

## Raising the Bar: Will your ERM practices set the standard?

Standard & Poor's (S&P) recently finalized its plans to include the evaluation of enterprise risk management (ERM) into its corporate credit rating process. S&P's rationale for doing this is that it believes a strong ERM program is a clear indicator of otherwise hard to measure aspects of a company, such as management capabilities, strategic rigor and ability to adapt to changing circumstances. S&P also believes the quality of a company's ERM program acts as a lead indicator and expects the deterioration or improvement in the quality of a company's ERM will drive rating changes before the consequences are apparent in published results. Beginning in the 3rd quarter of this year, non-financial institutions can expect to face explicit questions regarding their ERM practices and by 2009 these questions will translate into potential upgrades or downgrades in credit ratings.

S&P's ERM evaluation assessment will ultimately classify companies into four categories: 'weak', 'adequate', 'strong' or 'excellent'. Only companies with clearly defined risk tolerances and limit frameworks, deeply embedded risk-return cultures and effective internal and external risk communication practices will qualify for 'strong' or 'excellent' classification. There are very real benefits associated with achieving these top ratings. Firms that have invested in upgrading their ERM practices will likely have external and independent recognition of their efforts and financial advantages over their competitors. Conversely, those firms that fall into the 'adequate' or 'weak' categories will potentially face increased borrowing costs, greater pressure on loan covenants, a decline in bond demand and a diminished status as a trading counterparty.

The remainder of 2008, as indicated by S&P, will be spent evaluating ERM practices for all rated firms as part of the existing rating process. These evaluations will in turn result in the development of a best practice framework used to derive the ERM ratings for 2009. The question is, do you want to set the ERM standards by which your peers will be evaluated?

## S&P's ERM assessment framework

S&P is the first credit rating agency to apply an ERM assessment to non-financial institutions, but other leading credit rating agencies may soon follow. The move is the latest in a series of efforts by rating agencies and regulatory bodies to enhance the scrutiny of corporate governance practices, stock exchange listing requirements, and corporate risk management. The proposed ERM evaluation framework (see Figure 1) extends well beyond simple loss avoidance practices to include a review of more proactive steps taken to achieve an optimal risk/reward structure.

Figure 1. S&P's Proposed ERM Assessment Framework



S&P has yet to determine the precise weighting of the ERM score in corporate credit ratings, but it is likely to have a material impact. When S&P formally introduced similar ERM criteria into its assessment of insurance companies several years ago, it influenced the ratings of many firms and increased the transparency required in a number of their strategic decisions.

One of the challenges to S&P's current approach is the lack of definition around a number of the critical elements they will be evaluating, for example, risk appetite and tolerance. By taking advantage of this apparent white space, organizations have the ability to influence the rating scale they ultimately will be evaluated against.

## How do corporates rate?

While many non-financial institutions have made at least some effort to implement ERM, only a handful of leading firms could today demonstrate truly 'excellent' ERM capabilities. Our experience suggests that a number of companies struggle with extracting the value relative to the efforts, required for implementation. Other common shortfalls include:

- Reliance on compliance activities delivering limited business benefit
- Inability to model the ratings impact of risks faced
- Inconsistent risk assessment due to a lack of common methodologies
- Disconnects between risk and business decision-making processes
- No clear statement of risk appetite and inadequate risk limit settings and controls
- Inadequate risk governance and oversight structures
- Explicit understanding of the impact of risks of financial performance

## The benefits of sound ERM practices

There are numerous advantages attainable by adopting sound ERM practices and in some instances setting the standard. Robust ERM programs provide management with tangible business benefits including:

