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Enterprise Risk Management:

Standard & Poor's To Apply Enterprise Risk Analysis To Corporate Ratings

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Standard & Poor's Ratings Services today announced that after considering replies to our "Request For Comment: Enterprise Risk Management Analysis For Credit Ratings Of Nonfinancial Companies" published Nov. 15, 2007, we will enhance our ratings process for nonfinancial companies through an enterprise risk management (ERM) review. ERM will add an additional dimension to our analysis of management and corporate governance, creating a more systematic framework for an inherently subjective topic.

Ultimately, we will enhance transparency by providing investors and issuers our views of a management team's ability to understand, articulate, and successfully manage risk. The benefits of the ERM enhancement will be to make the process of forming our rating opinions more forward looking, achieve finer differentiation among ratings, and facilitate construction of "what if" forecast scenarios.

We will begin to incorporate ERM into discussions with rated companies in the third quarter and begin to include commentary in our reports in the fourth quarter. The reviews will focus predominantly on risk-management culture and strategic risk management, two universally applicable aspects of ERM. We will defer formal scoring of companies' ERM capabilities (e.g., "strong," "adequate," "weak," etc.) until we have conducted a sufficient number of reviews to permit reliable benchmarking and published evaluation criteria, which is unlikely to occur before 2009. Credit ratings and rating outlooks would be affected in the meantime only if we observe extraordinary conditions that change our existing perception of a company's business profile. We are also deferring incorporating analysis of emerging risk management and risk-control processes, except as noted below.

How We Define ERM

We will recognize companies' adoption of generally accepted risk-management standards such as COSO (promulgated by The Committee of Sponsoring Organizations of the Treadway Commission) or AS/NZS 4360 (created by the Joint Standards Australia/Standards of New Zealand Committee OB/7) or others, but consider them neither a prerequisite for nor sufficient evidence of effective risk management. Moreover, we will note common and exceptional practices across peer companies and ultimately judge the effectiveness of whatever risk-management processes are in use. While open-minded about the form of risk-management structure, we begin with certain expectations.

We see ERM as:

- An approach to assure the firm is attending to all risks;
- A set of expectations among management, shareholders, and the board about which risks the firm will and will not take;
- A set of methods for avoiding situations that might result in losses that would be outside the firm's tolerance;
- A method to shift focus from "cost/benefit" to "risk/reward";
- A way to help fulfill a fundamental responsibility of a company's board and senior management;
- A toolkit for trimming excess risks and a system for intelligently selecting which risks need trimming; and

- A language for communicating the firm's efforts to maintain a manageable risk profile.

Alternatively, we feel ERM is not:

- A method to eliminate all risks;
- A guarantee that the firm will avoid losses;
- A crammed-together collection of longstanding and disparate practices;
- A rigid set of rules that must be followed under all circumstances;
- Limited to compliance and disclosure requirements;
- A replacement for internal controls of fraud and malfeasance;
- Exactly the same for all firms in all sectors;
- Exactly the same from year to year; nor
- A passing fad.

Effect On Ratings

The potential effect of ERM on ratings will significantly depend on the type of the enterprise we are assessing. For larger, multinational corporations, highly developed and well-resourced ERM efforts will be standard. We expect to have very different interaction about risk management with those companies compared with less-diversified companies and those with fewer resources that are at an earlier stage, such as those in certain emerging markets.

The ERM-related discussions we will have with rated companies will build on our existing analysis of management's operating and financial track record; credibility of strategies, projections, and execution; response to competitive threats; and risk governance bodies and structures.

Our industry-focused rating analysts will incorporate an ERM discussion into the regular credit reviews on each company, emphasizing risk-management culture and strategic risk management, which are the most broadly comparable and critical of the four areas outlined in our original proposal. In the risk-management culture analysis, discussion topics will include:

- Risk-management frameworks or structures currently in use;
- The roles of staff responsible for risk management and reporting lines;
- Internal and external risk-management communications;
- Broad risk-management policies and metrics for successful risk management; and
- The influence of risk management on budgeting and management compensation.

In addition, we will incorporate our existing review of governance, accounting policies and issues, and derivatives into this much broader analysis of a company's risk-management culture.

Under strategic risk management, our analysts will explore:

- Management's view of the most consequential risks the firm faces, their likelihood, and potential effect on credit;
- The frequency and nature of updating the identification of these top risks;
- The influence of risk sensitivity on liability management and financing decisions; and
- The role of risk management in strategic decision making.

For now, we have decided to exclude additional analysis of the other two areas cited in our original proposal, risk-control processes and emerging risk management, beyond what is included in our current process. The additional effort required for us to scrutinize these company- and sector-specific areas may be of limited value at this time. An important exception to this is our ongoing review of risk-control processes that is already in place and that we can logically and consistently apply in new sectors.

Specifically, we have already conducted risk-control analyses using the Policies, Infrastructure, and Methodology (PIM) approach for electric power marketers and agribusiness companies with sizable trading operations. Building on that experience, we intend to examine the application of the PIM approach for oil and gas issuers with meaningful trading operations. What characterizes these exceptions is that unlike other corporate sectors with operational risks that are difficult to quantify, trading risks can be measured, modeled, and hedged. That allows us to apply a consistent approach that is within the realm of credit analysis tools we now use.

While we cannot audit assertions by company managers about their ERM procedures, we will closely examine the consistency between their statements and historical performance. We will specifically inquire about how they handled actual risks in the past. A discussion of ERM will become a regular part of our follow-up after significant drops in earnings or losses, significant restatements of past financial results, or material impairment losses and write-downs. Our discussions with managers about ERM will be to understand how consciously they have taken and retained risks and why they are comfortable with their net risk positions.

