STANDARD & POOR'S RATINGS SERVICES

RatingsDirect®

General Criteria:

Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers

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General Criteria:

Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers

1. Standard & Poor's Ratings Services is updating its criteria for evaluating enterprises' management and governance. These criteria update and partially supersede the article "2008 Corporate Criteria: Analytical Methodology," published April 15, 2008, and supersede the article "Management And Corporate Strategy Of Insurers: Methodology And Assumptions," published Jan. 20, 2011.

2. This article is related to "Principles Of Credit Ratings," published on Feb. 16, 2011.

SUMMARY

3. Standard & Poor's is updating its criteria for evaluating management and governance, which is a component of our assessment of an enterprise's creditworthiness.

4. The term "management and governance" encompasses the broad range of oversight and direction conducted by an enterprise's owners, board representatives, executives, and functional managers. Their strategic competence, operational effectiveness, and ability to manage risks shape an enterprise's competitiveness in the marketplace and credit profile. If an enterprise has the ability to manage important strategic and operating risks, then its management plays a positive role in determining its operational success. Alternatively, weak management with a flawed operating strategy or an inability to execute its business plan effectively is likely to substantially weaken an enterprise's credit profile.

5. The analysis of management and governance is one of the most qualitative aspects of our rating methodology. These criteria bring enhanced transparency to our ratings by articulating how we score this category of analysis. This qualitative analysis typifies characteristics and elements of management and governance that are most pertinent to credit analysis.

SCOPE OF THE CRITERIA

6. These criteria apply to corporate ratings and insurance ratings.

IMPACT ON OUTSTANDING RATINGS

7. We do not expect any significant rating changes as a result of the implementation of these criteria because they bring enhanced transparency rather than substantive change to our evaluation of management and governance.

EFFECTIVE DATE AND TRANSITION

8. The criteria are effective immediately. We expect to update our ratings over a period of up to six months.

METHODOLOGY

The Components Of Management Analysis And Related Metrics

9. The analysis of management and governance includes a review of the following:

- Management, which includes
- Strategic positioning,
- Risk management/financial management, and
- Organizational effectiveness; and
- Governance.

10. The first step, the assessment of management, can either positively or negatively influence the overall management and governance score, or can have no net positive or negative effect. The assessment of governance can be either neutral or can negatively influence the overall management and governance score. It cannot positively influence the score because it does not, in and of itself, provide enhancement to creditworthiness. However, a governance deficiency or deficiencies are often identifiable and the impact on an enterprise's creditworthiness is directly assessable.

11. To arrive at the overall management and governance score under the criteria, we first apply metrics for evaluating subfactors within the management components on which an enterprise is scored as positive, neutral, or negative for each. The enterprise's overall score for management and governance is based on a collective review of these outcomes, adjusted by our assessment of the governance subfactors.

Determining The Management And Governance Score

12. Management and governance is scored as (1) strong, (2) satisfactory, (3) fair, or (4) weak for the evaluation of corporate and insurance enterprises. These scores are determined by aggregating the assessments of the appropriate subfactors for management and then applying the seven subfactors for governance. Each analytic practice uses the management subfactors that are relevant to it: Appendix 1 describes the scoring methodology and the relevant subfactors for corporate enterprises; Appendix 2 describes the scoring methodology and the relevant subfactors for insurance enterprises. Table 1 explains the scoring for each of the subfactors for management, under the headings of strategic positioning, risk management/financial management, and organizational effectiveness. Table 2 explains the scoring for each of the subfactors for governance.

13. Analysis of management and governance is evidence-based. 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. However, some subfactors may receive a negative score if an enterprise fails to disclose key management and governance information.

14. From time to time enterprises may change their strategic direction, risk appetite, execution capabilities, governance, senior management, and/or board membership. This may be due to shareholder/stakeholder initiatives, regulatory pressure, or changes in priorities at the management or board level. Such changes necessarily require the reevaluation of all relevant subfactor scores. Evidence of these changes would be reflected in the relevant subfactor score(s).

