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Credit FAQ:

Standard & Poor's Looks Further Into How Nonfinancial Companies Manage Risk

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Managing enterprise-wide risks and capitalizing on opportunities are fundamental responsibilities of senior executives at all firms. Standard & Poor's Ratings Services' corporate credit ratings include evaluations of those managers' strategies, effectiveness, and credibility. These evaluations help us develop forward-looking opinions on credit strength by supplementing our fundamental analysis of the company's business and financial risk profile.

Beginning in September 2008, we widened the scope of our analysis of some nonfinancial companies' management to enhance our review of managers' ability to identify, monitor, and manage key risks -- those endemic to its industry and those that managers elect to take when running their businesses. Specifically, we started to look at how a firm's culture (communications, structures, incentives, and risk appetite) affects the quality of its decisions and at the role risk considerations play when making strategic decisions. We started risk management discussions with selected investment-grade ('BBB-' or higher) rated companies in the U.S. and Europe.

Any such discussions and exercises that we call "enterprise risk management (ERM) reviews" are simply extensions of the management assessments that have always been part of our rating process. Use of the term has confused some observers who misinterpreted this as a change to the ratings process.

The public spotlight on risk management has intensified since we began this initiative. The U.S. Securities and Exchange Commission (SEC) now requires that proxy statements that public companies file include disclosure of risk-based compensation policies, the role of the board of directors in risk oversight, and the nature of communications between executives and the board on risk issues. The National Association of Corporate Directors' Blue Ribbon Report on Risk Governance urges boards to assess risk in strategy, closely monitor risks in culture and incentives, and consider emerging risks to the firm's business. The International Organization for Standardization's ISO 31000 family of risk management standards define a common global approach to risk management. Greater public scrutiny follows the extended global recession and accompanying wave of corporate defaults -- grim reminders of the consequences of unpreparedness and weak risk management.

We receive a lot of questions when we discuss our ERM initiative with rated companies and in various public forums. Several posed at the March 12, 2010 ERM Summit: Panel Discussions on Risk Oversight hosted by the ERM Initiative of North Carolina State University's College of Management are typical and shown below with our responses.

Frequently Asked Questions

How does Standard & Poor's review of ERM compare with its existing reviews of management?

Management assessment and credibility have always been important in our corporate credit analysis. As financial markets and the operating environment become ever more complex and "risky," we see ERM as one possible avenue to facilitate a deeper management review.

What do you mean by "management credibility" and how does it affect credit?

By meeting with different management teams each year and the same management of a company year after year, analysts can distinguish between those with thoughtful, realistic agendas and those with hopeful or reactive approaches. Management achieves credibility to the extent the record demonstrates that a company's actions are consistent with its plans and objectives. Once earned, credibility helps support continuity of a particular rating level, because we can rely on management to do what it says to maintain or restore creditworthiness when faced with financial stress or strategic challenges. Once lost, credibility is difficult to restore.

When do you expect to finalize your ERM methodology and do you intend to publish more information on this methodology?

Investors should not view our ERM assessment as separate from our management assessment. We do not intend to publish a separate ERM methodology. However, our Corporate Ratings Criteria, a detailed collection of methodologies covering all aspects of our corporate ratings process, will reflect any ERM-related enhancements in management analysis.

Should investors expect to see more ERM-related commentary in your credit analyses?

We intend our reports to include more clarity and support for our opinions on management generally -- and how they affect a given rating. ERM issues alone are unlikely to drive a particular rating for most nonfinancial companies. However, ERM is a more prominent consideration in our ratings of insurance companies, where risk assessment is the fundamental function supporting the everyday underwriting and investment decisions of those firms.

Do companies connect ERM development with their credit ratings?

We believe that companies that embrace ERM are doing so for reasons beyond any anticipated credit rating impact. (More broadly, companies rarely strive to achieve a particular rating level as an end in itself.) Any positive credit rating action would stem from sustainably improved cash flows, operating performance, or competitive advantages realized from successfully managing risk. Likewise, a negative rating action would result from unexpected large losses, chronic underperformance, or competitive disadvantages resulting from poor risk management.

What changes would have to occur for most organizations to benefit from ERM?

