



Enterprise Risk Management: S&P Enhancement White Paper

*Learn how incorporating a strategic,
enterprise-wide approach to risk can
enhance your company's credit rating*

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Aon Global Risk Consulting

Executive Summary

On July 22, 2009, Standard & Poor's (S&P) released a progress report* regarding enhancement of its global rating process for non-financial companies by including enterprise risk management (ERM) assessments in its ratings.

S&P hopes that the addition of ERM factors into its credit analysis will improve the overall quality of S&P's ratings by enhancing its opinions on management of corporate borrowers. S&P views ERM as an organizing tool for assessments of management, helping it create a more systematic framework and common language for an "inherently subjective topic" and the ability to benchmark companies against each other over time*.

Since the third quarter of 2008, S&P has conducted ERM-specific discussions with more than 300 of its rated non-financial issuers, primarily in the U.S. and Europe. S&P intends to continue preliminary ERM discussions over the course of this year, with another progress report and more specific guidance by the end of 2009. S&P expects to begin incorporating ERM references into individual corporate credit rating reports in 2010. S&P does not plan to provide an exclusive ERM score but will instead factor ERM activities into its overall view of management.

Although S&P's ERM reviews bring additional attention to ERM, a successful ERM approach creates benefits beyond the rating agency review. Companies that adopt an enterprise view of risk often do so because this offers value through better awareness and control of risks, improved resource efficiency and enhanced ability to take additional business risk. Companies that have implemented successful ERM frameworks often achieve improved consistency in risk management practices and better response to escalating corporate governance requirements, regulatory pressure, capital availability and cost, capital deployment and market pressure through improved understanding of risk and mitigation options.

Aon's ERM practice provides a wide range of consulting services that assist our clients in addressing S&P's ERM discussion questions as well as gaining a competitive advantage through improved ERM and risk response capabilities. Aon's ERM consulting services include review of current risk management capabilities, development and implementation of ERM strategy and tools, and use of advanced quantitative risk analysis techniques to assist clients in better understanding, managing and reporting risk.

* "Progress Report: Integrating Enterprise Risk Management Analysis Into Corporate Credit Ratings" July 22, 2009
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1.0 S&P's Approach to ERM

Since the third quarter of 2008, S&P has conducted ERM specific discussions with more than 300 of its rated non-financial issuers, primarily in the U.S. and Europe. As part of these discussions, S&P has reviewed risk management structures, the roles of staff responsible for risk management, internal and external communication, and risk management practices and procedures. S&P has explored management's view of the most critical risks; the likelihood of these risks occurring; how critical risks are identified, monitored and updated; and the influence of risk sensitivity on liability management and financing decisions. These discussions have been based around seven primary questions:*

1. What are the company's top risks, how big are they, and how often are they likely to occur? How often is the list of top risks updated?
2. What is management doing about top risks?
3. What size quarterly operating or cash loss has management and the board agreed is tolerable?
4. Describe the staff responsible for risk management programs and their place in the organization chart. How do you measure the success of risk management activities?
5. How would a loss from a key risk affect incentive compensation of top management and planning/budgeting?
6. What discussions about risk management have taken place at the board level or among top management when strategic decisions were made in the past?
7. Give an example of how your company responded to a recent "surprise" in your industry. How did the surprise end up affecting your company differently than others?

S&P states the main purpose of these discussions has been to gather information that will help S&P enhance its assessment of the management of corporate borrowers. S&P also emphasizes its belief that the addition of ERM into its analysis will shed light on how well executives are incorporating risk into the management of organizations, and that this information will improve the quality of S&P's ratings.

In its recent announcement, S&P states that it does not plan to provide an exclusive ERM score and does not expect that ERM analysis will radically alter existing credit rating opinions. Rather, S&P will factor ERM activities into its overall view of management, with changes in ratings or outlooks expected only when S&P's view of management is affected by an organization's risk management approach.

