

# Enterprise Risk Management Reviews in S&P Ratings of Non-Financial Companies

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# S&P ERM Review for Non-Financial Corporations

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- **Our Objective:**

Gauge extent to which we believe strong (weak) ERM benefits (hurts) a company's competitive position, resilience, and ultimately, credit strength

- **Discussions with Approx. 300 companies to date**

- **10% of global ratings coverage / 15 industry groups**

- **Focused on Investment Grade and "Crossover" Credits**

- **Emphasis on Culture and Strategic Decision-Making**

- **What are we Actually Doing?**

Questioning management in ongoing credit rating reviews and outside review setting

Developing views of causes of historical multiple-notch rating changes, a.k.a. "credit cliffs"

Borrowing from experiences in Financial Institutions ERM reviews

Consolidating tools now aimed separately at governance, accounting, derivatives, liquidity

AAA
AA
A
BBB
BB
B
CCC

# S&P ERM Review for Non-Financial Corporations: Questioning Management

- **Risk Management Topics**

Organizational visibility, scope, and responsibility

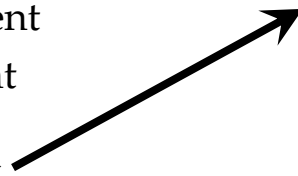
Process for risk identification, measurement, and updating

Policies, metrics, and incentives

Communications with internal and external stakeholders

Navigating the current stressed environment

Sectoral risks review



Selected "High Risk" Factors*...	Aerospace	Generic Pharma
Industry Cyclicity	✓	
Ease of Competitive Entry		✓
Product Quality	✓	✓
R&D Costs	✓	
Pricing Inflexibility		✓
Labor Costs/Efficiency/Unrest	✓	
Environmental	✓	
Regulation	✓	✓

\* *Key Credit Factors: Methodology and Assumptions on Risks in the Aerospace and Defense Industries, June 24, 2009 and Key Credit Factors: Business and Financial Risks in the Global Pharmaceutical Industry, January 22, 2009.*

# S&P ERM Review for Non-Financial Corporations: **Our Approach\***

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## **We look for...**

An approach to attend to key risks

Conscious risk selection

Awareness of risk tolerance/appetite

Knowledge of what can go wrong

A “Plan B”

Avoidance of outsized risks

Resilience

## **Not...**

A plan to eliminate all risks

Solely compliance and disclosure

A collage of disparate policies

A replacement for internal controls

Just having a Chief Risk Officer

\* *Standard & Poor's to Apply Enterprise Risk Analysis to Corporate Ratings, May 7, 2008.*

## S&P ERM Review for Non-Financial Corporations: **Discussion Questions\***

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1. What are the company's top risks? How big are they? How often are they likely to occur? How/when is this list updated?
2. What is management doing about each of the top risks it faces?
3. What size 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 impact incentive compensation of top management and on planning/budgeting?
6. Tell us about discussions about risk management that have taken place at the board level or among top management when making strategic decisions.
7. Give an example of how your company responded to a recent "surprise" in your industry and describe whether the surprise affected your company and others differently.

\* "Discussion Questions at Management Meetings", on [www.erm.standardandpoors.com](http://www.erm.standardandpoors.com)

- **Key Questions to Explore**

Would ERM review provide sufficient evidence for earlier action?

Would earlier action be warranted and informative in those cases?

Would ERM review provide different or more pronounced views on management?

- **Situational Examples**

Shift in growth strategy 6 months before announcement of hostile takeover bid

Degradation in frequency or quality of communication to investors or to S&P

New pay package for CEO

Habitual failure to meet financial forecasts

Unexpected changes in accounting practices, auditors, or departure of CFO

# S&P ERM Review for Non-Financial Corporations: Borrow from F.I. Experience

<b>Observation from stresses in Financial Institutions* ...</b>	<b>... Implication for ERM in Non-Financial Sectors</b>
Trends appeared at sector level first, individual bank level later...	... Could increase likelihood of wholesale rating changes across a sector
Aggregations across product lines & bus. units not identified until too late...	... May expect to see tools to spot aggregations, correlations
Risk controls often overridden...	... Likely to look closer at risk management stature, decision-making processes
Too much comfort drawn from statistical measures created in low-volatility era...	... Where statistical measures used, likely to look for long-dated test periods, robust back-testing
Incentives geared to short-term results, not long-term stability...	... May look closer at incentive systems, beyond just CEO compensation
Misalignment of traders' authorization levels and organization risk appetite...	... Likely to focus on clarity of risk appetite statement and means of implementation
Instances of over-reliance on models...	... Appreciation of experienced judgment in decision-making & testing/updating models where used

\* *Back to Basics: Further Lessons on Bank Risk Management, April 24, 2008.*

- **Wide variety of adoption, formality, maturity of ERM**
- **Heat maps and “Top Ten” lists common; Risk appetite/tolerance articulation is not**
- **Risk management is normally siloed at operational levels; Not strategic**
- **Emerging risk analysis is, well, emerging**
- **ERM fluency generally higher among companies...**
  - ...in energy, pharma, agribusiness, technology, some consumer products sectors
  - ...with fresh “battle scars”
  - ...rated in the upper investment grade-range (AAA, AA, A)
  - ...with public disclosure requirements
- **ERM focused on downside protection/compliance; Rarely on upside opportunity**

\* *Progress Report: Integrated Enterprise Risk Management Analysis Into Corporate Credit Ratings, July 22, 2009.*

- **We expect to –**

Continue company review discussions

Consolidate management assessment tools

Update credit analysis criteria to extent necessary

Progress report at year-end 2009

Incorporate updated management opinions in credit research reports in 2010

\* *Progress Report: Integrated Enterprise Risk Management Analysis Into Corporate Credit Ratings, July 22, 2009.*

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