NCSU
Steve Dreyer Interview Segment 1
The Future of ERM

Interviewer: Bonnie Hancock, Executive Director, NC State's ERM Initiative
Interviewee: Steve Dreyer, Managing Director, S&P

Hancock: Hello. I am Bonnie Hancock, Executive Director of North Carolina State University's ERM Initiative in the Poole College of Management. I am here today again with Steve Dreyer who is Managing Director at Standard & Poor's. He has been leading the ERM review process there. Thanks for joining me, Steve.

The first question I'd like to ask is a little bit of future thinking - Where do you see ERM going in the next five to ten years, or maybe couple of decades, is it going to evolve for a while? And then how do you see Standard & Poor's going about its review of ERM in the companies that it rates?

Dreyer: Well, one of the lessons that I've learned in the past three or four years we've been doing ERM reviews in non-financial companies is that my expectations are way too aggressive in terms of how quickly companies adapt to something like this and how quickly we, as analysts, adapt to asking questions that are different and picking up on the signals and messages we're getting from companies in a new area. You know, we're used to talking to companies about financial stuff and talking about coverage and leverage and cash flow and their debt structure and so forth.

So we do ask about management. We can talk about governance issues, operational management. But in some ways, ERM is somewhat of a new direction for us, as it is for the companies that we rate. So if I had—if I could rewind and forecast, you know, what is the evolution, what is the uptake, the embryonic period here that ERM will have to endure to really get to be mainstream, I'd probably talk in terms of decades instead of years. Not too many decades, but maybe a couple, I think, before it's really invisible to everyone. And I think that's ultimately where I see it going.

We've acknowledged that in our own rating process, we first started looking at ERM as a component of a financial analysis. We put it in a little box, and we looked at it alongside the traditional areas of our analysis—liquidity, capital structure, the business position, competitive position of the company and so forth. We're—we're abandoning that approach and integrating it more with the rest of our analysis because it really shows up everywhere.

So one thing that people will see us doing over the next few months is introducing a distinct management score on companies that we rate; it's not something we've asked our analysts to do previously. We've asked analysts to—to look at various aspects of a company, to interview management, and analysts have opinions about managements of the company. They're either aggressive or their—you know, they're open or they're not open, or they're more forward looking or less forward looking, or, you know, various kind of behaviors that they would observe.

But there really hasn't been any—in our process, any destination for that—those learnings that we have after, in many cases, knowing these companies for decades, meeting with them on a regular basis for years and years on end. So what we're doing is kind of bubbling all that information up, taking what we've introduced with ERM, adding to it some of the existing tools that we have for looking at—let's say, the use of derivatives for companies that have come out of the exposure, accounting reviews that we do on companies, aggressiveness of accounting choices that they make, a governance review that we've had in place for about ten years now. Bringing all that together into an overall score on management, we think, will be somewhat controversial, because it's highly subjective compared to the other things that we look at in a rating.

But I'm hopeful that it will help us and the people who use our ratings better understand the importance of the people who run the organization and the decisions—not just the decisions they've made historically, but their likelihood of the decisions that they're going to make, going forward. What—what is—that's really, in the end, what a rating is. It's a prediction, a prediction of a company's likelihood of repaying its debt. And it's going to be more likely to its debt if it makes the right decisions, the right decisions from the bondholder perspective, early on.

And we have to pick up on those decisions. If we want until the consequences of those good or bad decisions play out, it's—we're not doing any favors for anyone. I mean, our—our objective is to be more prospective.

So whether it be as a rating agency looking at companies or companies managing themselves, I think when the characteristics that we all talk about with regard to ERM—when that becomes second nature and really, not just integrated across the organization, but integrated across the behaviors that everyone has from day to day, then I think we'll have reached, you know, the goal of all of this. But I'm not even going to pretend to tell you when that's going to happen, because I've been disappointed, so far, frankly, in how difficult it has been to sort of—even the very basic benefits of ERM to be understood and valued by management of companies by—and more importantly, by the owners of those organizations, who you would think would be holding management to a very high standard. And sadly, that's not the case in most cases.

Most of the time, executives are put in place by a board, and they're put in place because we like these people and we think highly of them, and we're pretty much going to leave them alone, because if we tinker as a board, if we tinker, then obviously that criticizes our initial decisions. We must have made a bad decision. I'm not saying these are outward conversations, but I think that's kind of the psychology of what happens.

So, you know, maybe ERM is—along with a lot of other influences, maybe even regulation in some cases—will increase accountability for senior managers, and for boards representing the owners of the organization. And I think that that's all to the good.

Hancock: Do you think there's some chance that ERM will just fall away? That it will just be this fad that goes away or do you really think it'll just evolve very, very slowly until it is really fully adopted?

Dreyer: I think the principles behind ERM will evolve slowly, and they'll catch on, but the—the term "ERM" may not survive. It's—like any other brand name, it's sort of tied up in a lot of different emotions and feelings for a lot of different people. And I think when we first started using the term we had some trepidation about it, because it tended to be a favorite of all the consultants. And so we feared—and our fears were realized—that we would get sort of swept up in the kind of salesmanship of ERM. In retrospect, maybe we should have just called it "strategic risk management" or something like that, or "organizational risk management." It would have probably put us in a better place in terms of communicating what it is that we're after.

Having said that, there are some very positive trends going along here. I think one of them is the whole technology side of things. I think data availability to help senior manages make better decisions is there. I think, specifically, in the areas of ERM, of going out and collecting information on risks and monitoring those risks and sorting through the myriad sort of layers of organization and layers of types of risks, I'm very hopeful that those tools will continue to mature and put ERM capabilities into the hands of companies that may previously have thought themselves too small or too simplified to really get much benefit from it.

So I think—I think there are some positive trends. And the hype aspect of ERM, if only because of, you know, the 24-hour news cycle—or maybe, in this case, it's the 24-month news cycle—eventually, you know, you have to have something there. If it's only hype, it will go away and deserves to go away. But I don't think that's what's going to happen here. I think the concepts will survive. The term, the brand name "ERM," you know, could perhaps not survive. But whatever takes its place, I think, will—you know, will continue to grow in prominence.

Hancock: Thank you, Steve, for being here and for sharing those thoughts with us. For our audience, I'd like you to be aware of that our ERM Initiative website has a number resources related to how Standard & Poor's uses their ERM review as part of their ratings process. There's a searchable link to help you locate resources you may need. So again I would encourage you to take advantage of our website.