S&P continues to focus primarily on "risk culture" and "strategic risk management." S&P assesses evidence of each organization's risk culture through a review of communications, risk management roles, risk policies and procedures, and the influence of risk management on strategic decisions. S&P defines "strategic risk management" as the identification of main risks and how these risks are managed, updated, and impact decisions.

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With regards to ERM structure and management compensation practices, S&P continues to state that it does not have a preferred structure; S&P will look for efficacy of risk communications, as well as consistency between ERM practices and the Board's stated goals.

S&P's discussions to date have led to several interesting preliminary findings:*

- The level of adoption, formality, maturity, and engagement of ERM varies widely within and across sectors and regions
- Many companies exhibit an active management of risks with ongoing risk reviews and the assessment of high-impact/high-probability risks
- The way the risk management function fits in the organizational structure indicates how integrated a company's approach is to risk management; silo-based risk management, focused only at the operational managers' level, continues to be prevalent
- There appears to be a link between transparency and disclosure and companies' confidence about ERM
- Companies with a true enterprise-wide approach to ERM appreciate the importance of going beyond only quantifiable risks or even top 10 risks and they increasingly understand the importance of emerging risks
- Companies often facilitate their ERM execution via separate structures, with associated roles and responsibilities clearly defined
- Companies in industries with more quantifiable and hedgeable risks are generally more comfortable discussing ERM, but they tend to focus on controls of those specific risks
- ERM discussions, in general, have been more productive with investment-grade and public companies
- Firms in the distressed and highly leveraged rating categories (and S&P analysts) are focused primarily on near-term liquidity in the current financial environment
- Public companies often have more to say about ERM due to their attentiveness to compliance and the expectations of external stakeholders
- Not many companies have come to grips with the upside aspects of ERM, with focus often on assuring that downside risks are covered; S&P expects that, over time, more companies will recognize and articulate the competitive advantages of superior risk management
- There continues to be a strong compliance-driven push toward ERM; in the past, S&P has cited this as a possible danger

S&P intends to continue preliminary ERM discussions over the course of this year, leading to another progress report with more specific guidance by the end of 2009. S&P expects to begin incorporating ERM references into individual corporate credit rating reports in 2010.

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2.0 The Way Forward

As senior management prepares for preliminary ERM discussions with S&P, a first step will be to understand existing risk management activities and capabilities in general terms, and then to determine the organization's ability to respond to S&P's seven questions. This initiative presents an opportunity for companies to establish risk management practices that "fit" with their business requirements, management processes and culture, especially when there is uncertainty regarding an organization's current practices and/or capabilities, or identified gaps. This should result in improvements that leverage the organization's current strengths, align with best-in-class ERM practices in other organizations, and provide a competitive advantage in the ability to manage risk.

3.0 Aon's Response

Successful companies have processes and staff to manage their most significant known risks; however, risks are often managed in silos, resulting in lack of continuity across the organization and a tendency to manage risks independently within each functional area and business unit.

Companies that adopt an enterprise view of risk often do so because this offers value through better awareness and control of risks, improved resource efficiency, and enhanced ability to take additional business risk.

Companies that have implemented successful ERM frameworks often achieve improved consistency in risk management practices and better response to escalating corporate governance requirements, regulatory pressure, capital availability and cost, capital deployment, and market pressure through improved understanding of risk and mitigation options.

Aon's experience indicates that there are seven attributes of an effective ERM framework that can be implemented in stages to advance an organization toward more effective risk management:

- Established goals and oversight structure
- An understanding of existing risk management processes
- Effective risk identification and prioritization
- A disciplined approach to quantifying the most significant risks
- An effective approach to identifying and evaluating risk response solutions
- Successful implementation of risk response solutions
- Appropriate risk governance, culture and disclosure

Aon's global ERM clients represent a range of industries including energy, manufacturing, agriculture, financial services, entertainment, consumer products, and chemicals and pharmaceuticals. Aon's ERM consulting team helps our clients achieve maximum value from their ERM investment through a disciplined and

efficient approach to design, implementation and ongoing management of ERM frameworks. Typical benefits include:

- Increased senior management awareness of critical risks, potential impact on financial performance and organizational health, and risk response options
- Improved predictability of financial performance through better risk taking, forecasting and reporting
- Improved real-time understanding of balance sheet risks
- Enhanced strategic planning and business planning processes
- Improved corporate governance, including increased transparency about risk for internal and external stakeholders (board of directors, investors, creditors, regulators and rating agencies)
- Better allocation of resources and increased operational efficiency including risk-based decision processes
- More efficient risk management decisions, including whether to transfer, mitigate or avoid a particular risk, and improved understanding of the impact on company reputation

4.0 Aon's ERM Consulting Practice

At Aon, our objective is to efficiently partner with our clients to create and enhance the capabilities necessary for the company to manage risk on an ongoing basis. Aon's practical methodology enables clients to use ERM to drive value-based decisions regarding alternative risk strategies. Our ERM consulting practice helps clients achieve the maximum benefit from ERM frameworks from design through implementation and maturity.

To achieve success with our clients, Aon has developed a comprehensive and proven approach to help clients create and deploy a successful ERM framework. Aon works closely with our clients – both public and private – to leverage existing risk management capabilities and develop customized strategies for integrating those capabilities into a sustainable ERM approach. Our consulting team believes in a practical approach to ERM implementation that leverages existing organizational strengths, utilizes organizational resources appropriately, and fits within an organization's culture.

Although S&P's ERM reviews bring additional attention to risk management practices and overall risk governance, a successful ERM framework creates benefits beyond a successful rating agency review. For example, quantitative analysis of risks provides



the ability to link key risks to specific financial objectives and metrics, enabling improved strategic decision-making. An improved understanding of how risks are identified, managed and reported across the company enhances overall corporate governance, as well as existing business planning and strategic planning processes. ERM brings ongoing benefit to the operations by supporting identification, design and implementation of many types of risk solutions.

At a high-level, we engage with clients in the following areas:

Setting Goals and Determining Oversight Structure

In our experience, ERM frameworks will not be successful without senior management support, and our clients often create a senior management panel (or formal ERM Committee) to guide this work. Aon works with our clients to determine their risk management goals and optimal enterprise-wide risk governance approach. Aon conducts an assessment of each client's needs to help develop framework objectives and oversight structure to ensure that our clients invest in what is right for their businesses.

Evaluate Risk Process

Although client companies may not have a formal ERM framework, nearly all have a variety of existing risk management processes that provide a strong basis for good ERM practices. Aon will work with clients to conduct a current-state assessment of existing ERM capabilities and/or risk management functions. We use structured interviews, documentation reviews and knowledge of best practices to develop an ERM maturity scorecard across several dimensions.

Risk Identification and Prioritization

Risk assessment is a critical component of a successful ERM framework. Aon helps clients identify and prioritize key risks to the enterprise by working with risk experts and senior management at the business unit, operating company and enterprise levels. The resulting risk profile and prioritization of key risks supports development of risk mitigation options and determination of areas in which further analysis is needed.

Risk Quantification

Aon uses advanced risk analysis techniques to provide quantitative assessments of the potential impact of selected key risks. Depending on the type of risk, the amount and quality of data and the criticality of the risk, this analysis can take various forms ranging from high-level to detailed analyses and modeling. Results from these models are integrated with the company's risk where more or less risk may be desired. Risk modeling ultimately provides the organization with a risk vs. reward framework for evaluating risk mitigation strategies.

Risk Response Solutions

Using information developed throughout the ERM process, Aon works with clients to develop and assess alternative risk mitigation strategies. This includes evaluation of risk-reward tradeoffs for the alternative strategies (in comparison to existing risk processes and mitigation strategies), which facilitates management decision-making regarding the best use of risk management capital to manage risk and increase enterprise value.

