STANDARD & POOR'S RATINGS SERVICES

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How We Use Management And Governance Credit Factors

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*(**Editor's Note:** To form its ratings opinions, Standard & Poor's reviews a broad range of financial and business attributes that may influence the issuer's prompt repayment. The specific risk factors that are analyzed depend in part on the type of issuer. For example, the credit analysis of a corporate issuer typically considers many financial and non-financial factors, including key performance indicators, economic, regulatory, and geopolitical influences, management and corporate governance attributes, and competitive position. For more information, see our "Guide To Credit Rating Essentials," published Aug. 12, 2010.)*

Following the publication of "Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers," Standard & Poor's Ratings Services is providing some additional color on how we evaluate and analyze management and governance attributes in our ratings process. This article is not intended to be a substitute for the criteria--rather it assumes familiarity with them. The criteria apply to both corporate and insurance entities, but for the sake of simplicity, we discuss management and governance in the context of corporate enterprises.

In essence, the assessment of management and governance credit factors supplements the everyday metrics of traditional credit analysis such as cash flow, leverage, and EBITDA interest coverage ratios, by providing a way to analytically document our understanding of the capabilities, intentions, and tendencies of executive management and boards of directors. In our experience, this exercise enhances the quality of our evaluations of creditworthiness. The analysis of management and governance is a part of Standard & Poor's Corporate Ratings general criteria, having been developed to be applicable across a broad swath of the credit ratings spectrum and provide greater transparency and specificity on how management and governance attributes are evaluated and scored in the credit rating process.

Corporate Entities Business And Financial Risk: An Outline

A corporate credit rating is the combination of two opinions: one on the business risk profile of a corporate enterprise and the other on its financial risk profile (see "Business Risk/Financial Risk Matrix Expanded," published Sept. 18, 2012). In Standard & Poor's corporate criteria framework, management and governance attributes generally affect the business risk profile of a corporate enterprise.

Table 1

Standard & Poor's Corporate Ratings Methodology: Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	**Minimal**	**Modest**	**Intermediate**	**Significant**	**Aggressive**	**Highly Leveraged**
Excellent	AAA/AA+	AA	A	A-	BBB	--
Strong	AA	A	A-	BBB	BB	BB-
Satisfactory	A-	BBB+	BBB	BB+	BB-	B+
Fair	--	BBB-	BB+	BB	BB-	B
Weak	--	--	BB	BB-	B+	B-
Vulnerable	--	--	--	B+	B	B- or below

Business risk, shown on the left side of table 1, looks to the company's ability to generate future cash flows and is scored from "excellent" down to "vulnerable". Financial risk, which runs along the top of table 1, considers how the company is funded to achieve those cash flows. The financial risk profile is scored from "minimal" (which is best) down to "highly leveraged". A business risk score of "satisfactory" and a financial risk score of "aggressive" would lead to an indicated rating of 'BB-'. The ratings indicated in each cell of the matrix are the midpoints of a range of likely rating possibilities. This range would ordinarily span one notch above and below the indicated rating.

The four elements of the business risk profile assessment--country risk, industry risk, competitive position, and profitability and peer group comparisons--provide an outline of the analytical environment for the evaluation of management and governance.

Country risk covers the specific economic or country risks that may affect the entity's creditworthiness. Such economic or country risk pertains to the impact of government policies on the obligor's business and financial environment, and a company's ability to insulate itself from these risks. Industry risk covers a wide spectrum. It starts with a review of the business environment for the sector, the prospects for growth and stability, the pattern of observed business cycles, the vulnerability to changes in technology, and changes in the balance between supply and demand. Competitive position focuses on the sustainability of competitive advantage, which is often determined by cost leadership or product differentiation. Our evaluation looks at a company's product positioning and brand reputation, market shares, the installed customer base, geographic coverage, distribution capabilities, customer relationships, technology/manufacturing capabilities, and meaningful barriers to entry. Profitability and peer group comparisons reflect the fact that the credit ratings process is also a comparative exercise and would typically include the operating margins of an enterprise relative to its peers, along with its return on capital and its ability to generate cash flows and attract external sources of capital, particularly in periods of adversity (see also "2008 Corporate Criteria: Analytical Methodology," published April 15, 2008).

This analysis brings out something very important about the credit rating process. Although each of the business risk profile elements is analyzed and scored separately, no single element is considered in isolation or provides the sole determinant for a credit rating. We view these elements collectively and combine them into an overall business risk score for a corporate enterprise.

