

How to prepare for credit rating reviews under S&P's new enterprise risk management evaluation criteria*

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Background

In its continuing efforts to enhance its view of a company's financial profile and to be more forward-looking and predictive in its rating approach, in November 2007, Standard & Poor's (S&P) issued for comment a proposal for how it may begin to introduce enterprise risk management (ERM) analysis into its corporate credit rating process. As contemplated in its proposal, the deterioration or improvement of a company's ERM quality would potentially drive rating and outlook changes before the consequences are apparent in published financial results. The principal objective of S&P, in evaluating ERM, is to limit the frequency and severity of events that could possibly affect ratings.

Proposed Rating Process

S&P has been evaluating financial and insurance institutions ERM capabilities since 2005. Based on the success of this program, S&P expects to begin to assign scores of ERM quality to all non-financial companies it reviews and incorporate these scores into their credit rating process. The basis of these ERM scores will be information gathered during discussions with company managers as part of the normal credit review process.

S&P expects to tailor the ERM analysis to the firm being reviewed, based on its industry, company-specific risks, structure and culture. This analysis will be performed in the context of a customized and consistent general framework comprised of four major analytic components:

- Analysis of risk-management culture and governance,
- Analysis of risk controls,
- Analysis of emerging risk preparation, and
- Analysis of strategic risk management.

A firm will be assigned an ERM quality score based on a four level rating system—weak, adequate, strong and excellent.

Through this process, S&P will observe the following:

- How management defines its overall loss tolerance;
- The processes management has established to ensure that losses remain within that tolerance;
- The degree that management views risk and reward for risk in setting corporate direction; and
- Adherence to systematic and consistent practices that limit future losses to achieve an optimal risk/reward structure.

S&P will compare the company's ERM practices with sector risks, risks identified by company management and those of corporate peers. They will then form an opinion relative to the complexity of the risks the firm faces, as well as its vulnerability to those risks.

A firm will be assigned an ERM quality score based on a four level rating system—weak, adequate, strong and excellent. The weight of the score in the credit rating will vary depending on the importance of ERM for the particular company/sector.

Criteria

S&P has noted the following characteristics of firms achieving a given ERM quality score.

Weak:

- Missing complete controls for one or more major risks;
- Limited capabilities to consistently identify, measure and comprehensively manage risk exposures and thus limit losses;
- Sporadic execution of the firm's risk management program;
- Losses may be widespread according to a set of predetermined risk-/loss-tolerance guidelines; and
- Risk and risk management may sometimes be considered in the firm's corporate judgment.

Adequate:

- Manages risk in separate silos;
- Maintains complete control processes because the firm has capabilities to identify, measure and manage most major risk exposures and losses;
- Firm loss/risk-tolerance guidelines are less developed;
- Unexpected losses are somewhat likely to occur, especially in areas beyond the scope of the existing ERM practices; and
- Risk and risk management are often important considerations in the firm's corporate judgment.

Strong:

- Demonstrates an enterprise-wide view of risks, but is still focused on loss control;
- Has control processes for major risks, thus giving them advantages due to lower expected losses in adverse times;
- Can consistently identify, measure and manage risk exposures and losses in predetermined tolerance guidelines;
- Unlikely to experience unexpected losses outside of its tolerance level; and
- Risk and risk management are usually important considerations in the firm's corporate judgment.

Excellent:

- Possesses all the characteristics of a "strong" ERM program;
- Demonstrates risk/reward optimization;
- Very well-developed capabilities to consistently identify, measure and manage risk exposures and losses within the company's predetermined tolerance guidelines;
- Risk and risk management are always important considerations in the firm's corporate judgment; and
- Highly unlikely that the firm will experience losses outside of its risk tolerance.

Our sense is that S&P is serious about ERM and will approach their assessments with a critical eye.

Timeline

S&P introduced ERM analysis into their ratings process in mid-2008. However, ERM quality scores of individual companies will not be published until they have reviewed a sufficient number of firms to provide a range of comparability across firms and time. S&P expects this will likely require at least one year.

