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## Session 7, Part 2

Emerging Best Governance Practices in Commercial Financial Institutions:

Disclosure / Role of Credit Rating Agencies

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### Introduction

Thank you for the opportunity to participate in today's panel discussion on governance practices in financial institutions. Corporate governance is highly relevant to the formation of a credit rating opinion on a financial institution.

The role of credit rating agencies is to form an opinion about the capacity and willingness of a financial institution to meet its financial obligations in full and on time. Ratings are also assigned to debt issues such as bonds and are opinions of credit quality and the relative likelihood of default. In our discussion today I would like to review the elements of corporate governance that S&P focuses on as part of its determination of credit ratings.

Corporate governance is an integral component of Standard and Poor's analysis of commercial financial institutions. While strong corporate governance does not, by itself indicate strong credit-worthiness, it is clear that weak corporate governance can undermine creditworthiness in several ways and should serve as a red flag or warning indicator to credit analysts.

At the outset I would like to make the point strong governance is a journey, not a destination.

### Disclosure and Transparency

These can be of critical importance. If a firm maintains an aura of secrecy, investors will be suspicious and skittish. In addition the firm may be more prone to so-called headline risk, the consequences of which can be very damaging, especially in the current environment.

In judging the reliability of data, Standard and Poor's considers the accounting standards used as the basis of the financial statements, the reputation of the auditor, and the degree of

openness of the local business practice. Qualms about data quality (information risk) would translate into a lower rating and preclude a rating in the upper part of the rating spectrum.

A review of accounting quality is a critical prerequisite of the financial analysis. Comparisons of financial measures need a common frame of reference. Consolidation standards, revenue recognition methods, and depreciation methods are all scrutinized, as is off-balance sheet financings, such as leasing, securitizations, trust vehicles, and contingent liabilities.

Issues looked at in the context of transparency include:

- Changes in auditors, history of disputes with auditors, reputation and size appropriateness of auditors, history of non-standard audit opinions/adverse SOX opinions.
- Aggressiveness, frequent changes and/or complexity in accounting practices and reporting
- Restatements, history of material restructuring, write-offs, core asset sales and layoffs
- Aggressive strategy/history of revenue or income recognition and/or understating costs or liabilities
- Degree of reliance on derivatives and off-balance structures for profitability and/or capital management
- Aggressive/complexity in financial/leverage structure
- Aggressive or complexity in corporate/operating/tax structure
- Transparency of information to rating agencies, investors and shareholders
- Consistency in meeting forecasts/expectations shared with rating agencies, investors and shareholders

Strong corporate governance, demonstrated in part by the presence of an active, independent board that participates in determining and monitoring the control environment, may underpin a degree of credibility of financial disclosure.

In addition to disclosure and transparency Standard and Poor's also looks at other elements of corporate governance include ownership structure, management practices, and inter-company affairs and affiliated party transactions.

### **Ownership Structure**

Identification of the owners, the financial strength and supportive nature is an obvious area of focus. It's a fundamental rating criterion that entities are never rated on a standalone basis; links to parent companies or affiliates are important considerations. Ownership by stronger or weaker parents substantially affects the credit quality of the rated entity.

The existence of more than one major owner introduces additional issues regarding potential conflicts over control. Joint owners might disagree on how to operate the business. Even minority owners can sometimes exercise effective control or at least frustrate the will of the majority owners. Whenever control is disproportionate to the underlying economic interest, the incentives for the stakeholders could diverge. Cross-shareholding of groups and family-controlled networks can have negative implications.

Governance issues examined under ownership and control include:

- Board composition, proportion of independent directors, level of financial experience and independence of the audit committee.
- Multiple classes of voting stock, non-voting shares, poison pills or other takeover impediments.
- Related party transactions with controlling family or block-holders and/or their influence on major corporate decisions.

### **Management Practices**

Assessment of management is a significant determinant of credit-rating assignments. Rating analysis considers many factors that pertain to management, including:

- Track record and competence
- Management background and reputation
- Management depth and turnover
- Professional; or entrepreneurial style of management
- Any tensions among operating function, the finance function, or shareholder interests

### **Policies and Strategies**

Financial policies are assessed for aggressiveness or conservatism, sophistication, and consistency with business objectives. Business strategies are evaluated for realism, comprehension of competitive risks, and contingency planning. Comparisons of policies and projects with a company's track record form the basis for judging management credibility.

Issues looked at in the context of policies and strategies:

- Degree of aggressiveness in company's business model, growth and acquisition strategy/pattern;
- Aggressiveness of expansion into new/unproven products, business lines, industries and/or markets; major shifts or u-turns in business/operating strategy;

- Frequency of litigation and legal disputes against the company
- History of adverse government or regulatory actions, judgments or settlements against the company

### **Inter-company Affairs and Affiliated Party Transactions**

These activities pose special challenges, since it is difficult to ascertain that they are done on a truly arms-length basis. A propensity to engage in transactions with inside parties would give rise to skepticism about the company's conduct of its affairs, even if they were fully disclosed.

### **Summary**

To sum up corporate governance is an important rating factor; weak corporate governance practices can undermine creditworthiness. In the current difficult market conditions, strong disclosure is particularly important. Inadequate oversight of the integrity of financial disclosure can result in heightened funding and liquidity risk.