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Criteria | Financial Institutions | General:

Using Enterprise Risk Management To Evaluate Mergers & Acquisitions Of Financial Services Firms

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Standard & Poor's Ratings Services uses the Enterprise Risk Management (ERM) evaluation process to distinguish between those financial services firms that are able to moderate incidences of unexpected losses and thus improve the level of risk-adjusted returns, and those that do not have this capability. For the most part, the acquiring firm is expected to have an ERM process that allows it to adjust its processes to a changing environment.

An M&A of a firm whose size is significant in comparison, however, creates a situation in which that firm inflicts a massive change to its own environment. When a merger occurs, Standard & Poor's must determine whether this transaction significantly changes the environment, which may materially alter its assessment. This process usually places the firm on CreditWatch and initiates discussions with the firm about the characteristics of the transaction and the progress of the integration process.

Two major issues relating to ERM are part of the process to resolve the placement on CreditWatch. The first, and most important, is the project risk management of the integration and implementation project. Second is the impact of the M&A on the risk profile of the acquiring firm, which includes assessing the ability of the firm's risk management system to control risk in the newly created firm. If the resolution of these issues is positive, the M&A is expected to create a fully controlled new entity. If one or both of these issues do not have a favorable resolution, a significant possibility exists that there could be either a poor return from the transaction or an increased possibility of an unexpected loss and a negative rating.

Two major phases of an M&A project are: due diligence and implementation. Generally, Standard & Poor's has discussions with the acquiring firm at one or more points during the due diligence phase and similarly during the implementation phase. If at any time during either phase, we determine that the firm under review is performing poorly on any of the ERM issues, it will significantly influence our view of the acquirer's financial strength.

Due Diligence Phase

Integration project risk management

During the due diligence phase, Standard & Poor's looks for assurance that the acquiring firm has a robust risk management process to identify all of the major risk points of the implementation concerning sales and marketing, operations, systems, investment, and compliance, for example. Any firm that treats the due diligence phase as the time to develop a full and detailed integration plan for each of the major risk points, with checkpoints and due dates for each aspect, is viewed favorably. Financial services firms that cannot articulate such a process are viewed negatively. We form an opinion about the ability of the acquirer to avoid unexpected problems with the integration based on the scope, clarity, and degree of detail of the implementation plan. Implementation plans that defer or ignore major integration issues are viewed negatively. Comprehensive plans that address all of these issues with the merger are viewed favorably.

At the end of the due diligence phase, Standard & Poor's looks favorably on the acquirer that is able to identify

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clearly the risk management system of the firm being acquired, especially if the acquirer, from that knowledge, is able to draw up specific risk management plans for the merged operations. Such plans should include details about what risk management activities should be performed and by which firm—the firm being acquired or the acquiring firm. For example, would the acquired firm continue with its past practices or incorporate new ones from the acquiring firm? Would a combination of practices from both firms be more effective? Also, which firm's staff be accountable for the newly merged firm's risk management system? Standard & Poor's views acquiring firms that leave risk management planning until after the merger unfavorably.

Risk profile and appetite

Standard & Poor's views that the best practice for the acquiring firm is to assess the risk profile of the acquired firm at the time of an agreement of sale. In addition, the acquiring firm should have a clear idea of how acceptable the resulting risk profile of the combined firms will be and how the new risk profile compares with the risk appetite and preferences of each firm before the merger. If, in any way, the resultant risk profile is unacceptable, the acquiring firm should have a plan to achieve an acceptable risk profile. Moreover, if the acquisition results in a major adjustment to the risk tolerance of the newly formed entity, its management should be prepared to explain the reasons for this adjustment. Throughout the due diligence process, the acquiring firm's management is expected to refine its view of the risk profile and make adjustments as needed. However, we view unfavorably continual adjustment of the risk tolerance as more information becomes available about the acquired firm. An especially important aspect of the risk profile during this phase is developing a full awareness of any risks that were not fully disclosed or understood during the negotiation phase. Standard & Poor's looks for the acquiring firm to have an aggressive approach to search for such items that would include, for example, off-balance sheet risks such as litigation risks.