What it means to you

We have heard from many of our clients that they view this new credit rating assessment approach as somewhat of a pro forma exercise with a focus on documentation of existing practice rather than substantive assessment of risk management capabilities and practice. Our sense from following what the rating agencies have said in public and private statements is that they are serious about ERM and will approach their assessments with a critical eye. In fact, S&P views this initiative not simply as a compliance exercise but rather as a way to encourage management to improve risk management capabilities and practice and, by extension, credit quality and business performance.

While all companies must have some processes and approach to managing risk, our experience with many large, complex companies indicates that there is significant opportunity for improvement in current practice. Specifically, common risk management practice at many companies can be characterized by:

- Incomplete understanding of current risk profile.
- Overreaction to risk creating an overly risk averse culture.
- Fragmented (organizations and processes) approach to managing risk making it difficult to manage truly enterprise-wide risks efficiently.
- Inconsistent factoring of risk information into business decisions.
- Inconsistent approach to identifying, analyzing and responding to risks across business lines and functional areas.
- Failure to prevent or plan for risk events often leads to a culture of crisis response rather than proactive risk management.

Against this backdrop, achieving even a rating of “adequate” against the new S&P criteria may represent a challenge for many companies. As noted above, poor assessments against the ERM criteria may result in adverse credit rating decisions, increased cost of capital and lower earnings and share price performance. These impacts may be particularly acute for capital intensive companies that rely on ready-access to debt capital to fund its operations and growth plans.

Undertake an objective assessment of current risk management capabilities and practices against the defined S&P criteria.

What should you do now?

Given the impending implementation of S&P's ERM analysis, it is important for companies to understand the current level of risk management practice against S&P's criteria. This can be achieved by undertaking an objective assessment of current risk management capabilities and practices against the defined S&P criteria with a particular focus on:

- **Risk management culture and governance**—what is the company's risk management philosophy, how is this embedded within the organization and how is the company organized to manage risk?
- **Risk management process**—how does the company identify, assess and manage risk? How is this risk management process embedded within the company?
- **Risk infrastructure**—what are the tools, templates, policies, procedures, data, etc. that the company uses to identify, assess and manage risk?

Once companies understand current practices, these can be compared to the S&P evaluation criteria or other standard risk management frameworks (e.g. COSO ERM) to identify gaps. These gaps will serve as the basis for an improvement action plan.

The Value of Better Risk Management

Beyond simply responding to S&P's rating criteria, our experience indicates significant benefit may be realized through enhanced risk management practice to:

- Help achieve corporate objectives consistent with the overall risk tolerance of the organization;
- Establish processes for risk/opportunity identification and mitigation that are consistently applied across the organization;
- Integrate risk assessment into decision making at all levels;
- Effectively mitigate significant risks;
- Increase accountability and enhance the corporate culture for risk assessment and mitigation; and
- Force conversations around objectives and risks that reveal opportunities and allow the business to realize them.

How can PwC help?

PwC is able to assist your company in understanding how your current risk management practices and capabilities compare to S&P's evaluation criteria. Our services include:

- Conducting a Risk Culture Survey;
- Reviewing current state ERM framework and preparing a "Risk Snapshot";
- Benchmarking and gap analysis against S&P ERM and industry practices;
- Developing a roadmap to address gaps including specific action plans;
- Assisting with the implementation of action plans;
- Assisting with monitoring and reporting mechanisms to achieve sustainability; and
- Assisting in the integration of an ERM system with business and control function processes.

Who to call

Calgary

Scott Bolton
403 509 7502
scott.r.bolton@ca.pwc.com

Jenny Weingardt
403 509 6384
jenny.h.weingardt@ca.pwc.com

Montreal

Caroline Emond
514 205 5103
caroline.emond@ca.pwc.com

Ottawa

Roxanne Anderson
613 755 8702
roxanne.l.anderson@ca.pwc.com

Toronto

Brenda Eprile
416 869 2349
brenda.j.eprile@ca.pwc.com

Vancouver

Craig Campbell
604 806 7603
craig.campbell@ca.pwc.com

Winnipeg

Robert Reimer
204 926 2442
robert.j.reimer@ca.pwc.com

www.pwc.com/ca/erm