S&P's ERM Reviews for Non-Financial Issuers – Where Do We Stand?
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As we transition to 2009, it seems appropriate to provide an update on Standard & Poor's plan to integrate evaluations of enterprise risk management (ERM) programs into their credit review process for non-financial corporate issuers. Beginning in the third quarter of 2008, S&P began evaluating ERM programs as a component of their overall reviews of management effectiveness for rated entities. They began their reviews by focusing on two of the four core elements of their ERM assessment framework—an evaluation of the risk management culture within the organization along with an investigation of the strategic use of risk management data. As they move forward into 2009, S&P will continue to assess these two components and incorporate questions that help them better understand specific risk control procedures that are utilized as well as the processes developed to monitor and treat emerging risks.

With respect to the two core elements currently being reviewed, S&P looks specifically at the following information. To assess risk management culture, S&P is interested in:

- Risk management frameworks or structures currently in use
- Roles of staff responsible for risk management and reporting
- Internal and external risk management communication
- Metrics used to identify successful risk management
- Influence of risk and risk management on budgeting, management compensation, and other strategic decisions

To assess strategic risk management more carefully, S&P looks at:

- Management's views on risks the firm faces, including their perspectives on the risks' likelihood and potential impact
- Frequency and nature of updating the list of top risks
- The influence of risk sensitivity on liability management and financing decisions
- The role of risk management in strategic decision making

As of this writing, S&P has not yet begun to score ERM programs as part of their ratings review. They have stated that they desire to gain experience through ongoing reviews before implementing this next step in the assessment process. S&P anticipates by mid-2009 that they will be ready to assign one of four ERM program scores to each rated issuer. These scores are identical to those already used for ERM assessment of financial institutions, insurers, and selected energy companies and range from weak (1) to excellent (4).

To better understand the types of information that they are interested in, S&P has provided guidance on the characteristics of ERM programs that map to specific scores. An ERM program that is evaluated as "weak" features missing controls for one or more significant risks; provides limited capabilities to consistently identify, measure, and manage key risk exposures; and exhibits only sporadic execution of existing risk management procedures. ERM programs rated as "adequate" feature predominantly silo-based risk management procedures; a complete set of risk control processes to identify, measure, and manage significant risks; and experience infrequent unexpected loss events.

Those ERM programs that receive "strong" evaluations feature an enterprise-wide view of risks, but with a primary focus on loss control; can consistently identify, measure, and manage risk exposures within predetermined risk tolerances; and are unlikely to experience unexpected loss events. Finally, ERM programs identified as "excellent" can demonstrate true risk/reward optimization and are highly unlikely to experience losses that exceed its identified risk tolerance.

As we move up the scale from weak to excellent it is apparent that the emphasis is on demonstrated capabilities that are actively employed by the company. S&P's focus will be on developing an understanding of how dynamically the ERM program responds to ongoing threats and opportunities that arise in the business environment in which the rated firm operates. To provide issuers with guidance on how they will make these determinations, S&P has recently released a set of sample discussion topics and questions that their analysts will be interested in. These questions include:

- 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?
- What is management doing about top risks?
- What size quarterly operating or cash loss has management and the board agreed is tolerable?
- Describe the staff responsible for risk management programs and their place in the organization chart. How do you measure success of risk management activities?
- How would a loss from a key risk impact incentive compensation of top management and on planning/budgeting?
- Tell us about discussions about risk management that have taken place at the board level or among top management when making strategic decisions.
- 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.

To conclude, S&P has initiated their ERM assessment process and will be refining the methodology they employ to evaluate various facets of risk management programs in non-financial issuers during the first half of 2009. It is likely that by the end of this year, S&P will have embarked on published scoring of ERM programs of rated firms—something they have been doing for the past two years in the financial sector. It is highly advisable to be proactive in anticipating the questions that will be posed to your organization as you and other members of your organization meet with S&P analysts in the coming year.

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