



NONFINANCIAL CORPORATIONS, ERM AND THE RATING AGENCIES

Standard & Poor's (S&P) is inviting comment until February 1, 2008 on its proposal to include enterprise risk management (ERM) analysis for the credit ratings of nonfinancial companies. Although S&P may or may not follow a ratings scale similar to the one it developed for the insurance industry, the agency clearly intends to make an ERM assessment part of its ratings process. To help companies better understand the rating agency perspective, this paper briefly examines the emergence of ERM from the financial services industry; rating agency views of ERM; and what companies can expect as ERM takes hold.

WHITE PAPER

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Over the past decade, ERM has become a core capability for most corporations, first and foremost in financial services and increasingly in other industries. The rating agencies have determined that a company's ERM capability is a key indicator for its quality of management and creditworthiness, and they have been progressively publishing criteria for ERM assessment.

We believe that ERM is a key capability for any firm regardless of the stance of the rating agencies. However, rating agency considerations reinforce the influences that have brought ERM to the attention of senior management and boards.

ERM RATINGS EVOLUTION

ERM matured in the banking industry, where it has been a core competency for more than a decade. Its success and wide application among banks was driven by three factors: its clear benefits, increasingly specific and rigorous regulatory requirements, and rating agency assessment of companies' ERM competence. The latter is now being incorporated into broader credit rating judgments.

Insurance companies followed on the heels of the banking industry, with ERM becoming a component of that industry's rating processes in 2006.

The critical role of capital in the financial services industry has driven the near-universal use of ERM, but its adoption by other industries has been inconsistent. Certain industries — notably energy companies — have deployed ERM or

its essential elements, at least for trading operations, for example. But other non-financial industries have maintained more or less traditional risk management approaches.

Rating agencies themselves have also been inconsistent in applying ERM as a ratings standard. Moody's, for example, has been making formal Risk Management Assessments (RMA) on a selective basis since 2004, focusing on large corporations, including nonfinancial firms, that have significant economic exposure to financial, commodity or energy risk

(*Exhibit 1*). It remains to be seen whether Moody's will expand these assessments more broadly. Fitch has said that, when making a specific rating decision, it does not necessarily consider ERM to be distinct from a company's general risk management and financial control frameworks.

In putting forth its proposal for an ERM assessment of nonfinancial companies, S&P has indicated that ERM is a forward-looking framework that reflects management structure and practices as well as a company's commitment to, and effectiveness in, managing a broad array of risks.

EXHIBIT 1

Summary of Moody's Four Pillars of Risk Management Assessments (RMA)

- Risk Governance
 - Engagement of directors in the definition and review of the organizational risk philosophy (risk appetite and risk assessment methodology)
 - Responsibilities and reporting structure with regard to risk considerations (budgeting, capital adequacy and allocation)
- Risk Management
 - Risk control processes — unit- and operating-level reporting lines and risk discipline
 - 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 Analysis and Quantification
 - Risk quantification — metrics used for capital determination, limit setting and business operations
 - Risk monitoring and reporting — usefulness of reports and systems
- Risk Infrastructure and Intelligence
 - Risk infrastructure — systems
 - Risk intelligence — model validity and data quality

Companies that take a progressive approach to ERM will be rewarded, and those that lag will be at a disadvantage.

It is not clear whether S&P will develop a separate ERM ratings scale that identically follows what it developed for the insurance industry, but the intention to make ERM assessment part of the standard ratings process is unambiguous (*Exhibit 2*).

In short, things are about to change, and the implications are significant. As more rating agencies adopt an ERM assessment as part of their ratings process, companies that take a progressive approach to ERM will be rewarded, and those that lag behind will be at a disadvantage.¹

LESSONS LEARNED FROM BANKING, INSURANCE AND ENERGY RATINGS

Understanding how rating agencies' ERM criteria have evolved for the financial services, insurance and energy industries provides some clues to how nonfinancial corporations will be assessed.

