

Ratings Agencies Eye ERM for All Industries

In an effort to improve the overall quality of the credit rating process by broadening the scope of their analyses, the major credit ratings agencies are planning to incorporate an entity's enterprise risk management (ERM) activities as an explicit component of their ratings methodology. While this will come as no surprise in the financial services sector, where the agencies began using such evaluations as part of their ratings metrics as early as 2003, other industries will begin to be subject to these new analytics this year.

While the ratings agencies' intent in this area is unambiguous, it is potentially seismic — both in terms of the investment organizations may need to make in developing their ERM capabilities and in terms of what's at stake. Standard & Poor's (S&P), for instance, has said that changes in ERM assessments, good or bad, will drive ratings and outlook changes.

Agencies have been transparent about the criteria they apply to the financial services sector, and are now seeking to adapt these criteria as they expand this approach to non-financial organizations. As an example, Standard & Poor's is currently inviting comment from inter-

ested parties on its proposed approach to ERM analysis for non-financial companies. It recently stated:

"We now propose to introduce Enterprise Risk Management (ERM) analysis into the corporate credit ratings process globally as a forward-looking, structured framework to evaluate management as a principal component in determining the overall business profile." (The business profile, along with the financial profile, is one of the key factors of an S&P credit rating.)

The request for comment was scheduled to run through the end of February, and S&P expects to have decided by March 1 whether to go ahead and include evaluation of ERM in its rating methodology for corporate entities. In addition, S&P is actively communicating its intentions to interested parties through face-to-face meetings and seminars.

Similarly, Moody's Investors Service has been working to further develop consideration of ERM as a component of its ratings methodology, through its Enhanced Analysis Initiative and by means of formal Risk Management Assessments, building on the work it has been doing with insurers and banks. The latter focus has been on firms that

By James Maxwell

Editor's note: The flurry of corporate scandals highlighted by Enron and WorldCom that ultimately led to the passage of the Sarbanes-Oxley Act and related regulatory reforms also triggered more rigorous approaches by ratings agencies. The subprime credit debacle that erupted last summer spurred further criticism of the agencies, which are planning to add new metrics to improve their assessment of enterprise risk. Financial executives need to keep abreast of these developments, which add to the impetus behind sound governance practices and comprehensive risk management approaches.

have a significant exposure to financial, commodity or energy risk.

Agencies Moving Cautiously

It's important to note, however, that the agencies are proceeding cautiously. The benefit (and threat) to their ratings process through explicit inclusion of ERM is still subject to some debate, and there are a number of logistical challenges still to overcome. Not least of these will be ensuring that ratings committees have sufficient capability and understanding to be able to recognize, benchmark and differentiate ERM practices within the organizations they analyze.

Furthermore, agencies don't want to be seen as "quasi-regulators"; in other words, they don't want organizations to implement ERM simply because it interests the ratings agencies. Rather, ERM should be adopted as good management practice and as an end in itself — a natural outgrowth/supporter of a company's business strategy, not just a compliance exercise.

Indeed, the agencies are unlikely to be inclined to delve into the details of a company's ERM processes. Their interest is more likely to involve a high-level review of ERM strategy and management's understanding and support of that strategy. And that will potentially carry great weight.

Standard & Poor's *Ratings Direct* of Nov. 15, 2007 states: "We expect that deterioration or improvement in a company's ERM quality would potentially drive rating and outlook changes before the consequences are apparent in published financial results. Companies with superior ERM should have less volatility in earnings and cash flow, and will optimize the risk/return relationship."

However, S&P adds that actual scoring on ERM isn't imminent. "We would expect to introduce ERM... into the ratings process by the end of the first quarter 2008. However, we would refrain from assigning ERM quality scores to individual companies until we have reviewed a sufficient number [of firms] to provide a range of comparability across firms and time."

Risk Assessment Approach from Two Agencies

ERM Element	Standard & Poor's	Moody's
Risk management culture and governance	Organizational structure Risk management staff roles and accountability Risk communication (internal and external)	Responsibilities and reporting structure with regard to risk considerations (budgeting, capital adequacy and allocation) Engagement of directors in the definition and review of the organizational risk philosophy (risk appetite and risk assessment methodology)
Strategic risk management	Utilization of risk management and return on risk in corporate strategic decision-making Risk consideration within capital budgeting and allocation, product development M&A, performance measurement and other business practices	
Risk management processes and controls	Risk identification, measurement and monitoring Emerging risks preparation — environmental scanning, trending, stress-testing, contingency planning and other pre-loss practices Pre-loss expectation planning for negative events and post-loss performance Risk limit application and enforcement (e.g., risk financing, risk offset) Risk control processes — policies, infrastructure, methodology (PIM) Sector- and firm-specific risk control criteria	Risk appetite and limit-setting — portfolio diversification and its relationship to the business decision-making process Risk mitigation — risk control and risk financing technologies Risk control processes — unit- and operating-level reporting lines and risk discipline
Risk analysis and quantification	—	Risk quantification — metrics used for capital determination, limit-setting and business operations
Risk reporting	—	Risk monitoring and reporting — usefulness of reports and systems
Risk management infrastructure	—	Risk infrastructure — systems Risk intelligence — model validity and data quality

Source: Compiled by Marsh Inc.

