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Enterprise Risk Management: More Important, But Still No Panacea

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For the past year, unexpected risk exposures have turned into mounting losses that are battering corporate bottom lines worldwide. Now, as markets slump and reports of new write-downs appear daily, Standard & Poor's Ratings Services believes that a sharpened top-down focus on risk management and a commitment to integrate risk management vertically throughout an enterprise are essential. In short, enterprise risk management (ERM)—both as a philosophy and a discipline—is becoming a necessity, not an option.

We believe that employing sound ERM practices will improve companies' financial profiles. For more than a decade, ERM's tools and skills and the structure ERM imparts have helped companies and their managements identify, select, and mitigate a range of cross-functional and aggregated risks. ERM has evolved into a valuable tool that helps inform and direct management decisions. It can help managements to evaluate financial performance, improve product design and pricing, and guide strategic decision making. Sound ERM practices can also help firms optimize their returns for the level of risk they take. And over the past few years, ERM has even become an analytical tool that can help financial and ratings analysts better understand connections among a firm's various risks.

However, having ERM in place is not a guarantee that a firm can predict or avoid losses, nor is it a method to eliminate all risks. For example, the recent record losses at a number of banks and at some insurers have required significant recapitalizations to preserve creditworthiness. These events have revealed limitations and potential shortcomings in these firms' risk management function. Such losses also point to the need for improvements in measuring and monitoring risk and in the governance structure overseeing risk exposure and tolerance.

Where ERM Stands Today

Right now, we believe ERM is underfunded and underintegrated. At most firms, it's tucked away into silos with little top-level integration or silo-to-silo communication. Where that's the case, cross-functional risk awareness and mitigation of those risks suffer. Truly effective ERM requires not just a high-level manager—such as a chief risk officer—to oversee risk but also a companywide commitment to incorporate ERM into the firm's strategy, governance, and culture.

Although companies that recently had risk-generated losses could be less than likely to embrace the ERM concept immediately, many are taking steps to focus more top-level attention to it. More than a few firms that had substantial write-offs in the last two quarters recently created and filled chief risk officer positions.

Panelists and attendees at our December 2007 summit conference in New York City on ERM clearly were convinced of its value as well as its ability to help companies effectively identify, manage, and mitigate their current and future risks. However, ERM is still sufficiently new that how best to take it to its next integrative step throughout several industries is still being debated.

Strategic risk management will be the next frontier, risk management consultant James Lam told attendees. And implementing ERM is an effective way for companies to establish a strong strategic risk management function that can encompass an entire enterprise. However, finding ways to create and embed such a structure and culture throughout a firm and into its underlying values continues to challenge organizations. "It's a long process because

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organization and leaders change," said conference panelist Laurie Smaldone, until recently chief risk officer for Bristol-Myers Squibb.

The push must come from the top, especially from boards, because "ERM is frequently governance-driven," said panelist Ellen Hexter, director of integrated risk management at The Conference Board. To get directors behind the effort, though, could take extraordinary measures. "The strongest motivation I've seen is when boards had to pay from their pockets to settle shareholder suits," she said. Executives and employees also need to understand how ERM adds value, so companies must build, communicate, and implement policies and procedures, and they must train employees.

Another issue is disclosure. Although it is critical, it must be managed, as analysis of ERM can run the risk of exposing too much competitive information. "You're putting on the table the risks you're willing to take," said panelist Prakash Shimpi, the global ERM leader at Towers Perrin. "You have to be able to explain how you're creating value and the risks you're taking to do so."

In addition, a cultural acceptance of exposing and discussing risk and its effects must develop, which will require more than just a risk lexicon. "If an organization doesn't have a culture where you can evaluate risk without getting shot, [ERM] won't work," Ms. Hexter said.

ERM also provides constructive ways to know how a company can fail, so that mitigating moves can be made to prevent it, said panelist Rick Funston, principal at Deloitte & Touche LLP. However, he cautioned that ERM is also "one size fits one" and must be optimized for each company. Mr. Lam warned that ERM can give a false sense of security, but good customization can help avoid it.

ERM's Role In The Rating Process

At Standard & Poor's, an analyst's job is to provide prospective opinions when rating credits. Incorporating ERM analysis can provide more structure and consistency to our assessment of a company's risks. It enables analysts to drill deeper into quantitative financials, links risk management to overall corporate strategy, and allows greater prospectiveness in our company analyses.

The process of asking top executives at different companies how they manage risk can help us differentiate each company's risk management capabilities more effectively. Also, we consider a favorable ERM evaluation to be a competitive advantage that can positively impact a rating.

To date, Standard & Poor's has been integrating ERM analysis into rating processes for three industries—insurance, financial institutions, and energy trading firms in electricity marketing and agribusiness—to improve the quality of analytics.

Since introducing ERM criteria to our insurance rating process in 2005, we have witnessed a remarkable level of ERM evolution at these firms. Since then, we've expanded our assessment criteria to enable analysts to dig more deeply into risk volatility. This year, we expect to use our ERM criteria to conduct deeper examinations of insurance company asset/liability management, hedging, and cycle management and to expand our view of their strategic management capabilities as a means of optimizing risk.

In addition, we are creating a framework to analyze insurance companies' economic capital models from a risk

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management perspective to gain a more robust understanding of risks and risk tolerances at the companies we rate.

Our risk management analytics for financial institutions and energy trading desks, known as PIM (policies, infrastructure, and methodologies), are evolving into a more holistic enterprise-based approach to assessing risk. We are also beginning to incorporate ERM into our analyses of nonfinancial companies.

We intend to keep enhancing our evaluation of ERM.

Questions About ERM's Future

Because ERM is still new, it can be tempting to oversell it, overpromising results. That would only ensure that its integration in a company doesn't work.

Ultimately, ERM is not a panacea but rather a methodology that lends itself to the management of the likelihood of risks emerging. As company managements customize the process and learn from their experiences how it works best, they can enhance the process by which ERM enables the recognition of emerged risks and determine the most effective ways to control them.

Looking to the next step of ERM's evolution—both as an analytic tool and as a corporate risk assessment framework—several questions come up. On the analytic side, should ERM be the structure that frames the rest of the analysis, or should ERM continue to be its own analytic silo?

Although strong buy-in is evident for the insurance industry, nonfinancial companies are still not convinced that ERM assessments add value for them, according to comments we received this past November (see "Request For Comment: Enterprise Risk Management Analysis For Credit Ratings Of Nonfinancial Companies," published Nov. 15, 2007, on RatingsDirect, the real-time, Web-based source for Standard & Poor's credit ratings, research, and risk analysis).

Notwithstanding the market's experiences in 2007 and thus far in 2008, we still strongly hold the opinion that ERM will be key for future corporate financial health (see "Enterprise Risk Management: ERM Development In The Insurance Sector," published March 24, 2008, on RatingsDirect).

Through the rest of 2008, we expect to examine what strategies corporations are continuing to create as a result of our insurance company ERM exams. ERM enables insurers to see the cost of pursuing risk, and it's giving us a more robust and prospective understanding of credit, of risks that need to be mitigated, of risk tolerances, and of the benefits of diversification.

ERM at its best has already sharply reduced the possibility that companies will have outsize losses. It also tries to maximize revenue given the associated level of risk. A tangible benefit of our ERM analysis is that it provides us with a more consistent framework to assess not just a rating but also how effectively companies can strategically mitigate their risks.

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