Table 1

Summary Of Scoring Rules For Management Subfactors

	Positive	Neutral	Negative
Subfactors used to evaluate strategic positioning			
1. Strategic planning process (see paragraphs 16-17)	Evidence of strategic plans that contain specific financial and operational goals with clear measures of achievement.	Evidence of strategic plans, but aspects lack depth or specific financial/operational goals; achievement measures unclear.	Very limited evidence that strategic plans exist, or plans are superficial.
2. Consistency of strategy with organizational capabilities and marketplace conditions (see paragraphs 18-20)	Strategy nearly always consistent with enterprise's capabilities, taking into account marketplace conditions. A track record of market leadership and effective innovation.	Strategy generally consistent with enterprise's capabilities, taking into account marketplace conditions.	Strategy inconsistent with enterprise's capabilities or marketplace conditions. Abrupt or frequent changes in strategy, acquisitions, divestitures, or restructurings.
3. Ability to track, adjust, and control execution of strategy (see paragraphs 21-22)	Management has been able to convert nearly all strategic decisions into constructive action; has a track record of achieving financial/operational goals; successful relative to peers.	Management has been able to convert most strategic decisions into constructive action; has a track record of achieving most financial/operational goals.	Management often unable to convert strategic decisions into constructive action; often fails to achieve its financial/operational goals.
Subfactors used to evaluate risk management/financial management			
4. Comprehensiveness of enterprise-wide risk management standards and tolerances (applies to corporate enterprises only; see paragraphs 27-28)	Management has successfully instituted comprehensive policies that effectively identify, monitor, select, and mitigate key risks and has articulated tolerances to key stakeholders.	Management has a basic set of standards and tolerances in place, but may not have fully developed risk management capabilities.	Management has no or few defined standards and tolerances and little risk management capability.
5. Comprehensiveness of financial standards (applies to insurance enterprises only; see paragraphs 29-30)	Management has a comprehensive and sophisticated set of financial standards in place.	Management has a basic set of financial standards in place.	Management has no or few defined financial standards.
6. Risk tolerances (applies to insurance enterprises only; see paragraphs 31-32)	Management articulates and maintains conservative risk tolerances.	Management maintains moderately conservative risk tolerances.	Management maintains aggressive risk tolerances.
7. Standards for operational performance (see paragraphs 33-34)	Management has set rigorous and ambitious, but reasonable standards for operational performance.	Management has set standards for operational performance that are achievable and similar to industry norms.	Management lacks wherewithal, discipline, or commitment to achieve set standards, or has low standards.
Subfactors used to evaluate organizational effectiveness			
8. Management's operational effectiveness (see paragraphs 36-37)	Management has a demonstrated history of not incurring unexpected declines in earnings or cash flow emerging from operational risks.	Emergence of unexpected operational risks occasionally affects earnings or cash flow.	Emergence of unexpected operational risks regularly affects earnings or cash flow.

Table 1

Summary Of Scoring Rules For Management Subfactors (cont.)

9. Management's expertise and experience (see paragraphs 38-39)	Management has considerable expertise, experience, and a track record of success in operating all of its major lines of business.	Management has sufficient but unexceptional expertise and experience in operating its major lines of business.	Management lacks the expertise and experience to fully understand and control many of its businesses. The enterprise often deviates significantly from its plans.
10. Management's depth and breadth (see paragraphs 40-41)	Management has good depth and breadth across its major lines of business, and can withstand loss of key personnel without significant disruption to operations or cash flows in each of its significant business units.	Management depth or breadth is limited in some areas. The loss of key personnel would be expected to only temporarily affect the enterprise's operations or cash flows.	The enterprise relies on one or a small number of managers. The loss of key personnel would seriously affect the enterprise's operations.

Table 2

Summary Of Scoring Rules For Governance Subfactors

	Neutral	Negative
1. Board effectiveness (see paragraph 44)	The board maintains sufficient independence from management to provide effective oversight of it. The board retains control as the final decision-making authority with respect to key enterprise risks, compensation, and/or conflicts of interest.	The board manifests a lack of independence from management and provides insufficient oversight and scrutiny of key enterprise risks, compensation, and/or tolerates unmanaged conflicts of interest.
2. Entrepreneurial or controlling ownership (see paragraph 45)	Management and the board of directors have professional, independent members who are capably engaged in risk oversight on behalf of all stakeholders, including minority interests. The influence of controlling shareholders is offset by risk-aware professional management and a board that effectively serves the interests of all stakeholders.	Controlling ownership negatively influences corporate decision-making to promote the interests of the controlling owners above those of other stakeholders.
3. Management culture (see paragraph 46)	Management is responsive to all stakeholders' interests, appropriately balances those interests, and acknowledges that the board of directors is the ultimate decision-making authority.	Management's own interests (or those of a narrow group of stakeholders) are its primary concern, where dissent in the executive suite is generally not tolerated, or where management proves incapable of managing conflicts of interest arising between different stakeholder groups. Excessive management turnover can be an indicator of a governance deficiency in management culture. Alternatively, management dominates the board of directors, as demonstrated by the control exercised by the chair or CEO, or as evidenced by compensation and incentive programs that promote outsize risk-taking.
4. Regulatory, tax, or legal infractions (see paragraph 47)	The enterprise generally remains free of regulatory, tax, or legal infractions and has stable relationships with regulatory authorities.	The enterprise has a history of regulatory, tax, or legal infractions beyond an isolated episode or outside industry norms, representing significant risk to the enterprise.
5. Communication of messages (see paragraph 48)	The enterprise generally communicates consistent messages to all constituencies.	The enterprise communicates conflicting information to different stakeholders on significant issues.
6. Internal controls (see paragraphs 49-50)	The enterprise's internal control environment is not viewed as deficient.	The enterprise's internal control environment is viewed as deficient based on available evidence, such as restatements or delays in filings.
7. Financial reporting and transparency (see paragraphs 51-52)	Accounting choices are usually reflective of the economics of the business.	The enterprise's financial statements obfuscate the true intent or the economic drivers of key transactions, or the financial statements are insufficient to allow typical users of the financial statements to understand the intent and the economic drivers.