Potential Direct and Indirect Consequences

This change may have several implications for public companies, including:

- There will be independent assessment of the strength of ERM practices within organizations, and the results of such assessments may be publicly disclosed, as part of the ratings decision rationale.
- Organizations will be closely benchmarked against peers within their own industry sector and indirectly against other organizations and sectors.
- The relationship between investment in an effective ERM process and its tangible value to an organization may become far more acute (and measurable) than in the past, as the financial effect of a ratings downgrade or upgrade may be dramatic and far-reaching.
- Organizations that are prepared for and can take advantage of these changes may enjoy a significant competitive benefit over their peers.
- There may be significant consequential effects: a trusted, independent assessment of ERM capability would be of interest to many other stakeholder groups, including lenders, investors, regulators, customers and others.

The approach taken by the ratings agencies, at a high level, appears to be broadly similar. However, while it may have been possible to apply something of a consistent approach for financial institutions, ratings agencies will likely have to tailor their evaluation methodology for commercial organizations, depending on the industry sector and, possibly, an organization's geographical location. A short summary of the key components of the ERM evaluation approach for S&P and Moody's is provided in the table on page 45.

ERM Developing Momentum

The ratings agencies approach with respect to ERM underlines the growing view that effective ERM practices can add value to organizations. Notably, such initiatives can help

reduce earnings volatility.

A two-year study of 1,000 companies in the United Kingdom found analysts and investors prepared to apply a premium value to organizations that demonstrated lower earnings volatility over time. The study, cited in *Accountancy Age* (March 2006), surveyed companies over a 33-year period and found a 25-30 percent share price premium for companies in the quintile with the greatest profit stability versus those in the most volatile quintile.

Organizations considering the implementation of an ERM framework should assess the value such an investment may bring beyond the compliance aspects. The focus of ratings agencies in this area may blur the distinction between business value and compliance. However, when considering the value that ERM can bring, also consider the following:

- **All risks have an upside and a downside.** Through risk-taking companies give themselves access to potential rewards; risk management helps ensure that an organization is exposed, within its tolerance, to risks it's willing to assume and that it can mitigate, transfer or avoid other types of risk.
- **Risk management is also about reducing surprises that lead to earnings volatility.** For example, an effective crisis management approach might be a component of risk management that can help reduce earnings volatility.
- **Similarly, among the factors analysts consider when valuing a company is the net present value of future cash flows.** In this context, greater certainty of earnings can give them confidence in applying a lower discount. Similarly, confidence from ratings agencies in a firm's ERM framework may translate into confidence among other external audiences, such as market analysts and regulators.

Organizations: Be Prepared

In the current environment, few organizations are beginning the journey toward ERM from a standing

start. Most have implemented some form of risk management process, and many non-financial services organizations already are advanced in this area. Nonetheless, others view their investment in risk management more as a compliance exercise, and have not perceived or sought to maximize ERM's wider benefits.

As ratings agencies and other stakeholders bring ERM into greater focus, companies can benefit by assessing where they stand with respect to best practices, their ultimate ERM goal — and what achieving it might mean to external audiences — as well as how much time and resources will be required. Ultimately, the full value of investment in ERM will only be realized when an organization can articulate and communicate its risk management strategy to ratings agencies and other corporate stakeholders.

Clearly, implementing a robust ERM framework that can stand up to external scrutiny, particularly from the ratings agencies, will take time. While the agencies have not been specific with respect to their timetable for including ERM as a component of the ratings decision for all industry sectors, organizations that actively move themselves towards a state of readiness should be well positioned to reap the potential rewards.

JAMES MAXWELL is a Senior Vice President of Marsh Inc., based in its London, U.K., office. He can be reached by email at james.maxwell@marsh.com.

TAKEAWAYS

- >> The major credit ratings agencies have been incorporating risk management assessments into their financial services ratings for years. Now they are looking to expand that process.
- >> Ratings agencies are considering new analytics that would extend enterprise risk management (ERM) assessments to companies in all industries, starting perhaps as early as this year's first quarter.
- >> S&P has made it clear that changes in ERM ratings could have meaningful impact on its outlooks and ratings themselves, either as upgrades or downgrades.