Agenda item 4. The role of disclosure in risk assessment and enhancing the usefulness of corporate reporting in decision-making

Presented by

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CFA Institute
USER PERSPECTIVE ON RISK COMMUNICATION

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MAIN POINTS

• Relevance of risk reporting for investors
• Challenges and shortcomings of risk reporting
• Helpful way forward
## CFAI 2017 SURVEY- IMPORTANCE OF RISK INFORMATION

<table>
<thead>
<tr>
<th>Description</th>
<th>#</th>
<th>Rarely or never use</th>
<th>Often or always use</th>
<th>Average</th>
<th>Rank</th>
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</thead>
<tbody>
<tr>
<td>Operational metrics</td>
<td>250</td>
<td>5%</td>
<td>84%</td>
<td>4.28</td>
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<tr>
<td>Description of business model, business plans and strategy</td>
<td>249</td>
<td>5%</td>
<td>81%</td>
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<td>Supplemental financial performance</td>
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<td>79%</td>
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<tr>
<td>Capital commitments (near and long term)</td>
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<td>78%</td>
<td>4.08</td>
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<tr>
<td>Principal risks and uncertainties</td>
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<td>70%</td>
<td>3.94</td>
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<tr>
<td>Going concern and business viability related information</td>
<td>250</td>
<td>15%</td>
<td>65%</td>
<td>3.82</td>
<td>6</td>
</tr>
<tr>
<td>Off balance sheet arrangements</td>
<td>250</td>
<td>10%</td>
<td>65%</td>
<td>3.82</td>
<td>7</td>
</tr>
<tr>
<td>Customer related metrics</td>
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<td>12%</td>
<td>58%</td>
<td>3.68</td>
<td>8</td>
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<tr>
<td>Corporate governance information</td>
<td>249</td>
<td>17%</td>
<td>49%</td>
<td>3.58</td>
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<tr>
<td>Intellectual capital information</td>
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<tr>
<td>Sustainability information (environment, social and reputational risk)</td>
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<td>32%</td>
<td>25%</td>
<td>2.82</td>
<td>11</td>
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## REPORTING OF INFORMATION OUTSIDE FINANCIAL STATEMENTS

### Table 2: Reasons for Applying Information within Corporate Reports

<table>
<thead>
<tr>
<th>Sections within Corporate Reports</th>
<th>#</th>
<th>Assess Mgmt Qual</th>
<th>Valuation</th>
<th>S/t risk</th>
<th>L/t risk</th>
<th>F/stat ctx</th>
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<td>73%</td>
<td>40%</td>
<td>54%</td>
<td>52%</td>
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<tr>
<td>Description of business model, business plans and strategy</td>
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<td>52%</td>
<td>32%</td>
<td>60%</td>
<td>41%</td>
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<tr>
<td>Supplemental financial performance, revenue, asset quality, funding and liquidity information</td>
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<td>55%</td>
<td>56%</td>
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<td>Capital commitments (near and long term)</td>
<td>230</td>
<td>21%</td>
<td>65%</td>
<td>48%</td>
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<td>32%</td>
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<tr>
<td><strong>Principal risks and uncertainties</strong></td>
<td>229</td>
<td>28%</td>
<td>36%</td>
<td>58%</td>
<td>77%</td>
<td>23%</td>
</tr>
<tr>
<td>Going concern and business viability related information</td>
<td>214</td>
<td>31%</td>
<td>30%</td>
<td>46%</td>
<td>61%</td>
<td>17%</td>
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<tr>
<td>Off balance sheet arrangements</td>
<td>221</td>
<td>10%</td>
<td>48%</td>
<td>46%</td>
<td>63%</td>
<td>35%</td>
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<tr>
<td>Customer-related metrics</td>
<td>225</td>
<td>34%</td>
<td>51%</td>
<td>38%</td>
<td>44%</td>
<td>38%</td>
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<td>Corporate governance information</td>
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<td>65%</td>
<td>8%</td>
<td>24%</td>
<td>45%</td>
<td>14%</td>
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<tr>
<td>Intellectual capital information</td>
<td>177</td>
<td>26%</td>
<td>27%</td>
<td>15%</td>
<td>33%</td>
<td>24%</td>
</tr>
<tr>
<td>Sustainability information (environmental, society and reputational risk)</td>
<td>145</td>
<td>32%</td>
<td>11%</td>
<td>16%</td>
<td>38%</td>
<td>10%</td>
</tr>
</tbody>
</table>

# is the number of respondents who sometimes (-3 rating), often (4 rating) and always (5 rating) use information within sections.  
Mgmt Qual ← Management quality; S/t ← Short-term; L/t ← Long-term; F/stat ctx ← Financial statements context.