Strategic Positioning

15. The analysis of an enterprise's strategic positioning consists of three subfactors: (i) the strategic planning process, (ii) the consistency of the strategy with organizational capabilities and marketplace conditions, and (iii) the management team's ability to track, adjust, and control execution of strategy. The effectiveness of the strategic planning process determines how well an enterprise's financial and operational goals are articulated. In turn, the enterprises that have put in place strategies that are consistent with their capabilities and marketplace realities tend to perform better over time than their peers that have strategies that are inconsistent with their capabilities. Finally, strategies can only be effective if management can monitor and adjust execution to stay aligned with them.

Strategic planning process

16. An effective strategic planning process is critical to developing a formal and well-articulated strategy. This component includes evidence of a strategic planning process, the specificity of the plans, and the comprehensiveness of business units covered. The key indicator of the success of the strategic planning process is the result. A solid planning process ordinarily leads to a written strategic plan that includes projections, specific financial and operational goals, and clear measures for achieving the goals. The frequency and nature of an enterprise's strategic planning sessions provide insights into its strategic planning capabilities.

17. An enterprise receives a positive score for its strategic planning process if there is evidence of a written strategic plan that has specific financial and operational goals for all major business units and contains specific measures for achieving those goals. An enterprise with a positive score typically will have a methodology for producing estimates, forecasts, and projections that is transparent, and it will have well-supported assumptions underlying the plan. An enterprise receives a negative score if it operates without a strategic plan for many of its major business units, or if it develops a superficial strategic plan that lacks specific financial and operational goals for many of its major business units. Enterprises with some evidence of written plans, but which may lack depth, such as a lack of some specific financial and operational goals for their major business units, are scored as neutral. An enterprise also may be scored neutral if the measures for achieving goals are unclear.

Consistency of strategy with organizational capabilities and marketplace conditions

18. When assessing the consistency of an enterprise's strategy with its organizational capabilities and marketplace conditions, we compare management's planning assumptions with those of peer enterprises and with our own forecasts. A track record of abrupt or frequent changes in business strategy or acquisitions, divestitures, or restructurings that are inconsistent with existing strategies or capabilities indicates a higher level of business risk. The criteria are dynamic and allow for evolution of standards, expectations, and availability of information. For example, as financial regulators expand compensation disclosure requirements, the additional insight can help to identify the correlation between actual incentives and stated strategic intent.

19. An enterprise receives a negative score for the consistency of its strategy with its organizational capabilities and marketplace conditions if it has implausible, very aggressive, or overly optimistic strategies and projections that reflect weak internal planning capabilities or an insufficient grasp of challenges (or opportunities). For example, an enterprise receives a negative score if projections for revenue or earnings growth are significantly higher than results in the recent

past or relative to forecasts of peers, unless there are identified factors that support them such as a favorably-viewed acquisition or growth from a new business line. An enterprise with strategies that are generally consistent with its capabilities and that is cognizant of marketplace conditions, but is unlikely to display market leadership or notable innovation typically receives a neutral score. An enterprise receives a positive score if it possesses all of the attributes for a neutral score but also has a track record of market leadership and effective innovation, i.e., being among the first in its sector to respond to changes in market conditions successfully.

20. In addition, an enterprise generally receives a negative score for strategic consistency if it exhibits abrupt or frequent changes in business strategy or acquisitions, divestitures, or restructurings. Well-executed mergers and acquisitions can make strategic sense and benefit enterprises, so an enterprise will not receive a negative score if the acquisition (i) is consistent with the enterprise's capabilities, (ii) is appropriately valued and has potential for profitable growth, and (iii) displays strong prospects for successful integration based on either the enterprise's track record or statements regarding specific measures it will take to achieve a successful integration.

Ability to track, adjust, and control execution of strategy

21. This subfactor is a forward-looking evaluation of an enterprise's ability to track, adjust, and control strategic execution. The focus is on whether its strategy can be converted into constructive actions that lead to successful financial and operational performance. For example, management's ability to communicate its plans to lower management forms a part of the scoring of this subfactor. Looking at how the enterprise implements its strategy, plans, and policies helps to shape a view of management's consistency and credibility, and also helps in assessing performance versus plans. Determining why results meet or fail to meet expectations informs the important distinction between whether results originate from good or bad fortune or reflect management's actions.

22. An enterprise receives a positive score for its ability to convert strategy into constructive actions that lead to successful financial and operational performance. Characteristically, the management team will have a track record of achieving financial and operational goals and will be successful relative to peers. An enterprise that is unable to convert strategy into constructive action will receive a negative score, as evidenced by a track record of not achieving financial and operational goals. The score is also negative if the enterprise has insufficient or ineffective communication of strategic planning with lower levels of management. Management's objective appraisal of business units and disciplined approach to dealing with underperformance (divestiture, restructuring, or discontinuing businesses are among the options in such cases) are favorable factors. Consequently, management's approach toward, and plans for, poorly performing business units or those that no longer fit with the enterprise's strategy are key considerations in our evaluation. An enterprise that does not have a credible strategy for approaching poorly performing units will receive a negative score. An enterprise receives a score of neutral if it has achieved most, but not all, of the major goals that it defined in its strategic planning.