The Management And Governance Score Modifies The Business Risk Profile

The management and governance credit factors are amalgamated into an overall score, which is among the modifiers of an enterprise's business risk profile score. Modifiers in ratings methodology enhance the analytical process by allowing rating committees (which are our rating decision-making bodies comprising groups of analysts) to isolate initial ratings characteristics, such as competitive position and cash flow/leverage, and then use other characteristics to modify the committee's opinion on overall creditworthiness. In this way, the management and governance score can modify our initial view of overall creditworthiness. Modification by one or more rating notches, accompanied by an explanation for that modification, captures connections within our analysis between a company's management and governance and its other strengths and weaknesses within its business risk profile. Through this process, Standard & Poor's makes comparable judgments across a wide spectrum of management and governance structures--a necessity for a global ratings organization, which must take into account significant differences in legal, cultural, and reporting conventions for issuers worldwide.

Separating out and distinguishing between management and governance credit factors--but also considering them together--reflects the fact that management and the board have joint, but distinct, responsibilities for setting strategic direction, establishing and maintaining a competitive position for the enterprise, ensuring the timely development of products or services to retain business momentum, and navigating the risks that invariably accompany entrepreneurial activity. As noted, we view the assessment of those navigational skills, through analysis of the management and governance credit factors, as integral to generating an opinion on the future credit strength of an enterprise. Corporate performance has and will continue, on occasion, to vary significantly from the inferences that we can draw solely from an examination of the financial metrics of a corporate enterprise. These criteria help us to gain further insight into the credibility of the leaders of an enterprise, capture relevant risks associated with the management and governance of a rated issuer, and evaluate their significance for the rating in the context of the general credit profile of the enterprise.

Overall, these criteria recognize that exceptional management can improve a firm's business risk and that translates into better credit strength over the long term and, conversely, that poor management can lead to weaker debt servicing capabilities. Governance is different. Defective governance attributes are closely linked to credit weakness, but strong governance practices do not translate into a credit enhancement. Nevertheless, governance is not a secondary factor in these criteria, given that neutral scores for all of the governance subfactors are the prerequisite for a "strong" or "satisfactory" overall business risk score.

Questions Raised During The Comment Period

We received feedback on our request for comment, which we published on March 12, 2012 (see "Request For Comment: Management And Governance Credit Factors"). We would like to express our gratitude to all who communicated with us. The number and the quality of the comments we received have resulted in what we believe to be significant improvements to the criteria. We address some of the more frequently raised questions below.

Why does Standard & Poor's organize the management and governance subfactors this way?

This organization reflects a change we have made to the methodology of our ratings process, which separately evaluated governance from management. In our opinion, the reorganization better reflects the reality that management is answerable to an enterprise's board of directors (or functional equivalent) and makes clear that identified deficiencies in management's strategic positioning, risk management, and organizational effectiveness are primary responsibilities of the board. Our application of governance analysis in these criteria represents an adjustment on the assessment of the management subfactors. In this way, the governance evaluation serves as a constraint on the management evaluation.

Why does management and governance affect business risk but not financial risk?

We carve out management decisions that directly affect financial risk of the enterprise and deal with that in separate criteria on financial policy. In our view, that addresses the influence that management will exert on an issuer's financial risk profile beyond what is implied by recent credit metrics or what has already been built in cash flow and leverage forecasts.

What does Standard & Poor's mean by saying that the criteria are 'evidence based'?

Scoring management and governance credit factors presupposes qualitative standards for these attributes, which we outline in terms of "positive", "neutral", or "negative" evaluations for the management subfactors and "neutral" or "negative" evaluations for the governance subfactors. An enterprise receives a "neutral" score for any management or governance subfactor for which there is insufficient evidence to assign either a "positive" or "negative" score. Some respondents to our request for comment expressed concern that an enterprise with mediocre management and governance might find itself through non-disclosure at no disadvantage to an enterprise with demonstrably better management and governance characteristics. However, the criteria do allow for a negative evaluation if an enterprise fails to disclose key management and governance information (see paragraph 13 of the criteria). So 'keeping mum' will not necessarily result in a neutral score with these subfactors if, in our opinion and based on peer group comparisons, that information should be available and is capable of being disclosed. There is also another and perhaps less obvious feature about how these criteria have been constructed: a "strong" evaluation of management and governance will require evidence of positive management capabilities and a "weak" evaluation requires evidence of deficient or negative management and governance attributes.