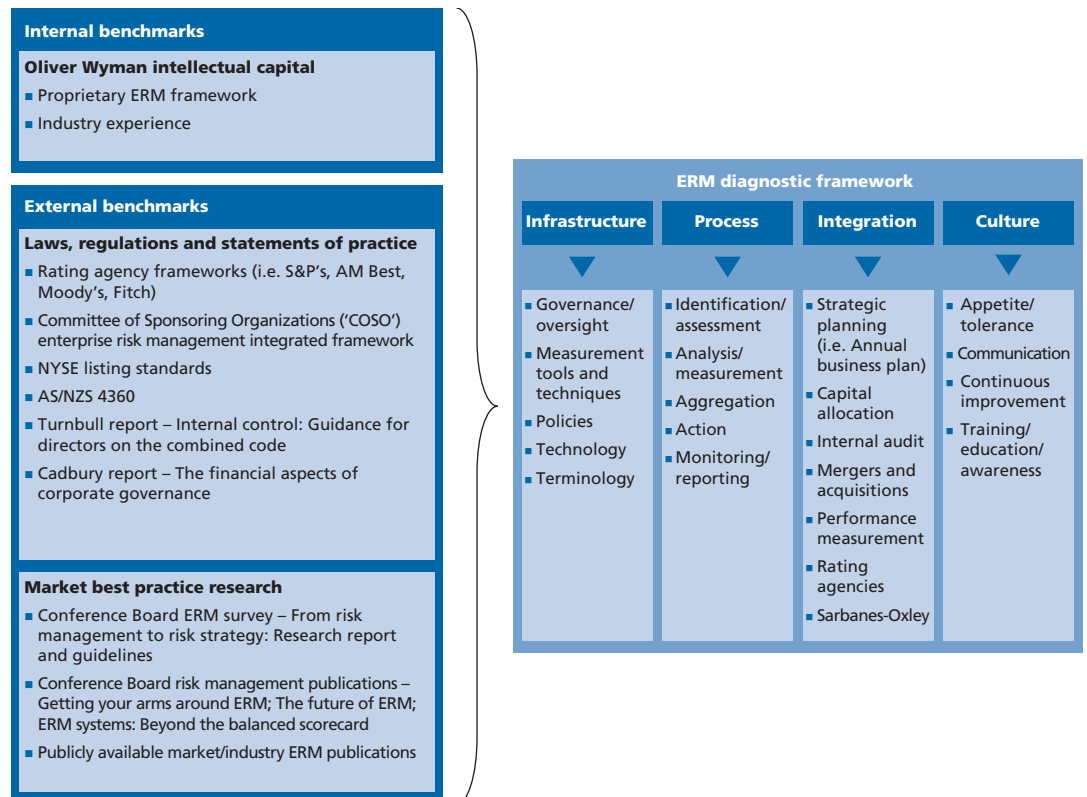
- Effective risk oversight and governance
- Assurance that risks align with strategy and balance sheet capacity
- Fewer surprises and losses, due to a culture of risk awareness
- Enhanced risk-return decision-making (e.g. deal pricing, structuring, hedging)

External recognition from rating agencies will add another very tangible benefit, providing firms with additional financial advantages over their competitors.

## How Oliver Wyman can help

Oliver Wyman’s Corporate Risk practice has worked extensively with major non-financial institutions in the development and enhancement of sophisticated risk and value management techniques, including ERM. Based upon our experiences with large corporations who have adopted advanced ERM practices in recent years, we recommend that companies re-examine their existing risk management practices and evaluate them against the S&P criteria and other leading approaches. As a starting point we suggest a systematic diagnostic of current practices across four dimensions (see Figure 2). The diagnostic will allow you to prepare for the upcoming S&P discussions and ensure your organization continues its progression towards improved risk-based decision making processes.

**Figure 2: Sample ERM diagnostic for management**



## Key diagnostic questions

### 1. Risk infrastructure

- Does risk management have effective independence to review and challenge risk decisions?
- Is the role and charter of risk functions and committees clear?

### 2. Risk management process

- Are all key risks clearly identified and consistently evaluated?
- Is the relative importance of individual risks known?
- Is the aggregate risk exposure measured?

### 3. Risk process integration

- Are consistent risk measurement, reporting and management processes in place?
- Are risk processes effectively linked to decision-making processes?
- Are investment decisions evaluated explicitly on a risk-return basis?

### 4. Risk management culture

- Does a culture of risk awareness pervade the organization?
- Is there a clear statement of corporate risk appetite?
- Are risks in strategic decisions adequately assessed?

We recognize that every organization is at a different stage of risk management development and faces unique challenges. Getting started with this diagnostic is just one of the many ways of assessing the effectiveness of your current ERM practices and defining a cost-effective implementation plan. Ultimately, ERM practices must be tailored to the organization's strategy, risk profile and organization design with the overall objective of enhancing value creation and performance. As one of the leaders in value-based ERM consulting, Oliver Wyman helps organizations create a customized approach to ERM, allowing each group to satisfy S&P standards and, most importantly, to reap the benefits of a robust, risk-based decision-making framework.

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