Risk Management/Financial Management

23. Risk management/financial management refers to the management of risk that is not covered elsewhere in criteria applicable for that enterprise type. For corporate enterprises, risk management applies to risks other than financial policy, which is covered by other corporate criteria. For insurance enterprises, it refers to financial management; other

risks are covered by criteria assessing enterprise risk management for insurers.

24. A corporate enterprise's risk management includes the subfactors:

- Comprehensiveness of enterprise-wide risk management standards and tolerances, and
- Standards for operational performance.

Assessing the sophistication and comprehensiveness of an enterprise's risk management is important because of the prospective impact of these policies on its financial profile.

25. An insurer's financial management includes the following subfactors:

- Comprehensiveness of financial standards,
- Risk tolerances, and
- Standards for operational performance.

26. Assessing an insurer's risk tolerance, prudence, and sophistication has always been a critical part of rating decisions. A view of management's philosophies and policies involving financial risk--and the degree of perceived conservatism or aggressiveness of these policies--is important because of the prospective impact of these policies on the firm's financial profile. Our review of an insurer's financial management evaluates management's policies and controls as evidenced by their impact on:

- Financial risk appetite,
- Capital structure,
- Liquidity policies,
- Investment policies,
- Derivatives usage, and
- Hedging practices and the use of other risk mitigants.

This evaluation of policies and controls is separate from our review of the risk exposures themselves, which form part of the financial risk profile.

Comprehensiveness of risk management standards and tolerances (applies to corporate enterprises only)

27. Corporate enterprises with a deliberate, consistent, articulated, resourced, and integrated approach that effectively identifies, selects, and prudently mitigates risks are more likely to build long-term credit strength as compared to enterprises with a casual, opportunistic, or reactive approach. Business managers demonstrate proficiency by institutionalizing comprehensive policies that recognize the complex interdependencies of the risks their businesses face, the trade-off between risk and reward, and the interplay between business and financial risk. The management of environmental and social risk is included under this subfactor. Questions to explore include:

- Does the enterprise regularly identify and assess the impact of critical strategic risks?
- Has the enterprise determined limits for acceptable levels of risk, and if so, how are they enforced?
- Does the enterprise hold accountable specific individuals for oversight of the most critical risks the enterprise faces, and if so, what are the rewards (consequences) for success (failure)?
- Does the enterprise employ an effective risk-based approach to strategic decisions?
- Has the enterprise effectively communicated to employees, owners, and other key stakeholders its tolerance for risk and commensurate expectations for earnings volatility?

28. This subfactor addresses the comprehensiveness of corporate risk management standards and tolerances as opposed to the degree of aggressiveness or conservatism of those standards and risk tolerances. A corporate enterprise that has comprehensive and sophisticated standards and tolerances receives a positive score if it has successfully institutionalized comprehensive policies that effectively identify, monitor, select, and mitigate key risks and has articulated tolerances to key stakeholders. Corporate entities that have no or few defined standards and risk tolerances receive negative scores. The score is neutral if an enterprise has basic standards and risk tolerances, or standards and risk tolerances that are not comprehensive across most significant business lines. Such an enterprise may not have fully developed risk management capabilities.

Comprehensiveness of financial standards (applies to insurance enterprises only)

29. Some insurers have not given serious thought to the balance between the risks that they take and their financial resources to absorb adverse outcomes of those risks. Others have reached firm conclusions about the matter. This limits the comprehensiveness of management's financial standards. For many insurers, a simplistic standard--such as a debt service coverage ratio or a leverage ratio, in either case based on reported figures with no adjustment--is the only focal point of such policy considerations. By contrast, more sophisticated managements have thoughtful and more comprehensive policies that recognize the complex interdependencies of the risks their insurance enterprises face, the trade-off between risk and reward, and the interplay between business and financial risk. Questions regarding this issue include:

- Has the insurer determined standards or limits for key financial metrics, such as leverage ratios, required capital levels, profit targets, and liquidity?
- Are these guidelines detailed or general?
- Do the guidelines apply to many areas of the operation or just a few?

30. This subfactor addresses our analysis of the comprehensiveness of an insurer's financial standards as opposed to the degree of aggressiveness or conservatism of those standards. An insurer that has both comprehensive and sophisticated financial standards receives a positive score. Such an insurer has predetermined limits for all significant risks and detailed guidelines for effective operational management of the business. Insurers that have no or few defined financial standards receive negative scores. The score is neutral if an insurer has basic standards, or standards that are not comprehensive across most significant business lines.

Risk tolerances (applies to insurance enterprises only)

31. An insurer's management's risk tolerances are compared to Standard & Poor's published criteria to assess the aggressiveness or conservatism of a company's financial policies. (See the articles in the "Related Criteria And Research" section for additional information on the benchmarks used for ratings analyses.) Specific practices--such as risk tolerances for macroeconomic stress and catastrophic risk--can be telling about management's financial risk tolerance. Other indicators of risk tolerance include levels of leverage, debt service coverage, investment risk, liquidity, asset-liability mismatches, and over/under utilization of hedging. The risk tolerance evaluation addresses:

- What are management's specific financial risk limits?
- What are the amounts and types of capital in the capital structure and what is the level of leverage employed?
- What is the amount and quality of liquidity available relative to the firm's needs in periods of stress?
- What are the quality and allocation of invested assets and measures of capital adequacy?

