

Adviser

Enterprise risk management for ratings of non-financial organisations

Standard and Poor's has recently announced that they will expand their ratings analysis of non-financial organisations to include a review of enterprise risk management (ERM). This change in process will affect all non-financial services companies and can lead to potential upgrades or downgrades to companies' credit ratings. In this Adviser, we ask and answer some of the questions clients might have about the new change.

What has Standard and Poor's announced in terms of incorporating ERM into its corporate credit rating process?

Standard and Poor's (S&P) has recently announced the expansion of their rating methodology for non-financial organisations to include a review of enterprise risk management (ERM). Prior to 2008, S&P included ERM in its rating process for financial companies. S&P is now the first credit rating agency to apply ERM assessment to non-financial organisations. Other credit rating agencies may also follow soon.

By the 3rd quarter of 2008, ERM will become a part of the standing agenda in S&P's review meetings with rated companies and S&P will finalise benchmarking criteria in the 3 to 6 months that follow. By mid 2009 these discussions and commentary will become a factor in evaluation and possible scoring of ERM quality, as a factor of the ratings decision.

Why did Standard and Poor's decide to include ERM in determining company ratings?

S&P's rationale for doing this is that they believe a review of an organisation's attitude and commitment to ERM can bring deeper insight into how effectively a company manages risk, and how well it is managed overall. Such insight has a bearing on expectations over a rated entity's future financial performance and stability, and therefore a bearing on its ability to tolerate additional risk and on its credit rating. Including ERM in the ratings process is therefore part of the ongoing improvement of S&P's ratings methodology.

What does the S&P's ERM assessment framework look like?

S&P's ERM assessment will ultimately classify companies into four categories: 'weak', 'adequate', 'strong' or 'excellent'. Only companies with clearly defined risk tolerances and limit frameworks, embedded risk return cultures and effective internal and external risk communication practices will qualify for 'strong' or 'excellent' classification.

The framework covers four areas: ERM culture and governance, strategic risk management, risk control processes and emerging risks. The main focus for S&P, however, will be on risk management culture and governance, and strategic risk. S&P analysts are unlikely to delve deeply into industry or sector specific risks and how they are managed.

Clearly, the quality and extent of public disclosure on risk will be important – S&P plans to evaluate commentary in public documents such as the report and accounts as part of its ERM evaluation methodology. S&P will also put relevant questions to managers as part of the review process, and will discuss ERM with issuers during regular periodic meetings.

Proposed ERM Framework – Corporate Ratings



How will this affect my organisation?

All non-financial companies in all sectors globally will now need to consider ERM as part of the standing agenda in review meetings with S&P. Given the direct correlation between an organisation's credit rating and both its cost of debt and the attitude towards it of counterparties, there is potentially a lot at stake.

How will an ERM evaluation improve the ratings process?

An existing part of the ratings methodology is an assessment of management effectiveness. Of necessity, this has been a highly qualitative exercise, and the expectation is that using the ERM framework will provide additional consistency and transparency. S&P believes that ratings can benefit from the additional insight gained as to the effectiveness of an organisation's management and from additional confidence over future financial strength that good ERM brings. It is likely that the effect of ERM on ratings in the long term will be on the margins; organisations with highly developed ERM programmes might see a positive impact on the ratings while organisations with unexpectedly poor ERM programmes might see a negative impact.

What are the benefits of a sound ERM?

Companies can benefit from a number of advantages by adopting a sound ERM programme. These can include:

- effective risk oversight and governance
- reduced uncertainty
- alignment of risks to business strategy
- greater investor confidence and lower cost of capital
- less volatility in earnings and cashflow and potentially a more favourable risk/return outcome

My organisation has a risk management process in place, what does this mean for us?

Every organisation is at different stages of risk management development and faces its own challenges. All programmes tend to be tailored to the organisation's strategy, risk profile and organisational design and hence if risk management processes are in place, the chances are that some or all of S&P requirements will have been met. However, there may be additional elements that will need to be put in place, or existing practices that require improvement. It is worth using the framework as an assessment tool to 'sense check' and ensure S&P's expectations in this area are met.

What services can Marsh provide in light of this change in the ratings process, and will they satisfy S&P's expectations in this regard?

Marsh has developed an S&P ERM Readiness Assessment which helps organisations to consider their existing risk management processes and practices and evaluate them against S&P criteria. Our methodology also acts as a basis to help organisations improve their ERM programmes. We are well positioned on this issue and have been actively participating as S&P have developed their thinking on ERM and have developed a number of relevant relationships within S&P.

If you would like further advice and assistance on this issue, please contact:

James Maxwell
Principal Consultant
Tel: 0207 357 3643
Email: james.maxwell@marsh.com