Beginning in August 2004, S&P assessed banks, investment banks, brokerages and mortgage lenders on the quality and robustness of risk culture, risk appetite, risk aggregation, and capabilities to manage operations, legal and reputation risks at the enterprise level.² Given the effectiveness of S&P's assessments, the rating agency's trading risk management (TRM) framework was embraced by energy companies with large trading and market risk exposures. The TRM framework grew to include a full evaluation of risk management policies, infrastructure and

EXHIBIT 2 Summary of S&P's ERM Ratings Scale for Nonfinancial Corporations

ERM Score	Description
Excellent	<ul style="list-style-type: none"> ■ Achieves risk/reward optimization ■ Possesses very well-developed capabilities to consistently identify, measure and manage exposures to risk and losses within predetermined tolerance objectives ■ Unanticipated losses are highly unlikely to occur ■ Risk management is always considered important in corporate decision making
Strong	<ul style="list-style-type: none"> ■ Demonstrates enterprise-wide risk view but is still loss control focused ■ Possesses capabilities to consistently identify, measure and manage exposures to risk and losses within predetermined tolerance objectives ■ Unanticipated losses are unlikely to occur ■ Risk management is usually considered important in corporate decision making
Adequate	<ul style="list-style-type: none"> ■ Manages risk in separate silos ■ Possesses moderate capabilities to identify, measure and manage most major exposures to risk and losses ■ Unanticipated losses are somewhat likely to occur ■ Risk management is often considered important in corporate decision making
Weak	<ul style="list-style-type: none"> ■ Lacks complete controls for one or more major risk(s) ■ Possesses limited capabilities to systematically identify, measure and manage exposures to risk and losses ■ Risk management may sometimes be considered in corporate decision making

Note: A similar ratings scale has been in use for insurance companies

methodologies (PIM), which provided a broader framework for energy companies and financial institutions to adopt for organizing risk management protocol.

Moody's addressed ERM evaluation for all industries in 2004 through its RMA framework. By defining a standard structure for evaluating risk governance,

risk management, risk analysis and quantification, and risk infrastructure and intelligence, Moody's put into practice its view that ERM can be evaluated consistently across all industries. It has stipulated, however, that "key targets" for RMA are large organizations with significant exposure to financial or commodity risks.³

¹ "Request for Comment: Enterprise Risk Management Analysis for Credit Ratings of Nonfinancial Companies," *Standard & Poor's*, November 15, 2007

² "Enterprise Risk Management for Financial Institutions: Rating Criteria and Best Practices," *Standard and Poor's*, November 2005

³ "Risk Management Assessments," *Moody's Investors Service*, June 2004

After Hurricane Katrina, ERM was a differentiating factor in the results of individual insurers.

The rating agencies have applied special standards for the insurance industry, but even in that arena each agency has its own distinctive approach. For example, Moody's has highlighted the need for boards of directors to be closely involved in risk oversight.⁴ Fitch has released the preliminary results of testing for a proprietary capital model, called Prism⁵, with which it aims to assess risk-based capital for insurers within a single framework — a quantitative, bottom-up approach to enterprise-wide risk management.

S&P has been bullish on adoption of formal ERM programs in the insurance sector. It has pointed out that, after Hurricane Katrina, ERM was a differentiating factor in the results of individual insurers. Those with a strong ERM approach were able to quickly verify that their losses in the disaster were close to previously reported estimates of hurricane exposure; companies with weaker ERM often had difficulty assessing their losses in the period after the event and ultimately reported losses well in excess of previously reported “probable maximum loss” levels. S&P has already undertaken initial ERM evaluations for 241 insurers globally and rated only 13% “excellent” or “strong,” while most (82%) were rated “adequate.”

SO WHAT DOES IT MEAN FOR OTHER INDUSTRIES?

Through its *Request for Comment: Enterprise Risk Management Analysis for Credit Ratings of Nonfinancial Companies*, issued November 15, 2007, S&P has commenced the process of adding an ERM perspective to its assessment of all rated corporations. It has illuminated the parallel objectives of ERM and its own rating process in identifying significant risk events, in defining risk tolerance and in simplifying

information flow about risks and financial consequences. S&P's ERM scope and process will focus on four principal areas (*Exhibit 3*):

- risk management culture and governance
- risk controls
- emerging risk preparation
- strategic risk management.