32. Responses to these questions help to reveal how conservative or aggressive management is. An insurance enterprise receives a positive score for risk tolerance if it articulates and maintains conservative risk tolerances. An insurance enterprise receives a neutral score if it articulates and maintains moderately conservative risk tolerances or has some specific risk tolerances that could impair its financial performance during a period of moderate stress. An insurance enterprise may also receive a neutral score if it maintains some risk tolerances that are aggressive, but they are mitigated by other factors so as not to be harmful to the insurance enterprise's overall risk profile. An insurance enterprise that maintains aggressive risk tolerances or that has few defined risk tolerances receives a negative score.

Standards for operational performance

33. An enterprise's financial goals for operational performance are distinct from its strategic goals. Even enterprises that set financial goals, such as for earnings and sales, might not have the wherewithal, discipline, or management commitment to achieve the objectives they have set. These goals should be viewed in the context of an enterprise's past record and the financial dynamics affecting the business.

34. An enterprise receives a positive score if it sets ambitious, but achievable standards for operational performance. Unexpected performance issues rarely interfere with the enterprise's strategy. An enterprise receives a neutral score if it sets standards for operational performance that are achievable and similar to industry norms. An enterprise receives a negative score if, in our opinion, it either (i) sets low standards or (ii) does not have the wherewithal, discipline, or management commitment to achieve the standards that it sets.

Organizational Effectiveness

35. The analysis of an enterprise's organizational effectiveness includes three subfactors: management's operational effectiveness, expertise and experience, and depth and breadth. Enterprises that have track records of successfully executing their plans will generally be able to better manage their risks than other enterprises. The analysis of organizational effectiveness is based on the answers to such questions as:

- How has an enterprise performed compared with the expectations that its management provided?
- Does management have good depth across its most significant businesses, or does it rely on one or a few managers?
- Does the enterprise have a history of unusual events or emerging operational risks, in particular those that materially affect earnings and cash flow?

Management's operational effectiveness

36. A history of unusual events or emergence of unexpected operational risks, in particular those that materially affect earnings and cash flow, can cast doubt on management's ability to operate its business effectively going forward. This operational volatility can negatively affect an enterprise's overall risk profile.

37. An enterprise receives a negative score if unusual events or emergence of unexpected operational risks regularly affect earnings or cash flow while an enterprise receives a positive score if it has a history of not incurring such events. An enterprise receives a neutral score if it reports unusual transactions or events that affect financial performance only occasionally.

Management's expertise and experience

38. Management's expertise and experience in operating each line of business is an important determinant of an enterprise's success. Management's expertise should be evaluated in the context of its ability to grasp and react to market conditions, financial conditions, and competitive challenges. Organizational structure and management's breadth and diversity of experience should support the strategy to execute plans and produce the desired results in order to be scored positive. Determining whether management has considerable expertise in operating its lines of business or lacks the ability to fully understand and control its business helps to differentiate a stronger management from a weaker one. The evaluation of management's expertise and experience is also based on its track record of implementing constructive actions. An important consideration is what could cause performance to deviate from management's stated expectations. Forecasting is more difficult in some industries than others, and unforeseen factors outside of management's control can upset the best-laid plans. An acknowledgement of risks and an understanding of how various factors could affect earnings and cash flow reflects favorably on management's credibility.

39. An enterprise receives a positive score for management's expertise and experience if it has demonstrated expertise in operating all major lines of business based on its ability to identify, plan for, and successfully react to changing market conditions, as reflected in the enterprise's track record and in comparison to peers. Such an enterprise has a track record of success in continuously and dependably executing its plans, excluding any events that, in our opinion, are unforeseeable. Alternatively, an enterprise receives a negative score if management lacks the expertise and experience to fully understand and control its business. Such an enterprise has a track record of often deviating significantly from plans. The score is also negative if the enterprise does not acknowledge its risks or does not demonstrate an understanding of significant factors that could affect its cash flows and earnings. An enterprise that demonstrates either unexceptional expertise in operating its lines of business or only a basic understanding of the significant risks in specific lines of business will be scored as neutral.

Management's depth and breadth

40. The depth and breadth of management influence an enterprise's ability to respond to challenges and capitalize on opportunity. Enterprises that rely on one or a few managers, which is known as key man risk, face the potential for significant disruption to operations upon the loss of key personnel.

41. An enterprise that has a management team with good depth and breadth across all significant business units receives a positive score. Such an enterprise can absorb the loss of senior managers without significantly disrupting operations or cash flows in each of its significant business units. An enterprise receives a neutral score if management depth or breadth is limited, although the loss of a few key managers would not be expected to meaningfully affect the enterprise's overall cash flows or earnings. If one or a small number of individual managers are critical to the success of an enterprise's operations, the score for this subfactor is negative. For example, if the loss of one or a few key managers could disrupt a significant operation that would meaningfully affect the enterprise's overall cash flows or earnings, the score is negative.