Responses To Our Request For Comment

We received written comments on our proposal to introduce ERM analysis from more than 60 respondents, including six from associations representing hundreds of rated companies. In addition, we received about 30 informal responses by telephone or in-person conversations. The respondents represented virtually all industries and global regions, with the majority from Europe and the U.S. About 60% of the responses came from rated nonfinancial companies, with the remainder from interested unrated companies, consultants, accounting firms, and financial institutions. Comments generally supported our proposal to introduce ERM analysis, with some reservations and recommendations.

Among the responses were some doubts that we could successfully integrate a meaningful ERM analysis into our process. Recent record losses at financial institutions that were previously subject to ERM analysis raised questions about the value of applying a similar analysis to nonfinancial companies. Others voiced concerns about our ability to apply ERM analysis equitably across diverse industries and regions. And some respondents were wary about the large investment that we and the companies we rate might have to make to process the new information.

The capital markets turmoil of recent months has managers and boards of financial institutions fundamentally rethinking their risk-management functions. That will translate into new insights and concomitant updates to our own risk-management analysis. The focus of these updates will be on the probabilities, magnitudes, and types of losses that institutions may experience. However, the fundamental structure of our analysis will remain intact. While the assumptions underlying our ERM analysis will evolve, recent events have reconfirmed the importance of focusing on risk management as part of the ratings analysis. Clearly, the downturn in the financial sector will provide new insights into these processes, which will guide our future analysis of institutions' ERM capabilities. Since mid-2007, we have changed ratings or outlooks on some financial institutions as a result of our view of their risk appetite, risk management, or both.

Applying ERM equitably across companies is important, but no less so than accounting for differences among sectors. We will approach risk culture and strategic risk management consistently to provide a common foundation for comparability and benchmarking of basic ERM capabilities and performance. We will reflect differences between sectors by weighting ERM's importance by sector and by diving more deeply on certain risks.

We will make judgments on a sector-by-sector basis about the overall importance of risk management to the future ability of companies to repay debt obligations. While all types of firms may experience extraordinary volatility by making poor risk-management decisions, our ratings process will take into account sector-specific risk management. For example, risk management for companies in the auto sector would be weighed more heavily than for transmission and distribution utilities. Automakers and suppliers are exposed to intense global competition, volatile production costs, and the challenge of constantly adapting to evolving customer preferences and regulatory mandates. Even moderately flawed risk management for these companies can result in devastating losses and bankruptcy. At the other end of the spectrum, transmission and distribution utilities generally enjoy a supportive regulatory environment; have monopolistic service territories; serve stable markets; and have relatively predictable long-term capital spending and financing needs. Faulty risk management for a utility could impact its allowed return on equity, but is less likely to appreciably denigrate its ability to repay debt.

For companies exposed to a single risk type that could cause material credit deterioration (e.g., commodity price risk for an agribusiness), we will perform a more in-depth review of how the companies manage that particular risk. In those cases, we will apply our PIM review to address that risk in a structured way.

Common recommendations expressed by a majority of respondents included: avoiding a "check-the-box" exercise, looking at the upside as well as the downside of risk, and giving credit for existing disclosures and frameworks. We agree with these sentiments and will incorporate them into the design of our methodology. A questionnaire approach might overemphasize controls of historical risks and underemphasize forward-looking analysis of risks that have not yet occurred. We also doubt that a form-filling exercise will provide greater understanding of management's intent and capability.

Concerning the "upside," we expect the ERM benchmarking process to result in a range of risk-management performance and ultimately deviations from "standard" performance, both positive and negative, which could influence ratings. Existing disclosures and frameworks will be the starting point of our discussions, but the discussions themselves will provide the greatest insights for our analysis.

Overall, the comments we received affirmed the value of ERM and its relevance to the credit ratings process, as well as numerous considered recommendations that we have incorporated and will continue to incorporate. While the formal comment period has ended, we continue to welcome views on the effectiveness of our ERM analysis enhancements.

Next Steps In Our Implementation Of ERM Analysis

While we are introducing this initiative globally, practical considerations will result in a staggered implementation. We expect ERM discussions with companies to begin to be incorporated into regularly scheduled review meetings in the third quarter of this year. Within a year from commencement, we expect all companies will have had at least an initial ERM discussion with our analysts.

Findings from these discussions will be examined first for particular analytic sectors in a particular region to develop preliminary benchmarks, then compared with larger groups of companies for more context. For example, after we complete a sufficient number of reviews, we will compare ERM results for U.S. medical supply companies first with each other, then with U.S. health care companies, then with health care companies globally, and then with all companies globally. Through this comparison, we will develop benchmarks that will form the basis of scoring at some future date and will help us identify both positive and negative outliers suggesting rating or outlook actions in the near term.

We will include ERM analysis in our reports across all sectors when we feel that we can assess relative performance levels, which we expect to begin to occur in the fourth quarter of 2008. Our analysis is likely to focus on significant gaps when a company is compared with industry peers.

Just as the introduction of ERM for a company is unlikely to radically change extant decision-making processes, we do not see ERM analysis radically altering our existing credit rating opinions. Its value will be incremental in most cases, negligible in a few, and eye-opening in some others. We expect that ERM analysis will drive some rating and outlook changes, but not before we have been able to benchmark companies against each other and over time.

The following contributed to this article: Amra Balic, Keith Bevan, Richard Cortright, Evan Gunter, Laurence Hazell, Raam Ratnam, Terry Pratt, Trevor Pritchard, Ivana Recalde, Jayne Ross, Lisa Wang, Jeanette Ward, and Arthur Wong.