Beyond indicating that ratings will begin to incorporate ERM analysis by the end of the first quarter 2008, S&P has not reached

EXHIBIT 3

Summary of S&P ERM Evaluation: Four Major Analytic Components

- Analysis of risk management culture and governance
 - Organizational structure
 - Risk management staff roles and accountability
 - Risk communication (internal and external)
- Risk controls
 - Risk identification, measurement and monitoring
 - 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
- Emerging risk preparation
 - Environmental scanning, trending, stress testing, contingency planning and other pre-loss practices
 - Pre-loss expectation planning for negative events and post-loss performance
- 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

⁴ “North American Insurers Face Three Significant Governance Challenges,” *Moody's Investors Service*, June 2007

⁵ “Prism — U.K. Non-Life Insurance 2005 Beta Testing Results and Review,” *Fitch Ratings*, July 2007

Companies that merely pay lip service to new ERM reporting requirements will not gain the advantages ERM offers.

any conclusions about the timing of implementation or whether the approach will be broadly applied immediately or in phases. Although the corporate community may push back during the commentary period, especially with regard to timing and implementation hurdles, we do not expect S&P to back down.

S&P says that it does not view ERM as an intrinsic quality of the company being rated but rather as the framework through which it assesses the quality of the company's general approach to managing risk. S&P has taken care to note that ERM and regulatory compliance are not analogous. It has pointed out that a compliance culture may, in fact, mask a deficient risk management culture and processes. In fact, by focusing only on compliance, a company is less likely to embrace ERM as a management tool and may delegate critical risk management activity to the regulator.

Like other agencies, S&P has stated that it will not set the management agenda for the companies it rates. It has pointed out that insurance companies were unfamiliar with the ERM concept when S&P first started discussing it with them in 2005, and that the insurance community's subsequent adoption of the concept validates the economic and business benefits of ERM.

In short, while the rating agencies are not dictating adoption of an ERM approach to management, they recognize its value as a management tool. Further, companies that merely pay lip service to new ERM reporting requirements — rather than embedding an enterprise-wide risk management approach in their management processes — may be following the letter of the law, but they will not gain the advantages ERM offers.

RATING AGENCY CHALLENGES

Clearly, the rating agencies face implementation challenges in the broad, heterogeneous corporate universe. Banks and insurance companies share “common risk currency” because both require that their core risks are adequately capitalized for reasons of consumer protection and market stability. Similar homogeneity exists among companies that trade actively in commodities, which is why energy and natural resources companies have been early exponents of ERM.

Beyond these sectors, the situation is more complicated. Many companies do not take on risks that are easily quantified in terms of capital. Companies in different sectors run very different risks in the course of their business and have suitably disparate approaches to managing and mitigating them. S&P says that it considers some factors common to all companies — risk governance, operating risk and liquidity risk, for example — but others, such as market risk and credit risk, have divergent forms and consequences from sector to sector.

Even fundamental risk management concepts such as diversification have interesting implications in the ERM evaluation process. Earlier this year, a working group of enterprise risk managers acknowledged the challenge of balancing a traditional emphasis on preventing losses with the necessity of fostering entrepreneurial risk taking.⁶ This dichotomy already poses a challenge to the ratings process; some insurance companies, for example, believe Fitch's Prism model generally rewards diversification, despite the fact that some insurers prefer — for strong actuarial reasons — to concentrate on particular coverage lines.

Given the diverse corporate universe, rating agencies are unlikely to take the prescriptive approach to ERM that has served them well in the financial services arena. Development of ERM will be largely left to the companies themselves, and implementation is likely to remain an idiosyncratic process that will require substantial involvement of senior management, together with close direction and oversight by the board. Nonetheless, rating agencies' expectations will undoubtedly influence companies' approaches to ERM.

We expect that an ERM assessment will feed into the overall ratings decision, but scores will not be disclosed explicitly to investors for some time. In addition, both S&P and Fitch have hinted that they will give companies space to improve their risk practices before acting on their credit ratings.

⁶ “Emerging Governance Practices in Enterprise Risk Management,” *The Conference Board*, February 2007

ERM is an essential part of creating and maintaining operating efficiency, developing organizational resilience and adding economic value.

DON'T WAIT FOR THE RATING AGENCIES

There is no longer any uncertainty surrounding ERM and its value in the credit rating process. Over the last decade, during which Towers Perrin has been offering ERM services to both financial and non-financial corporations, there has been significant development in the art and science of ERM.