Governance

42. The analysis of governance covers a number of risk factors relating to how an enterprise is managed; its relationship with shareholders/stakeholders, creditors, and others; and how its internal procedures, policies, and practices can create or mitigate risk. Strong governance (such as the presence of an active, independent board) does not, by itself,

enhance creditworthiness. Good governance practices cannot overcome a weak business or financial risk profile, though they would generally help to protect an already strong business.

43. The outcome of governance analysis does not, in itself, raise the overall management and governance score. The impact of governance analysis is either neutral or negative. For example, an enterprise receives a neutral score for board effectiveness where a small proportion of the board's members are enterprise insiders and where overall board skills are sufficient to provide proactive oversight of management's activities. Conversely, this subfactor is scored as negative if board composition includes several management insiders to the point where the board can no longer maintain its independence from management and exercise appropriate oversight over risk taking, compensation, and/or conflicts of interest. A negative result can arise from a variety of perceived shortcomings or potential problems that are considered significant either individually or in combination. Any governance deficiency translates into greater overall risk and will lead to a score of no higher than fair. Any individual governance deficiency or combination of governance deficiencies that are considered severe will lead to a score of weak. A governance deficiency is severe when any negative governance subfactor alone or in combination with another or other subfactors impairs the ability of the enterprise to execute strategy or manage its risks.

Board effectiveness

44. A key governance issue is the effectiveness of the board of directors' independence from management as evidenced by their scrutiny of management. Therefore assessing the board's effectiveness entails looking beyond affiliations that inform formal notions of director autonomy. This subfactor is scored as neutral if the board provides appropriate oversight of key enterprise risks, compensation, and/or conflicts of interest. In such cases, the board is supportive of management but retains control as the final decision-making authority for high-level matters. In contrast, this subfactor is scored as negative if the board provides insufficient oversight and scrutiny of management. Evidence of this could include strategies or compensation programs that promote outsize risk-taking or that tolerate unmanaged conflicts of interest and/or inadequate succession planning for senior management.

Entrepreneurial or controlling ownership

45. Entrepreneurial or family-bound ownership and control of management can be a governance deficiency. However, this is not a deficiency (i.e., it has a neutral impact) if, although ownership is concentrated, management and the board of directors have professional, independent members who are capably engaged in risk oversight on behalf of all stakeholders, including minority interests. For enterprises with those characteristics, the influence of the controlling shareholder/stakeholder is offset by risk-aware professional management and a board of directors that effectively serve the interests of all stakeholders. In rare cases, a board lacking any independent representation can receive a neutral evaluation, but only if it has a proven track record of discharging its fiduciary responsibilities on behalf of all stakeholders. Ownership structure is a governance deficiency if controlling ownership negatively influences corporate decision-making to promote the interests of the controlling owners above those of other stakeholders.

Management culture

46. Management culture can be a governance deficiency for any enterprise. The impact is neutral if management is responsive to multiple stakeholders' interests, appropriately balances those interests, and acknowledges that the board of directors is the ultimate decision-making authority. Management culture is a governance deficiency and gets a negative subfactor score where management's own interests are its primary concern, where dissent in the executive

suite is generally not tolerated, where management is responsive only to a narrow group of stakeholders, or where management proves incapable of managing conflicts of interest arising between different stakeholder groups. Excessive management turnover can be an indicator of a governance deficiency in management culture. Management culture is also a governance deficiency where management dominates the board of directors as indicated by the control exercised by the Chair, CEO, or other key executives, unless that is offset by clear evidence that the board prevails against such pressure in exercise of its oversight responsibilities. For example, by ensuring that management incentives and compensation programs do not promote outsize risk-taking.

Regulatory, tax, or legal infractions

47. A history of regulatory, tax, or legal infractions beyond an isolated episode or outside industry norms is a governance deficiency. This is a neutral factor for an enterprise that avoids them and has a history of stable relationships with regulatory authorities. On the other hand, this is negative for enterprises that have frequent infractions or confrontations with outside parties, including regulatory authorities, that represent significant risk to the enterprise as evidenced by a history of material losses or an adverse impact on the enterprise's reputation.

Communication of messages

48. The communication of conflicting messages to different constituencies is a governance deficiency. An enterprise that generally communicates consistent messages to all constituencies receives a neutral score for messaging. Where there is evidence that an enterprise communicates conflicting information to different stakeholders on significant issues, it receives a negative score.

Internal controls

49. The score for this subfactor is negative if there is evidence of material deficiencies in the internal control systems based on an enterprise's reporting on internal controls or other evidence such as restatements or delays in filings. However, an enterprise will receive a score of neutral for this subfactor if there is evidence that the potential deficiency has been remedied or is rendered immaterial. The score for this subfactor is neutral if there are no observed material deficiencies in the internal control system.

50. An example of a material deficiency that would produce a negative score is when an enterprise discloses material weaknesses from inadequate information system controls over key processes as part of its report on the design and operating effectiveness of its internal controls (e.g., pursuant to Sarbanes-Oxley Section 404 in the U.S.), and it affects the validity and accuracy of financial data.