Why should a company get a positive score just for having a strategic plan?

We believe that firms with well-reasoned, well-resourced, and well-executed business plans are more likely to achieve a long-term competitive advantage that underpins sustainable credit strength--and that starts with having a plan in first place. Even a company that is scored "positive" on its strategic planning process may not achieve similar scores on the consistency of its strategy with capabilities and conditions, and on its ability to track, adjust, and control strategic execution. In any event, in order to receive an overall score of "strong" on management and governance, a company needs positive scores in at least five of the eight management factors, so even top marks on all aspects of strategy is not enough to gain an overall score of "strong".

Governance comprises a large subject matter--why only seven subfactors?

Governance analysis is taking place in the context of providing a credit rating: it is not a stand-alone subject matter for us. We have identified those aspects of governance that have and will continue to affect credit ratings and outlooks. "Board effectiveness", "entrepreneurial or controlling ownership", and "management culture" are probably on everyone's list of governance hot topics. Others, such as "regulatory, tax, or legal infractions", "communication of messages", "internal controls", and "financial reporting and transparency" can be leading indicators of governance deficiencies. These factors address key attributes of creditworthiness, for example, the reputational risk of such infractions; and investor confidence when issuers communicate inconsistent messages to the marketplace or face the possibility of restatements with a poor internal control environment or shoddy financial reporting.

Management can have a positive evaluation. Why not governance?

The primary reason is that governance does not, in and of itself, constitute credit enhancement for Standard & Poor's credit ratings, as stated in the criteria. There is also another significant reason that comes from our review of governance literature and our own experience in assessing the more than 3,000 corporate enterprises we rate. Precisely determining what actually constitutes positive, strong (or good) governance has proven to be elusive even for the most experienced and seasoned thinkers on the subject. Consequently, we are not currently in a position to offer market participants a credible and comparable way to identify, assess, and compare governance attributes that could provide credit enhancement. However, it is our opinion, and our experience, that governance deficiencies at rated enterprises can, and on occasion have led to both sudden and sharp deterioration in credit quality and that is why we have "neutral" and "negative" options for the governance subfactors.

How will the management and governance score affect existing credit ratings?

Although these criteria are new, the concepts have been--for many years and to varying extents--included in our analyses of business risk. The rating committee for each company will now evaluate to what degree the new management and governance evaluation is already "baked in" to the current rating through previous management or governance assessments and previous business risk scores. Nonetheless, the new criteria provide a way to more transparently identify the role played by management and governance in our analyses. All else being equal, a "weak" management and governance score would typically result in a lower rating (because of weaker business risk) than if the company had a "fair" score, although it could be a much greater adjustment depending on the severity of the deficiency or deficiencies. Similarly, through the business risk profile assessment, a "strong" score could result in a higher rating among otherwise like companies. Management and governance scores of "satisfactory" or "fair" would typically not reflect a differentiation in business risk profiles.

What about ESG? Why were social and environmental factors not considered originally?

We received significant feedback about the role of environmental, social, and governance (ESG) factors as a source of material risk to corporate financial performance. We were reminded that matters like climate change and employee relations are no less risks to an enterprise than, for example, deficiencies in management expertise or board effectiveness. We found this feedback persuasive--and all the more so in the context of initiatives that Standard & Poor's has undertaken, for example, to promote global consistency and analytic rigor on matters like climate change, clean energy, and the impact of regulations restricting the emission of greenhouse gases. Consequently, under the comprehensiveness of risk management standards and tolerances subfactor we have added specific reference to the management of environmental and social risks. Since these criteria have been designed to facilitate a collective view of management and governance, placing the evaluation of environmental and social risk with the management subfactors permits a "positive", "neutral", or "negative" evaluation of the management of these risks.

What became of Standard & Poor's initiative on enterprise risk management (ERM)?

Work we have been doing since 2006 in applying the analysis of enterprise risk management capabilities to nonfinancial companies has been incorporated into these management and governance criteria. Although primarily found under the heading "comprehensiveness of enterprise-wide risk management standards and tolerances", elements of ERM are extant throughout. We had decided not to publish scores on companies' ERM capabilities in part because we felt it could be taken out of context. These criteria on management and governance credit factors provide that context, leaving us to conclude that an overall score on management and governance is a more appropriate fit with our credit analysis process.

Related Criteria And Research

- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008