BARRON'S

Wanted: A Corporate Risk Score Card

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If the food industry can offer helpful labeling about the nutritional value of its ingredients, why can't other types of companies do the same?

The Assize of Bread and Ale, the first food regulatory law in British history, stemmed from an important realization by King Henry III: Bread and beer of suitable quality, fairly priced and packaged, were essential to the well-being of his people.

Seven centuries later, U.S. President John F. Kennedy carried the torch by introducing a Consumer Bill of Rights, which included rights to safety, to be informed, to choose, and to be heard. To JFK, the need to inform consumers extended beyond the government's commitment to safety: It was imperative for the "efficient and equitable functioning of our free competitive economy."

Informing stakeholders has become an increasingly important public-policy objective, as exemplified by the 1990 Nutrition Labeling and Education Act. Despite chemical complexity, diversity of ingredients, and differences in manufacturing methods, very different products—from flash-frozen yogurt chips to artisanal pasta sauce—have identically structured Nutrition Facts labels that depict their key ingredients in a standardized way. As a result, consumers can judge the appropriateness for their own circumstances and objectives.

Nutrition Facts
Serving Size 360 g

Amount Per Serving			
Calories 240		Calories from Fat 40	
		% Daily Value*	
Total Fat 1g			1%
Saturated Fat 0g			6%
Trans Fat			
Cholesterol 0mg			0%
Sodium 7mg			4%
Total Carbohydrate 36g			12%
Dietary Fiber 11g			40%
Sugars 6g			
Protein 10g			
Vitamin A	9%	• Vitamin C	1%
Calcium	4%	• Iron	36%

*Percent Daily Values are based on a 2,000 calorie diet. Your daily values may be higher or lower depending on your calorie needs.

Nutritiondata.com

Food labeling shows that complex and substantially different products can be described in consistent ways, providing useful disclosures without endangering trade secrets. Greater awareness about harmful ingredients leads to positive behavioral changes, spurring innovation and providing public benefits.

Let's take this model from food to finance. Empowering corporate stakeholders with comprehensive and useful information is vital to the well-being of companies, financial markets, and economies.

Greater transparency also lessens the need for regulatory constraints and prohibitions.

Extensive financial regulation enacted in the wake of the 2007-09 financial crisis focused on higher capital requirements, resiliency, better disclosures for financial products, and enhancements to the securitization and derivatives markets. But comprehensive disclosures about one of the principal causes of financial crises—risk exposures of financial institutions—are still unavailable.

Recent negative headlines further highlight the need for greater risk transparency. Despite intense regulatory scrutiny, a large commodities brokerage firm went into bankruptcy due to outsize bets on European debt; a venerable commercial bank suffered sizable losses in its investment portfolio; European banks were severely hurt by government-debt exposures; and some of the largest banks saw 30%-40% declines in stock prices during the euro panic of August 2011.

The role of financial statements is to help stakeholders understand the future prospects of companies, evaluate their suitability, and compare investment alternatives. To remedy the gap in standard disclosures, I propose a Corporate Risk Score Card to offer a new view of an institution's risk profile and business model. To make existing information about all types of firms more complete, it would provide insights into strategic vision and value propositions, business models and revenue drivers, risk appetites and the components of risk, and processes and controls that support long-term viability.

THE CORPORATE RISK SCORE CARD starts with an aggregate measure of risk relative to a company's assets and risk-bearing capacity. This measure must incorporate all relevant dimensions of market, credit, operational, liquidity, and counterparty risks. Meanwhile, the risk-bearing capacity must be carefully defined to include current and contingent capital, insurance, hedges, and crisis-management contingency plans.

Since most measures of risk are calibrated to a relatively recent history, this aggregate risk measure must be supplemented by standardized stress tests that depict the firm's risk under a range of scenarios. The measure must also be detailed across types of risk, giving investors insight into the nature of the firm's business model and revenue drivers.

Corporate Risk Score Card

Risk (% of Assets)	**8%**
Risk (% of Risk Bearing Capacity)	**80%**
Stress tests: 2007-09 –110%; 1998 – 95%; 9/11 – 87%	
Risk Drivers	**% marginal**
Market – Fixed Income	**10%**
Market – Equities	**20%**
Market – Currencies and Commodities	**5%**
Credit and Counterparty	**30%**
Operational	**25%**
Funding and Liquidity	**10%**
ERM Radar	**likelihood/severity**
Strategic	**2/8**
Reputational	**4/7**
Political & Regulatory	**4/9**
Risk Intelligence Rating	**7**
Decision Making	**7**
Crisis Management	**6**
Processes and Tools	**8**
Governance Rating	**5**
Processes and Controls	**4**
Incentives and Compensation	**6**
Composite Credit Rating	**BBB+**
Fundamental (A-); CDS-Impl (BBB); Stock-Impl (BBB+)	

* likelihood, severity, intelligence and governance: 1-10 scale

Consistency in risk measurement is absolutely essential: To be effective, standardized ways of measuring and aggregating risks must be put in place. Exposures that don't lend themselves to aggregation, such as strategic, reputational, and regulatory risks, can follow a standard approach that depicts their perceived likelihood and severity.

Understanding how a company manages and governs risk-taking is also important. A risk-intelligence rating would represent a firm's ability to use forward-looking risk tools in making effective decisions, alleviating threats, and capturing opportunities. A governance rating would evaluate a company's practices, processes, controls, and incentives. A composite credit rating would enhance fundamental credit analyses using ratings implied by credit and equity markets.

As leading boards and management teams can attest, an integrated view of the company's business model and risk enhances long-term performance.

We may hope that some companies gradually start to disclose this information to enhance brand equity and differentiation. Thus, the Corporate Risk Score Card should be tested by internal use and voluntary disclosures from industry leaders—later solidified by regulatory actions that make it a part of standard disclosures.

The ability of leadership teams, boards of directors, investors, and counterparties to understand forward-looking risks of complex institutions is critical to the productive functioning of modern economies. There are clear benefits to empowering stakeholders with consistent and useful information so they can make effective business and investment decisions. Companies will be better managed and governed. Market mechanisms will help discourage unproductive behaviors and boost proper incentives. The resiliency of the financial system should improve as well, fostering dynamism in a world economy that has moved far beyond the production of bread and ale.

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