Financial reporting and transparency

51. 51. Financial statements and related disclosures are the primary source of information regarding an enterprise's current and earlier period financial condition and performance. This analysis starts with a review of accounting principles applied (in particular, any unusual practices) and the underlying assumptions used. The analysis of disclosures--such as detailed schedules of reserves, contingent liabilities, and ranges of assumptions used--can provide a better understanding of an enterprise's risks. The purpose is to determine whether the ratios and statistics derived from the financial statements can serve as meaningful measures of an enterprise's performance and position relative to both its peer group and the larger universe of enterprises.

52. The score for the financial reporting and transparency subfactor is neutral if an enterprise's accounting practices and

transparency are at least adequate. When alternatives are available, the enterprise's accounting choices are usually reflective of the economics of the business. Enterprises that have weak accounting practices or that lack financial transparency receive negative scores. For example, a negative score may be warranted if an enterprise's financial statements obfuscate the true intent or the economic drivers of key transactions, or the financial statements are insufficient to allow users of the financial statements to understand the intent and the economic drivers. Another example is if an enterprise's financial statements require an unusually large number of analytical adjustments (compared with peers) because of the enterprise's specific accounting policy choices. Further, financial reporting has a negative impact if disclosures are contradictory to information provided to investors through other means (e.g., investor presentations) or if the frequency of financial reporting is less timely when compared to peers.

Frequently Asked Questions

53. Question 1: Where there is a lack of information for any subfactor in management and governance, how is that subfactor scored?

54. This is an evidence-based analysis. If there is no information to indicate that a subfactor should be scored as either positive or negative, the subfactor is scored as neutral, unless it is the result of a failure to provide needed information, in which case that management subfactor is scored as negative and could in certain circumstances also lead to a negative "Communication of Messages" governance subfactor score.

55. Question 2: What is the overall score for management and governance where there is no one governance subfactor that is potentially harmful to an enterprise's risk profile, but in aggregate two or more subfactors are potentially harmful to the enterprise's risk profile?

56. Management and governance is scored as weak if a group of subfactors is viewed as potentially harmful to the enterprise's risk profile. As an example, an enterprise's management culture could be scored as negative, which apart from other characteristics may lead management and governance to be scored as fair. However, if the subfactor of internal controls is also scored as negative and the combination of these two governance deficiencies is potentially harmful to the enterprise's risk profile, then management and governance is scored as weak. Of course, any one subfactor could be sufficiently harmful to the enterprise's risk profile, such that management and governance is scored as weak.

57. Question 3: How does a change in senior management affect the scoring of individual subfactors?

58. Evidence of a change in any subfactor due to a change in management is reflected in the subfactor score. To the extent an enterprise changes senior management, board composition, strategic direction, risk appetite, or execution capabilities, the relevant subfactor scores may change based on updated information.

59. Question 4: How do you determine that there is insufficient board oversight of management in order to score that subfactor as negative?

60. Board of director processes and directors' interactions with management are largely hidden from view, so the evidence for a negative assessment will be indirect and circumstantial. Circumstances that could indicate a lack of board

effectiveness are numerous. Some indicators of this governance deficiency are based on board members having another relationship with the enterprise or because they have been co-opted by management. Examples of affiliations of board members with the enterprise include enterprise or subsidiary executives; individuals associated with firms that provide professional services to the enterprise; and individuals associated with enterprises that have substantial interconnecting relationships. Most boards will have some members that are either insiders or are affiliated with the enterprise in another capacity, but a board with a preponderance of such members is likely to receive a negative score for this subfactor, absent evidence of appropriate oversight of key enterprise risks. Conversely, short tenures combined with high turnover may also be evidence of a lack of board effectiveness and independence. When these conditions combine with evidence of strategies or compensation programs that promote outsize risk-taking, that tolerate unmanaged conflicts of interest, or where there is inadequate succession planning, this constitutes evidence of insufficient or unsustainable board oversight of management. The critical element of independent mindedness--or the lack of it--which is the highway to a negative assessment, will be evidenced by a number of facts and circumstances like these.

61. Question 5: What are examples of where the subfactor "regulatory, tax, or legal infractions" would be scored as negative?

62. A negative score would result if, due to management's actions or failure to act, an enterprise's relationship with a regulator eroded to the point where it affected the enterprise's ability to conduct business and led to failures to maintain its competitive profile. For example, a relationship of mutual trust and respect between enterprise and regulator is an important consideration for many utilities that require regulatory consent regarding rate-setting and, in turn, their ability to service their debt obligations. Where tax is avoided in a legitimate and lawful way the enterprise would receive a neutral score, but if that shaded into tax evasion, a negative score would result. Similarly, while many rated enterprises have to cope with lawsuits of various kinds, which they can choose to litigate or settle without necessarily triggering a negative evaluation, the deliberate or negligent breaking of law in areas as varied as product defects to criminal sanctions against commercial bribery, will be assigned a negative score. A negative score for this subfactor, among other things, reflects the cost to the enterprise and distraction for management that accompanies these events.

63. Question 6: What are some of the conditions that could lead to a positive score for the subfactor "comprehensiveness of enterprise-wide risk management standards and tolerances"?