Implementation Phase

Integration project risk management

Standard & Poor's expects to talk to a firm at least once or more times during the implementation phase. The optimal time for these discussions are close to major milestones that were identified during the due diligence phase. Because we do not expect that acquiring firm will have anticipated all contingencies during the due diligence phase, there should be discussions about the manner in which the acquiring firm handles unexpected findings and steps that were more difficult than expected. Financial services firms that are able to execute their plans in a timely manner and make immediate adjustments to plans to resolve new problems are viewed favorably. Financial services firms that find their implementation dragging for extended periods of time and plans that keep adding significant deferred items are viewed negatively. During this phase, important implementation issues to discuss include which key employees should be retained and the degree to which the newly created firm is able to add staff or to streamline operations for which there are overlaps without creating operational holes.

Standard & Poor's pays particular attention to whether the acquiring firm is keeping control of the newly acquired businesses or whether it plans to transition from one control system to another, in which there may be periods during which there are no controls. This is a particular concern if the acquired business has risks to which the acquiring firm is not familiar. There have been many instances of newly acquired businesses that have mandates to grow by a new owner that does not understand the risks that they have acquired or because of physical or organizational distances does not exercise adequate risk controls. We are especially concerned if there is any evidence of this type of situation. In addition, concern is heighten if there is more turnover among the risk

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management staff immediately before or after the acquisition.

Risk profile

Standard & Poor's looks for prompt implementation of any changes in the retained risks that are identified during the due diligence phase. Indefinitely deferred implementation of plans to modify the risk profile after the merger are viewed negatively.

Specific Concerns For Financial Services Firms

Examples of specific areas of concern for mergers and acquisitions of financial services firms include:

- Inadequate assessment of asset quality including investments and reinsurance receivables;
- Quality of underwriting portfolio management and underwriting expertise not assessed;
- Inability to articulate clearly a combined risk appetite;
- Inadequate assessment of credit and counterparty exposure;
- Failure to assess fully market risks;
- Failure to assess regulatory and political risk, including mandatory approvals and requirements;
- No assessment of economic conditions or foreign exchange exposures;
- Back office and internal control weaknesses not identified;
- Failure to meet strategic goals and projected cost savings; (This may arise if businesses are incompatible or a loss of management focus on the core business.)
- Goodwill or intangible assets overvalued, making return hurdles difficult;
- Excess optimism in evaluating future business growth prospects that could drive excessive risk taking to achieve unrealistic growth goals;
- Failure to retain key staff in operating and risk management positions and sales staff; and
- Excess focus on short-term earnings accretion rather than long-term value.

Specific Concerns By Business Sector

Insurance

- Outstanding claims, contingent liabilities, and unexpired risks not accurately quantified;
- Failure to determine the impact on group exposures and aggregates especially in terms of high-risk coverage;
- Failure to migrate to a more favorable distribution system or provider network if this was part of the rationale for acquisition; and
- Inability to integrate different types of sales channels, such as brokerage and career forces.

Financial Institutions

- Lack of timely and robust aggregation of market and credit risk exposures across the combined entity;
- Lack of a clear understanding of the degree of stickiness of deposits of the acquired institution;
- Failure to assess accurately the quality of the loan portfolio of the acquired institution;
- Inability to integrate a consistent valuation methodology across the combined entity and to reconcile accurately valuation discrepancies for complex structured transactions on the traded portfolio; and
- Failure to integrate and leverage fully the distribution network and footprint of the acquired institution.

Other concerns about acquisitions that do not relate directly to ERM exist, especially the price paid for the new

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business compared with the expected value from acquiring the firm. Standard & Poor's continues to evaluate the success that financial services firms have in acquiring new firms so that they increase a firm's value.

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