After years of experience with ERM, both financial and nonfinancial corporations have found that ERM is an essential part of creating and maintaining operating efficiency, developing organizational resilience and adding economic value. As such, it has become an integral part of the strategic planning and corporate finance activities for many organizations. Therefore, the issue for most companies is not whether to implement ERM but how to identify the appropriate ERM activities and implement them. Some companies start by taking stock of risk management activities that constitute an ERM “foundation” and adding those that would more effectively achieve strategic and business objectives (*Exhibit 4*).

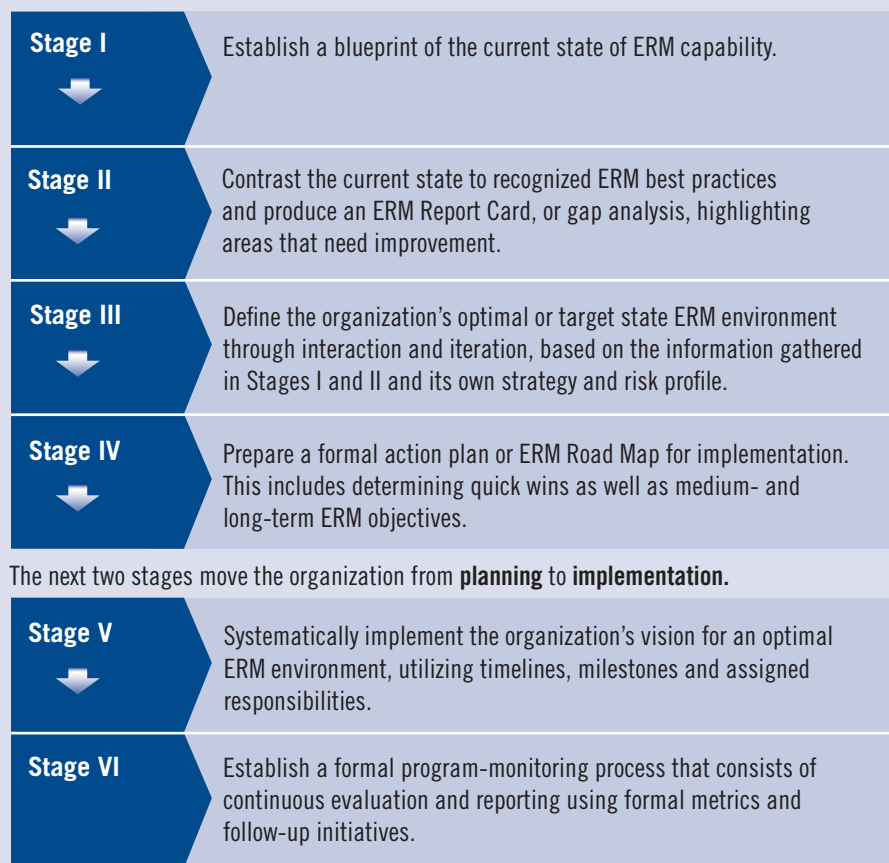
If maintaining robust credit ratings is a stimulus for organizations to look more closely at their risk management practices, structures and processes, then perhaps that in itself is beneficial. ■

EXHIBIT 4

Towers Perrin ERM Road Map Methodology

World-class organizations understand that ERM is an essential capability, independent of the stance of the rating agencies. These organizations have prioritized effective ERM as a value-added business initiative and strive to implement “best in class” ERM programs.

Towers Perrin has applied the following six-stage ERM Road Map methodology to guide organizations in their journey to achieve and maintain an ERM environment that works for them.



For more information, visit the Towers Perrin Web site at www.towersperrin.com or contact:

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ABOUT TOWERS PERRIN

Towers Perrin's ERM practice offers clients the ability to understand the full spectrum of risks faced by their organization and to create additional value by actively managing their key risks. Clients can deploy ERM to upgrade business planning through better articulation, quantification and oversight of the risks that drive value, and improve their ability to assess and implement risk solutions — both operational and transactional — to achieve their business objectives.

Towers Perrin is a global professional services firm that helps organizations around the world optimize performance through effective people, risk and financial management. The firm provides innovative solutions to client issues in the areas of human resource strategy, design and management; actuarial and management consulting to the financial services industry; and reinsurance intermediary services. The firm has served large organizations in both the private and public sectors for over 70 years. Our clients include three-quarters of the world's 500 largest companies and three-quarters of the *Fortune* 1000 U.S. companies.