64. Enterprises with a true enterprise-wide approach have a holistic view of risk management that goes beyond evaluating only quantifiable risks or even top 10 risks. They have processes to identify and address emerging risks. Generally, enterprises scoring positively for this subfactor exhibit an active management of risks and have ongoing risk reviews including assessments of low probability but high impact events. These enterprises employ a risk-based approach to strategic decisions and can demonstrate success in doing so. Such enterprises have effectively communicated to employees, owners, and other key stakeholders their tolerance for risk.

APPENDIXES

Appendix 1: Use Of Management Metrics In Determining The Management And Governance Score for Corporate Enterprises

65. The scoring methodology for corporate entities utilizes the following subfactors:

Strategic positioning

- Strategic planning process
- Consistency of strategy with organizational capabilities and marketplace conditions
- Ability to track, adjust, and control execution of strategy

Risk management

- Comprehensiveness of risk management standards and tolerances
- Standards for operational performance

Organizational effectiveness

- Management's operational effectiveness
- Management's expertise and experience
- Management depth and breadth

Governance

- Board effectiveness
- Entrepreneurial or controlling ownership
- Management culture
- Regulatory, tax, or legal infractions
- Communication of messages
- Internal controls
- Financial reporting and transparency

66. Table 3 describes the scoring methodology for corporate entities.

Table 3

Scoring Of Management And Governance--Corporate Entities

Score	Related Subfactors
1. Strong	At least five of the eight strategic positioning, risk management, and organizational effectiveness subfactor scores are positive, and none are negative--and--no negative scores for governance.
2. Satisfactory	At least three of the eight strategic positioning, risk management, and organizational effectiveness subfactor scores are positive, and none are negative--and--no negative scores for governance.
3. Fair	Combinations not covered by other descriptors--or--any negative score for a governance subfactor.
4. Weak	Five or more of the eight strategic positioning, risk management, and organizational effectiveness subfactor scores are negative--or--key aspects of management are potentially harmful to the company's risk profile--or--any governance deficiencies are considered severe.

67. As depicted in table 3, one or more negative subfactor scores will constrain the overall management and governance score to no higher than fair, regardless of the actual tally of subfactor scores. A score of negative for any subfactor

indicates that there is a material deficiency in the management or governance of a company. If a specific subfactor or group of subfactors is viewed as potentially harmful to the company's risk profile, management and governance will be scored as weak. For example, management and governance will be scored as weak if a company's management has a history of experiencing unusual items that regularly affect its financial performance to the point of being harmful to the company's risk profile. Management and governance will be scored no higher than fair if one or more governance subfactors are scored as negative, and scored weak if there are deficiencies in governance that are considered severe.

Appendix 2: Use Of Management Metrics In Determining The Management And Governance Score For Insurance Enterprises

68. The scoring methodology for insurance entities utilizes the following subfactors:

Strategic positioning

- Strategic planning process
- Consistency of strategy with organizational capabilities and marketplace conditions
- Ability to track, adjust, and control execution of strategy

Financial management

- Comprehensiveness of financial standards and risk tolerances
- Risk tolerances
- Standards for operational performance

Organizational effectiveness

- Management's operational effectiveness
- Management's expertise and experience
- Management depth and breadth

Governance

- Board effectiveness
- Entrepreneurial or controlling ownership
- Management culture
- Regulatory, tax, or legal infractions
- Communication of messages
- Internal controls
- Financial reporting and transparency

69. Table 4 describes the scoring methodology for insurance entities.

Table 4

Scoring Of Management And Governance--Insurance Entities

Score	Related Subfactors
1. Strong	At least seven of the nine strategic positioning, financial management, and organizational effectiveness subfactor scores are positive, and none are negative--and no negative scores for governance.
2. Satisfactory	At least three of the nine strategic positioning, financial management, and organizational effectiveness subfactor scores are positive and none are negative--or--one subfactor score, other than risk tolerances, is negative and at least four are positive--and no negative scores for governance.
3. Fair	Combinations not covered by other descriptors--or--any negative score for a governance subfactor.

Table 4

Scoring Of Management And Governance--Insurance Entities (cont.)	
4. Weak	Five or more of the nine strategic positioning, financial management, and organizational effectiveness subfactor scores are negative--or--key aspects of management are potentially harmful to the enterprise's risk profile--or--any governance deficiencies are considered severe.

70. As depicted in table 4, one or more negative governance subfactor scores will constrain the overall management and governance score to no higher than fair, regardless of the actual tally of subfactor scores. However, a satisfactory score can result if one management subfactor, other than risk tolerances, is scored as negative--balanced by at least four other positive assessments and no negative scores for governance. If a specific subfactor or group of subfactors is viewed as potentially harmful to the company's risk profile, management and governance will be scored as weak. For example, management and governance will be scored as weak if a company's management has a history of experiencing unusual items that regularly affect its financial performance to the point of being harmful to the company's risk profile. Management and governance will be scored no higher than fair if one or more governance subfactors are scored as negative, and scored weak if there are deficiencies in governance that are considered severe.

RELATED CRITERIA AND RESEARCH

- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Holding Company Analysis, June 11, 2009
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Investments, April 22, 2009
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Life Insurance Criteria: Liquidity, April 22, 2004

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.