The results in Tables 1 and 2 show the following:
KEY CHALLENGES INVESTORS FACE WITH RISK REPORTING

- Proliferation and emergence of risk types (Cybersecurity, climate - physical and liability risk etc) makes it challenging to have traditional trend analysis.

- Boiler plate, generic disclosures.

- Need for prioritization of principal risks.

- Inadequate articulation of risks (i.e. probability and severity of risks).

- Lack of common language and comparable measures (e.g. risk appetite).

- Fragmentary and heavily siloed reporting of different risk types—Often very hard to see forest from trees.

- Limited transparency by companies on risk mitigation measures.

- Poor transparency of impacts across different time horizons.

- Limited linkage to business model and strategy.

- Limited delineation of financial impacts (e.g. quantified exposure) and cross reference to financial statements.
PWC- REVIEW OF RISK REPORTING-2015 FTSE 350

INVESTORS CONSIDER PRINCIPAL RISKS & UNCERTAINTIES TO BE AN AREA OF MOST REQUIRED IMPROVEMENT

reporting

How specific and detailed have FTSE 350 companies been in their risk reporting?

In response to regulatory change, commercial imperatives or competitor pressures your company may have been working hard behind the scenes to review, challenge and improve the quality of its risk management and internal controls. But we think there is more to be done to really give an insight into key risks. The latest regulatory change comes in the form of the 2014 UK Corporate Governance Code – in particular the new statement on a robust assessment of principal risks and the viability statement, which requires a focus on risks to liquidity and solvency. These statements mean that interest in risk reporting will only intensify.

The 2014 Code will have companies looking again at their risk management processes and how they identify, manage and mitigate their principal risks. We hope this will mean companies go beyond the bland and often boilerplate disclosures that are currently made. In particular there is scope for the principal risk disclosures to be more company-specific. We’d like to see more information on changes in the risks, the company’s appetite for them and in the management or mitigation that is applied to them.

The challenge

Many companies have greatly increased their focus on enterprise risk management since the financial crisis. They’re thinking more deeply about how they set their risk appetite and how they identify, assess and manage new risks or changes in existing risks.

Findings from our previous reviews of corporate reporting show how as a result, the quality of risk reporting has improved. Our 2007 review of narrative reporting practices among the FTSE 350 found that, back in 2006, only 22% of companies were clearly disclosing their principal risk and uncertainties. Now, reflecting changes to the Companies Act, this is the norm among FTSE 350 companies. Similarly, in 2007, only 57% of companies that disclosed risk information indicated how those risks were managed or mitigated. In last year’s survey, this had risen to 94%.

But risk reporting is still a work in progress – and it’s important to keep moving forward. Having surveyed its chartered financial analyst members, the CFA Society of the UK concluded:

“The area of the annual report that shows greatest need for improvement is – by a considerable margin according to our respondents – the disclosure of principal risks and uncertainties.

Given that over 90% think this is a useful disclosure this is clearly an area which deserves more attention from companies, and perhaps also from regulators.”

The spotlight on the quality of risk reporting is therefore inevitable and likely to intensify. The 2014 UK Corporate Governance Code – effective for reporting periods on or after 1 October 2014 – is the latest regulatory spur for improved risk management and reporting. Regulators and others will be interested to see its impact.
1. Corporate disclosure of investment plans are limited to 1-2 years, even though companies usually establish plans for the next 5-10 years.

2. Corporate disclosure of financial forecasts is limited to a 1 year timeframe compared with estimates from financial analysts that usually cover the next 5 years.

3. Only about 5-10% of companies analyzed specifically discuss long-term risks and only 25% report on the sensitivity of their impairment test to adverse scenarios.

4. Long-term risk disclosure is discouraged by a ‘perfect storm’ formed by the combination of vague regulatory requirements, race to the bottom among peers, limited role of auditors, fear of litigation and limited demand from financial analysts.

This disclosure gap inhibits the exploration and management of long-term risks by...
When giving strategic and sustainability information, the furthest most companies looked ahead was five years to 2020. In contrast, when giving data on their markets, some companies are willing to look ahead 25 years.