Risk Management Implementation

Aon's risk experts help clients design and implement a wide range of risk management solutions, including:

- **Asset management** – including supply chain management, asset protection, business continuity planning, safety management, and risk control practices
- **Liability management** – including claims organization design, claims strategy, risk financing solutions including insurance/reinsurance and capital market solutions, merger and acquisition support, and captives and risk retention groups
- **Governance** – including risk management strategy and operations, risk governance control process, internal and external reporting, risk scorecards and performance metrics, and links to financial reporting and disclosure processes
- **Human Capital** – including human resource strategies, performance management, training and development, organizational design, risk management staffing and outsourcing
- **Data Management** – including risk management data and systems, acquisition of data from inside and outside the company, data and system controls, and reporting tools and processes

Governance, Culture and Disclosure

Aon's ERM experts work with management teams to improve risk governance practices. This involves a review of risk management practices, identification of strengths and development of a forward-looking risk management strategy. Deliverables may include recommendations addressing risk management process, tools, capabilities and resources focused on practical risk management improvements. Aon also helps identify and map existing risk ownership, determine gaps in ownership and develop governance solutions to close these gaps. Aon's approach also depends on a collaborative dialogue with our clients to determine the appropriate needs of the business in order to design effective communication processes and tools.

5.0 Case Studies

The following brief case studies are provided to demonstrate the breadth and depth of Aon's experience in helping clients develop and sustain advanced ERM frameworks, and communicate the results both internally and externally.

Designing a customized ERM framework integrated into existing governance processes

A rapidly growing gas processor wanted to evaluate its existing risk management capabilities and implement a sustainable ERM approach that leveraged the organization's strengths and closed identified gaps. Aon assessed existing risk management activities and decision processes by reviewing various operating, strategic and financial documents and interviewing management representatives. Existing practices were assessed against risk management standards and ERM best practices using Aon's proprietary ERM Evaluation Scorecards. Aon leveraged the Evaluation Scorecard results to design a customized, multi-year ERM implementation strategy that is fully integrated with existing and accepted governance structures, management routines and decision processes.

Using an ERM framework to realize untapped resources and opportunities

Aon conducted an ERM study for a global petroleum conglomerate. The project was focused on systematic identification and assessment of risk, and integration of risk management into the client's executive level decision-making process. Aon developed and documented the risk profile, prepared quantitative analysis of the most critical risks utilizing key performance indicators, helped its client improve the financial planning and budget process and produced a financial forecast showing a significant improvement in operating profit (\$400 million) based on this enhanced risk information. Through this project, Aon helped increase understanding of correlations in macroeconomic and risk forecasts, resulting in higher profitability than had previously been forecasted -- thereby freeing capital for additional internal and external investment opportunities.

Risk quantification and decision support framework tied to strategic planning

Aon helped a large manufacturing client develop advanced risk quantification models for key operational risks. This included a framework to update the models as business conditions change and new information develops. Aon consistently translated internal information from subject matter risk experts into a reliable quantitative framework. The project concluded with the development of metrics to quantify the financial impact of key risks on enterprise value, and linkage of this information to the strategic planning process.

Enhanced transparency with external stakeholders

Aon helped its financial industry client improve external disclosures about risk, including improved communications with rating agencies and equity analysts. This included analysis of prior risk disclosures and rating agency presentations, comparison with improved risk information and development of new risk reporting and communication tools. The resulting material helped the senior management team conduct strategic risk management reviews with the board and external stakeholders.

6.0 Aon's Commitment

Aon is fully committed to providing clients with a practical, quantitative approach for optimizing risk performance and the ability to execute a wide range of risk solutions. We help clients improve financial performance through a full range of ERM services that will be tailored to fit each client's specific requirements.

With more than 2,000 risk consulting experts in 90 locations, Aon has the resources, processes and technologies to deliver an end-to-end solution including world-class quantitative analysis, ERM consultants, and risk technology expertise.

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