highly fluctuating top-end properties
- Relatively low average value where demand is consistent and strong
- Regulated properties are un-modernised on vacancy so demand tends to be high

Long-term view taken and financial stability enables short-term price fluctuations to be withstood.

In 2015 a good description of the risk management processes at Grainger is provided which gives a clear view of how they go about managing risk. They disclose 9 principal risks with a statement of their risk appetite to each and how they are managing the risk. An example of one of the risks is shown below:

Risk or uncertainty	Possible impact	Risk appetite	Management
5 A significant failure within or by a key third-party supplier or contractor.	Increased costs; inability to deliver performance objectives to satisfaction of stakeholders; possible legal action and regulatory sanctions; reputational damage.	We utilise a significant range of third-party services and so recognise that we carry an inherent risk of some kind of unforeseen failure. However, through management and control we seek to minimise this risk.	<ul style="list-style-type: none"> – Established internal controls and management systems and with regard to third-party contractor/supplier base – Established 'three lines of defence' model to facilitate stronger monitoring and controls – (see further information in 'Future Developments' section on page 29)

This year, for the first time, they provide a long term viability statement. The period chosen for the analysis is 4 years in line with their business planning period. They provide useful background information on their historical cash flow and then outline two scenarios that they have modelled and which they have determined their business would be able to survive. They modelled a steep crash over two years followed by a slow recovery and a steady decline in property prices.

Finally Grainger highlight future developments in their risk management approach.

Over this longer term view there has been a huge improvement in the volume, quality and usefulness of risk disclosures. The most recent developments are certainly a very welcome addition with much potential. Some organisations have taken a fairly minimal approach so far but over time I would expect the range of risks and scenarios that are modelled and disclosed to improve and for investors to gain a much better picture of corporate resilience.

3. The Contribution of Actuaries

When the FRC announced the new risk reporting “requirements” the IFoA thought that this could be an ideal opportunity for actuaries to expand their influence into other sectors by helping companies to respond to the changes. The Working Party that I chaired has been working hard over the last two years to consider ways to engage with non-insurance entities and to support them in making changes. It has been hard going. Most companies have not seen the new “requirements” as a radical change and have generally adopted an incremental approach. In a number of cases the new disclosures have been minimal and won’t really add a great deal of value to investors. But, in some cases, such as Grainger, a deeper and more helpful analysis has been disclosed. This will hopefully spur others to further improve their disclosures and their processes.

Actuaries have a great deal to offer a wide range of companies in their risk management processes. We have great strength in the quantification of risk, modelling & scenario analysis as well as softer skills in leadership, communication and governance. We aren’t however the first port of call for companies outside the insurance industry.

It will take time to develop our reputation in other industries and sectors. There will be pioneers who make a personal leap into other sectors or firms that encourage actuaries to develop their business in non-traditional areas. There are already some early promising signs of this in the Oil & Gas Industry and the Pharmaceutical Industry where the long term nature of their business will be in tune with our actuarial skill set. The opportunity for actuaries is huge but it will take time, patience and ongoing focus for us to succeed.

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