The value of strong risk management practices, or failings of weak ones, is more likely to emerge in extraordinary or unexpected circumstances. In many cases, senior executives introduced ERM as a compliance exercise and hence are more likely to focus on ERM's loss-avoidance features and less likely to see opportunity in superior risk management. The biggest factor we have seen behind companies realizing value in ERM is when they have a large, unexpected loss or they witness harm occurring to competitors, suppliers, or customers.

What is the current state of ERM in most organizations you are reviewing?

At companies that have a formal ERM program -- by no means a majority -- ERM is generally in a nascent stage. We find their most common approach is to maintain a "risk register" or "heat map" that classifies top risks by likelihood and impact along with a mitigation strategy for each. Fewer companies assign specific ownership for key risks, develop alternative mitigation strategies, and communicate risk tolerances clearly across their organizations. Very few companies we have reviewed seem fully imbued with a culture that integrates risk assessment into strategic decision-making, clearly communicates risk appetite to internal and external stakeholders, and has a fully engaged and risk-astute board of directors overseeing risk.

What tools, systems, or additional guidance do business leaders need to help them effectively lead an ERM effort?

In our opinion, a major step would be the adoption of measurement and reward systems that better inform managers about risk and can incentivize actions that support long-term strategies. When companies deem avoiding a significant loss as important as realizing a significant gain, they will have crossed a major threshold. This level of importance would follow from a company defining and communicating its risk appetite in a way that all stakeholders can understand and that managers can act on.

For many organizations, ERM focuses on risk identification and assessment and remains at the senior management and board levels. As they try to push ownership of risk management down the ranks of the organization, what issues do they need to consider?

The biggest challenge seems to be creating a language for risk that line managers, senior executives, board members, shareholders, regulators, and other stakeholders can digest. We believe that successful risk culture begins with fostering open dialogue where every employee in the organization has some level of ownership of the organization's risks, can readily identify the broader impacts of local decisions, and is rewarded for identifying outsize risks to senior levels. In such cultures, strategic decision-making routinely includes a review of relevant risks and alternative strategies rather than a simple return-on-investment analysis.

To what extent are expectations changing for board oversight of all types of risks that confront an enterprise?

We note that boards are increasingly identifying a need to pay more attention to oversight of risk management. To some degree in the U.S., recent SEC proxy disclosure rules and guidance from the National Association of Corporate Directors in its report, "Risk Governance: Balancing Risk and Reward," have had an effect. Perhaps most influential was the first-hand observation of risk-management failures that recently occurred in the banking sector and throughout the global economy. We observe that board members often feel a need to understand better what can really damage a company's performance or, in extreme cases, jeopardize its survival.

How common among companies you have reviewed is the formation of a risk committee on boards of directors or at the executive level?

Forming a risk committee at the board level is generally at the discussion stage, with a consensus apparently building that a risk committee or the audit committee should take ownership of the process of risk-management, but the responsibility to oversee risks remains a key role of the board at large. Executive level risk committees are more common, and led in some cases by a chief risk officer, a financial officer, or, in other cases, the CEO. While the current best-practice debate favors certain structures above others, we believe that whatever structure companies choose should support open lines of communication between the board and senior management, and that the board should actively challenge key assumptions that underlie strategic decisions.

What functional level is typically responsible for overseeing risk management in most organizations?

Only a few companies we rate have a chief risk officer with enterprise-wide responsibility reporting to the CEO, but their numbers have increased in recent years, particularly in the energy sector. Some firms are developing the role, although most companies have at this point decided that other executives can carry out the functions of a chief risk officer. In our opinion, risk management itself is ultimately the responsibility of all managers in an organization.

What will ERM look like in five years?

We believe that ERM eventually will not be a distinct discipline because it will become integrated with everyday practice. At some point, risk management may be likewise part of every senior executive's repertoire of skills.

What are the next steps and timing for Standard & Poor's regarding ERM?

We will continue to communicate with companies on risk management -- broadly speaking. We will study the causes of historical defaults and sudden rating changes to learn whether differentiating companies based on how they handle this function may help us to rate companies.

Have you published any other articles on the subject?

Yes. See Progress Report: Integrating Enterprise Risk Management Analysis Into Corporate Credit Ratings, published July 22, 2009, and Credit FAQ: Enterprise Risk Management For Ratings Of Nonfinancial Corporations, published June 5, 2008.