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Progress Report: Integrating Enterprise Risk Management Analysis Into Corporate Credit Ratings

Corporate & Gov't Ratings:

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In May 2008, Standard & Poor's Ratings Services announced its intention to include enterprise risk management (ERM) assessments in ratings of nonfinancial companies (see "Standard & Poor's To Apply Enterprise Risk Analysis To Corporate Ratings," published May 7, 2008, on RatingsDirect). Since the third quarter of last year, our analysts have begun to incorporate specific ERM discussions into their regular meetings with the companies we rate, focusing on risk-management culture and strategic risk management as two universally applicable aspects of ERM.

Among other things, we've been reviewing risk-management structures, the roles of staff responsible for risk management, internal and external communication, and risk-management policies and metrics. Our analysts have explored managements' views of the most consequential risks that their firms face, their likelihood of occurring, how these top risks are identified, monitored, and updated, and the influence of risk sensitivity on liability management and financing decisions.

The main purpose of these discussions has been to gather information that will help Standard & Poor's enhance our opinions on management of corporate borrowers. The turbulence in the global credit markets has provided us an opportunity to discuss and observe the results that risk management practices in real time. However, we are conducting this phase of information gathering with deliberation and care to defer making conclusions about ERM's value until after we have conducted a sufficient number of meaningfully detailed discussions.

Our sharpened focus on ERM is part of the evolution in how we look at companies we rate. We have always assessed risks and management capabilities across an enterprise as part of our overall evaluation of a borrower: The financial risk and business risk profiles are the two main parts of our credit analysis. We view ERM as an organizing tool for assessments of management, helping us create a more systematic framework and common language for an inherently subjective topic.

Just as a company's introduction of ERM is unlikely to radically change its current decision-making processes, we don't see ERM analysis radically altering our existing credit rating opinions. We expect its value to be incremental in many cases, negligible in a few, and eye opening in some. We believe that this analysis will result in some rating and outlook changes once we have been able to benchmark companies against each other over time.

ERM Practices And Advancement Differ Across Companies

The sharp deterioration in the external environment in which all companies operate provides a test for risk management decisions made during more placid times. We observe that companies entered the current economic recession at vastly different levels of preparedness, liquidity reserves, and strategies for coping and recovering. Although it's too early to count the ultimate survivors, or make conclusions about whether (or to what extent) investment in ERM may have contributed to some companies' ability to endure stress, we have noted anecdotally that effective or ineffective risk management is often cited as the root of success or failure. As we expand our ERM discussions with company managers and observe their performance during the ongoing economic and financial difficulties, we expect to build a foundation for opinion-making on risk management effectiveness.

Since late 2008, Standard & Poor's analysts have conducted more than 300 ERM discussions with rated issuers, principally in the U.S. and Europe, equating to about 10% of our global coverage of nonfinancial companies. We use seven primary questions as the basis for these discussions:

1. What are the company's top risks, how big are they, and how often are they likely to occur? How often is the list of top risks updated?
2. What is management doing about top risks?
3. What size quarterly operating or cash loss has management and the board agreed is tolerable?
4. Describe the staff responsible for risk management programs and their place in the organization chart. How do you measure the success of risk management activities?
5. How would a loss from a key risk affect incentive compensation of top management and planning/budgeting?
6. What discussions about risk management have taken place at the board level or among top management when strategic decisions were made in the past?
7. Give an example of how your company responded to a recent "surprise" in your industry. How did the surprise end up affecting your company differently than others?

Preliminary Findings

Based on our discussions, we note that:

- The level of adoption, formality, maturity, and engagement of ERM varies widely within and across sectors and regions. We haven't seen many companies provide clear examples of definitions for risk tolerance or risk appetite. While that's not surprising (since ERM is still relatively new), a preliminary conclusion could be that many companies find it difficult to ensure uniform behavior across the enterprise.
- Many companies exhibit an active management of risks with ongoing risk reviews and the assessment of high-impact/high-probability risks.
- The way the risk management function fits in the organizational structure indicates how integrated a company's approach is to risk management. We observe that "silo-based" risk management, focused only at the operational managers' level, continues to be prevalent.
- There appears to be a link between transparency and disclosure and companies' confidence about ERM; many companies have been willing and able to provide considerable detail about risk management practices.
- Companies with a true enterprise-wide approach to ERM appreciate the importance of going beyond only quantifiable risks or even top 10 risks. They increasingly understand the importance of emerging risks.
- Companies often facilitate their ERM execution via separate structures, with associated roles and responsibilities clearly defined. The ERM function's reporting line is typically to the CFO or the CEO, often with a direct line of communication to the board of directors, commonly to the audit committee. However, we have also seen numerous examples of risk-management structures that lack stature and influence in their organizations.
- Companies in industries with more quantifiable and hedgeable risks are generally more comfortable discussing ERM, but they tend to focus on controls of those specific risks. Examples include: energy, pharmaceuticals, agribusiness, and some manufacturers.

- ERM discussions, in general, have been more productive with investment-grade and public companies. Firms in the distressed and highly leveraged rating categories (and our analysts) are focused primarily on near-term liquidity in the current financial environment. Public companies often have more to say about ERM due to their attentiveness to compliance (i.e., these companies are more sensitive to the expectations of external stakeholders, such as auditors, regulators, rating agencies, etc.).
- Not many companies have come to grips with the upside aspects of ERM. Focus is instead on assuring that downside risks are covered. There is a very strong compliance-driven push toward ERM, which we cited as a possible danger in the past. We expect that, over time, companies will recognize and articulate competitive advantages that arise as a result of superior risk management.

Next Steps And Timing

After what we feel was a solid start to this initiative, we will continue to engage with issuers on ERM in our regularly scheduled management meetings. We will work in parallel to review our management assessment approach, looking for opportunities to make our evaluations more consistent and transparent in our credit ratings for nonfinancial companies. We plan to publish another progress report by the end of 2009 and to incorporate ERM references into individual corporate credit rating reports in 2010.

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