The Association of Corporate Treasurers

Comments in response to
Enterprise Risk Management (ERM) Analysis for Credit Ratings of Non-financial Companies
Issued by Standard and Poor's,
November 2007

February 2008

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance.   Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments. This document is on the record and may be freely quoted or reproduced with acknowledgement. The ACT welcomes the opportunity to comment on your consultation.

In this case we have consulted our membership through our credit ratings working group and the Policy and Technical Committee.

Comment

Effective risk management is recognised as a significant element in optimising the predictability of cash flows and company valuations.   It has consequently become increasingly important to organisations as part of both strategic and tactical business development.   Investors *should* benefit from risk management processes which attempt to address the firm's risk environment, mitigate the financial cost of business disruption and loss and reduce excess risk capital held against non-remunerated risks.[1]

Making investors aware of whether firms have ERM in place and what resource and emphasis the management place on it is to be commended. Our concern is that in non-financial businesses the concepts and implications of ERM appropriate to financial

[1] E.g. Robert C. Merton, You Have More Capital Than You Think, *Harvard Business Review*, November 2005, ISSN 00178012, Vol. 83 Issue 11, p84-94

companies will not provide comparably useful, measurable and qualitative results. Further empirical work needs to be done.

Our key concerns are as follows.

- The risk environments for financial and non-financial businesses have many components in common. However they are also materially different. Assessment of the ERM framework for a non-financial business with the objective of contributing to the assessment of the firm's propensity to default but using an approach from the financial sector, must make all due allowance for these differences. It is unlikely to be measurable in the same way

- The ACT has reservations about whether the paper's proposed approach to identifying and measuring risk, and scoring the effectiveness of an ERM, will be properly appropriate to a ratings review of default probability in non-financial businesses. We agree that too complex a scaling should be avoided. This is particularly an area where the agency's *judgement*, simply set out, is what ratings users will be looking for

Background

The paper sets out the straightforward premise that ERM analysis will be an additional tool for assessing a non-financial firm's propensity to default. The proposal suggests as its aim a clarity and consistency in this analysis leading to an ERM 'score' for each rated company. The paper discusses at some length S & P's overall prior experience with ERM in the financial sector, quoting extensively an example from the insurance industry where understanding risk likelihood *and* impact is an explicit output of operations. There is an acknowledgement that this is a quite different industry sector but the analysis relies on the same principles being applicable to non-financial firms

The ACT has reservations about whether the principles of ERM will indeed transfer between these industry sectors. In particular the approach of management to loss in a financial environment will be built on the intrinsic activities of the company – often using a measuring tool such as Value-at-Risk (VaR). It is not clear to us that this is useful for the understanding of many of the risks faced by non-financial firms, especially as those risks are often cash-flow risks rather than asset price risks[2]. VaR may have utility where measurable financial price risks are concerned, especially when managing assets rather than cash flows, but the full spectrum of business risks likely to destroy value will not be captured. Risks and the approach to their management may reasonably be considered to be more complex in many non-financial businesses. It is debatable whether a complete set of tools exists in any event for the measurement of these risks.

Scoring

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[2] E.g. Christopher L. Culp, Merton H. Miller and Andrea M. P. Neves, Value at Risk: Uses and Abuses, in Joel M. Stern and Donald H. Chew, JR, *The Revolution in Corporate Finance*, 4th Edition, 2003, Blackwell Publishing, Oxford, ISBN 1405107812, pp. 416-429

As part of the analysis you intend to create a continuum of scores from 'weak' to 'excellent' to be included in a rating to assist investors as part of their overall credit review. You will recognise the individual nature of non-financial firms' positions on risk but look for consistent patterns in management and operations. It is not immediately clear however how these differences can be managed in a unitary scoring system.

It is also not clear whether the scores will only measure the *existence* of ERM and its attendant processes or whether those processes are active and can be expected to be implemented by the firm effecting both occurrence reduction and loss given occurrence. Numerous examples can be quoted - e.g. from the Oil or Chemical sectors – where it is highly likely scores would have been strong or excellent but where events and outcomes showed the effectiveness of procedures to mitigate loss to be low. For example, the trade-off between risk and capital (highly relevant to financial organisations) may allow a bigger, stronger company better to withstand any given level of loss relative to a weaker competitor. Hence such a company may deem a more sophisticated level of ERM process unnecessary (and thus receive a lower score) if it considers its risks to have only modest impact on its financial health – though its valuation may suffer if it has an excess of not-fully-remunerated-capital.

The proposal suggests that depending on company and sector you will apply different weightings when you integrate your ERM score into the credit rating assessments. The ACT considers this weighting process to be important and would expect this to clarified with respect to each rating

Risk identification

The paper identifies a number of risk types and associated controls for various industry sectors. Whilst the examples are clearly not exhaustive and indicative only, the ACT feels that creating a relatively structured ratings model driven by a matrix approach to identifying risks does contrast with the intention of recognising individual or sub-sector characteristics. Our concern is that investors may respond to the model rather than the particular credit considerations of any given firm or debt security. In addition it is not clear how the model will be predictive of emerging risk or how the balance between known and unknown risk will be considered.

TREASURY, RISK
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PROFESSIONALS
ACT

The Association of Corporate Treasurers

The ACT is the international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences, publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

Our 3,600 members work widely in companies of all sizes through industry, commerce professional service firms.

Further information is available on our website (below).

Our policy with regards to policy and technical matters is available at
http://www.treasurers.org/technical/resources/manifestoMay2007.pdf

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