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Standard & Poor's to Focus on ERM in Ratings Analyses

The turmoil in the capital markets has forced management and boards to take a serious look at enterprise risk management ("ERM"). And if current financial woes aren't sufficient, Standard & Poor's ("S&P") has made sure that ERM will be on their minds. In May 2008, S&P announced that it would expand its ratings analyses to include a review of ERM not only for financial and insurance companies and certain energy trading firms, as is currently the case, but for all companies it rates. As a result, companies desirous of a good S&P rating must now give priority to enhancing their ERM processes, or else risk lower ratings or downgrades.

S&P defines ERM as an approach to assure that a company is attending to all risks; a set of expectations among management, shareholders, and the board about which risks a company will and will not take; a set of methods for avoiding situations that might result in losses that would be outside a company's tolerance; a method to shift focus from "cost/benefit" to "risk/reward"; a way to help fulfill a fundamental responsibility of a company's board and senior management; a toolkit for trimming excess risks and a system for intelligently selecting which risks need trimming; and a language for communicating a company's efforts to maintain a manageable risk profile.

ERM is nothing new. It has guided companies in their efforts to identify, select, and mitigate a variety of cross-functional and aggregated risks for several years. However, for most companies ERM is underfunded and underintegrated. A siloed, mechanistic process, which is focused only on compliance, has been the hallmark of most risk management efforts. S&P's new emphasis on ERM is meant to ensure that risk management becomes vertically integrated throughout the companies it reviews.

S&P has already begun incorporating commentary on ERM in its reports. However, S&P is still in the process of creating benchmarks and published evaluating criteria to serve as a basis for formal scoring. Finalizing these will take until at least the middle of this year. Meanwhile, credit ratings and ratings outlooks will only be affected if extraordinary conditions change existing perceptions of a company's business profile.

S&P's ERM evaluations are focusing on two aspects of its original four pronged approach to ERM: risk management culture and

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strategic risk management. Risk control processes and emerging risk management, the two other aspects of ERM, are for the most part not included in its review.

The risk management culture analysis consists of discussion topics such as: risk management frameworks or structures currently in use; the role of staff responsible for risk management and reporting lines; internal and external risk management communications; broad risk-management policies and metrics for successful risk management; and the influence of risk management on budgeting and management compensation.

The strategic risk management analysis investigates: management's view of the most consequential risks the firm faces, their likelihood, and potential effects on credit; the frequency and nature of updating the identification of these top risks; the influence of risk sensitivity on liability management and financing decisions; and the role of risk management in strategic decision making.

S&P will discuss with companies: how key risks are identified, updated and dealt with; how risk tolerance is defined and communicated; who owns risk in the organization and how success is measured; the level of board involvement in risk management; and, if an unexpected event occurred, what was the company's response.

In assessing a company's ERM, S&P states that it will take into account variations among types of enterprises and sectors. Its standard for a larger, multinational corporation will be a highly developed and well resourced ERM effort. A lower standard will apply to a company that is less diversified or has fewer resources because it is at an earlier stage of development. When analyzing risk within sectors, S&P will also engage in a more in-depth review of risk types that are particular to the sector.

Generally, S&P's discussions will be outgrowths of its existing analyses of a management's operating and financial track record; credibility of strategies, projections, and execution; response to competitive threats; and risk governance bodies and structures. S&P believes that incorporating risk analyses into its ratings can provide more structure and consistency to its assessment of a company's risks. It will enable "analysts to drill

deeper into quantitative financials, links risk management to overall corporate strategy, and allows greater prospectiveness in [S&P's] company analyses."

A vertically integrated approach to risk management does not mean a company will always be able to foresee or avoid losses. In fact, ERM did not seem to predict the problems of many large banks. Several financial institutions that had detailed risk-management practices collapsed as a result of the current financial environment, while others with similar practices have survived. S&P acknowledges the limits of ERM and states that it is "not a panacea," but a methodology that lends itself to the management of the likelihood of risks emerging.

Nevertheless, even without the extra incentive provided by S&P, there are plenty of reasons to implement sound ERM practices. They can improve strategic thinking and planning of directors and executives, enhance a company's risk-reward ratio for projects, develop key performance indicators, and help to allocate resources more effectively. While in this transition period, before formal scoring begins, companies should take the time to develop a risk management plan that is individually tailored, consistent, and meets industry best practice standards.

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