When companies do provide forward-looking information in their strategic reports, they do so over a variety of different periods. The period used when talking about their strategy may differ from that considered in their discussion of their market, or that used in any forward-looking KPIs. This inconsistency is hard to understand as a reader. It will look particularly strange if, in future, you provide forward-looking information that doesn’t correspond to the period covered by your viability statement. You’ll need to give readers enough context to understand.
28% of companies make reference to strategic timelines.

30% of companies explain the reason for risk movement.

42% of companies link KPIs to strategy.

40% of FTSE 100 companies provide some insight into their differentiating factors.

2016 was a year of relatively little regulatory change, which is reflected in the limited evolution of annual reports over the period. However, 2017 brings a number of new requirements and associated challenges for companies and we believe this brings an exciting opportunity for companies to do more.
Risk dynamics also need to be put in context. Some companies, such as Pearson [Example 4], have introduced risk case studies to bring more depth to certain key risks.

Whilst 61% of companies indicated risk movement, only 30% of the FTSE 350 gave any commentary as to why the movement had occurred. Fresnillo [Example 5] provided a clear explanation of the reasoning for changes in their heatmap.

Our survey showed that companies and directors have a sense of improvement in risk reporting: 72% of them agreed or strongly agreed that annual reports provide useful insights into companies’ principal risks and how they are managed. Investors were far less convinced – only 36% agreed or strongly agreed.

“Risks tend to be boilerplate and not really those that keep company executives awake at night and/or relevant to key stakeholders.”

61% of companies indicate risk movement

30% of companies explain the reason for risk movement

19% of companies provide a risk heat map
### Risk Profile Summary

**Risk** | **Rating** | **Appetite** | **Description of change**
--- | --- | --- | ---
Strategic | High | Proactive | Changing market landscape in addition to regulatory reforms potentially impacting the business model.
Operational | High | Cautious | Greater reliance on technology. More intrusive and enforcement lead regulation. Improved processes and employee training to reduce inherent risk.
Liquidity | High | Cautious | Significant mitigation has been implemented but has been partially offset by increased liquidity requirements from clearing houses.
Credit | Medium | Minimal | Enhanced monitoring system infrastructure globally is partially offset by deterioration in counterparty quality given macroeconomic conditions.
Legal and compliance | Medium | Averse | New regulations have been introduced in addition to increased regulatory scrutiny of markets where ICAP has regulated entities.
Financial | Low | Minimal | Profile remains stable with no major changes in operations or appetite.
Reputational | Medium | Averse | Increased due to the continued uncertainty in the regulatory environment.
Market | Low | Minimal | Remains stable as a second order impact risk.

*Note: This is intended as an indicative summary of the Group's risk profile only.*
INVESTORS FIND CLIMATE-RELATED RISK DISCLOSURES ARE HIGHLY INADEQUATE

79% of investors that think there are barriers to increasing climate related investment.

In addition, poor availability of research and analysis and a lack of standardised sector definitions are also barriers.

This investor sentiment that there is a lack of credible investment opportunities is backed up by the point that 66% of the investor respondents do not hold any green bonds in their portfolios. Since the green bond market is relatively small, at USD232.2bn¹ issuance outstanding in July, it is unsurprising that many respondents don’t hold any.

All respondents however, felt that investment institutions were ‘quite’ to ‘very’ important for driving low-carbon transition. Climate related-risk disclosure remains a problem for investors. When asked about the adequacy of risk disclosure 56% said that disclosure is ‘highly inadequate’.

56% of investors think climate-related risks disclosure is ‘highly inadequate’

The survey reveals even higher momentum for social impact investing than for climate related investment, with 73% of respondents citing that they will increase social impact related investments. This could be because investors are increasingly thinking about what the sustainable development goals mean for them, and how they can address these challenges. Social impact
Investors trigger first major campaign to push 62 leading banks to back TCFD climate reporting recommendations

Letter signed by shareholders with $2trn in assets aims to corral support for clear environmental disclosure.

by Paul Verney | September 14th, 2017

More than 100 of the world’s biggest institutional investors representing nearly $2tn in assets have launched one of the first major campaigns to push the world’s largest banks to back the recent recommendations of the Taskforce on Climate Related Financial Disclosures (TCFD) launched by Mark Carney, Governor of the Bank of England and Chairman of the G20’s Financial Stability Board (FSB), which also supported it. They have written to the 62 of the world’s largest banks demanding more robust climate-related disclosure, citing research that up to 20% of banks’ investment portfolios could be at risk because of market dislocation as a result of climate-related asset stranding.

Banks targeted include Australia and New Zealand Banking Group, Bank of America, Deutsche Bank, HSBC Holdings, JP Morgan Chase, Mitsubishi UFJ Financial Group, Inc. and TD Bank.

The investor group, which is being co-ordinated by ShareAction, the UK non-profit, and Boston Common, the US asset manager, says the banks should align their public disclosures with the recommendations of the TCFD, including outlining their climate-relevant strategy and implementation, climate-related risk assessments and management, low-carbon banking products and services, and public policy engagements and collaboration with other actors on climate change.

The banks have also been invited to outline how they are managing climate risk subsequent to the 2015 Paris COP21 Agreement. The investor group says responses will not be made public but will inform a related report due to...
2017 CFAI ESG SURVEY INSIGHTS: IMPEDIMENTS TO USE OF INFORMATION

FACTORS LIMITING INVESTOR ABILITY TO USE NONFINANCIAL INFORMATION IN INVESTMENT DECISIONS

- Lack of appropriate quantitative ESG information: 55%
- Lack of comparability across firms: 50%
- Questionable data quality/lack of assurance: 45%
- Lack of sufficient material information: 42%
- ESG disclosures are boilerplate, general and/or not company-specific: 36%
- Cost of data gathering and analysis too high: 35%
- Too much immaterial information being disclosed by companies makes it difficult to access material information: 32%
- Disclosure not frequent enough: 29%
- Other: 6%
WAY FORWARD
DESIRED WAY FORWARD

• Adoption of EDTF and TCFD seven fundamental principles (include all relevant and material risks; timely; consistent over time; comparable; clear, balanced and understandable; relevant for business model; convey how risk is managed)

• Prioritization of principal risks

• Quantify risks (i.e. probability and severity of risks, scenario analysis)

• Integrated reporting principles- Connectivity, Tell a story that links business model, strategy, risk and performance or financial impacts

• Distinguish impacts across different time horizons (short, medium and long-term)

• Delineate risk interconnectedness of risk factors
Climate-related risks and opportunities can impact organizations’ financial performance.

FSB-TCFD FRAMEWORK: A WAY FORWARD
LINK TO STRATEGY, TRANSLATION TO FINANCIAL IMPACT
USEFUL WAY FORWARD: CONVEY INTERCONNECTED NATURE OF RISK FACTORS
BANK RISK- (SOURCE 2017 SHAREACTION PUBLICATION)

<table>
<thead>
<tr>
<th>Type of risk</th>
<th>Possible effect of climate change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credit risk</strong></td>
<td>Under low carbon scenarios, loans to high carbon companies risk becoming impaired where clients have failed to transition to a low carbon business model and are left with stranded assets and other financial losses. Under high carbon scenarios, financial commitments made to clients in vulnerable sectors are likely to be the first to become impaired. Taking a longer-term view, high carbon scenarios are likely to increase credit risk across all sectors and regions. Moody’s Heat Map has shown that credit impact from environmental issues varies widely across sectors globally, both in terms of materiality and timing.</td>
</tr>
<tr>
<td><strong>Market risk</strong></td>
<td>Climate change could contribute to a wide range of market risks – affecting commodities, currency valuations and creating equity risk. Physical and transitional risks are likely to impact commodity prices (such as oil and agricultural commodities), and extreme weather events can reduce the value of currencies in countries where there is wide-spread economic disruption. The output of crop production will be affected by climate change in the short- to medium-term, thus providing a particularly salient example. Increased food prices affect general inflation, with food being a large component of the consumer price index. Recent recurrent droughts have affected agricultural output in Australia, leading to an increase in prices globally.</td>
</tr>
<tr>
<td><strong>Liquidity risk</strong></td>
<td>As seen in the housing market in 2008, liquid markets can become illiquid very quickly. Transitional risks could cause assets linked to high carbon sectors to become illiquid if there are capitulations, panic selling and bankruptcies. Under high carbon scenarios, companies severely affected by the physical impacts of climate change might find themselves in financial difficulty, and assets linked to those companies risk becoming illiquid.</td>
</tr>
<tr>
<td><strong>Reputational risk</strong></td>
<td>For banks wishing to attract and retain customers and staff, those could be a concern.</td>
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</table>
THANK YOU!