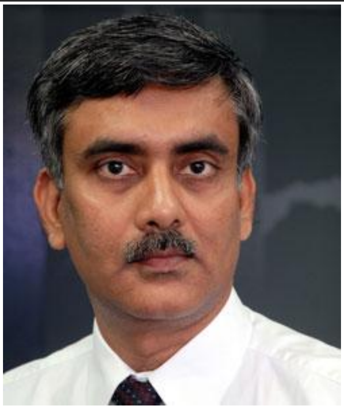
Corporate Governance and Credit Rating



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Introduction

Credit rating, which essentially comments on the degree of safety associated with the repayment of principal and interest against debt instruments, is arrived at using a composite framework that assesses the various risks a company is exposed to. The key factors evaluated include business risk, financial risks, and management related risks. While the credit rating process does not involve a detailed assessment of corporate governance practices *per se*, any issue that could potentially impact creditor interest is factored in as part of the analysis of management quality. We need to reiterate though that ICRA assigns credit ratings to companies on the basis of their overall ability to meet their obligations to creditors; the quality of corporate governance is just one component in this assessment.

What, therefore, are the corporate governance practices that are evaluated? Ownership, management quality, succession planning, internal controls, and corporate culture—the potentially significant factors that can influence both the "willingness" and "ability" to honour obligations towards creditors—come into play in the review of governance. As the international credit rating agency Moody's Investors Service[1] has noted, "Governance practices alone do not drive ratings; rather, governance can have an effect within the context of specific company weaknesses, such as poor management, risky strategy, or poor controls. In most cases, and particularly for large issuers, the governance assessment process yields a confirmation that oversight is reasonably good, and that governance does not have a distinctive impact on the rating. However, governance can be a clear factor—both negative and positive—in quite a few rating actions."

Key Governance Attributes

We now proceed to examine some of these important governance attributes, especially with respect to their potential impact on creditworthiness.

Ownership: ICRA seeks to evaluate areas like constitution of the company, shareholding pattern, transparency in shareholding, and changes in shareholding pattern over a period of time. From the rating perspective, an entity constituted as a partnership or proprietorship is viewed less favourably than a public limited company because of the potential lack of continuity in the case of death or retirement of a partner or proprietor, or, as has been seen in practice, the possibility of large sums being withdrawn by one or more partners to the detriment of the partnership or proprietorship firm's capital structure. Similarly, an opaque shareholding pattern, where the identity of the owners is not easily identifiable, tends to be discomforting to for the rating analyst. In case a company has private equity funds as shareholders, ICRA needs to examine whether the investments carry any compulsory buyback clauses at assured rates of return and the potential impact of the same on cash flows. A simple and transparent ownership structure, in ICRA's opinion, lowers areas of potential conflict of interest and related-party transactions.

Management Quality: While being very qualitative and difficult to measure, this is an important driver of corporate governance with possibly the most direct impact on creditworthiness. Quite apart from overall competence, which to a great extent gets reflected in the financial numbers, ICRA also looks at the promoters' experience in the business, the depth of the management pool, the track record of other companies under the same management, and the related-party transactions entered into; the last, a key area of concern from a corporate governance perspective in many business groups, can have a particularly negative impact on credit rating. Assessment of loans, advances and other forms of support (for instance, guarantees provided for the raising of debt) to group companies has always been an integral part of credit analysis. If a "strong" company has a history of providing support to other companies in the group, and can be expected to do so in the future as well, the same needs to be duly factored in while assigning credit ratings. On the other hand, a "weak" company belonging to a "strong" group stands to gain from the likelihood of such support in case of need.

Succession Planning: Succession planning is a key governance issue for companies in which the promoter family has a dominant stake, especially in those where the personal credibility and skills of the promoter have an overwhelming influence on the company's operations. In such circumstances, the potential concerns are mitigated if the top management set-up consists of professionals with experience and expertise in their respective function areas. It must be emphasised though that concerns on succession planning are not limited to small promoter-driven companies alone. Purely from a governance standpoint, leadership transition risk is a risk with many larger companies as well, and this could apply both to transition to the next generation or to professional managers considered "outsiders". The issue can turn tricky if members of the business family concerned cannot agree on the appropriate succession plan or the next generation has different strategies and vision for the firm.

Transparency and Disclosure: ICRA, in the course of its rating exercise, is often privy to information that is not available in the public domain; to that extent therefore, ICRA's assessment of credit quality is not contingent on the candidate company's disclosure standards. At the same time however, a track record of timely disclosures is considered positive even from the credit perspective in that it is indicative of the management's intention to communicate honestly and transparently with all its stakeholders. Of particular importance is a company's adherence to accepted accounting standards. Aggressive accounting policies, restatements, and inadequate or misleading disclosures raise questions on the quality and integrity of a company's management and Board of Directors.

While on disclosures, it may be mentioned that a particularly tricky area is consolidated accounts. Listed companies are mandated to provide consolidated group accounts. While this does impart an element of transparency to a company's operations, the fact is that most holding companies, through which groups exercise control, are not listed, and no information is publicly available on them. It is therefore difficult—in fact, often impossible—for a credit rating analyst to get an overall view of a group's consolidated profitability, leveraging or cash flows, and a listed company may appear debt-free, even as its debt and investments are parked in unlisted holding and investment companies.

Internal Controls: Establishing the adequacy or otherwise of a company's internal control systems is clearly beyond the scope of a rating exercise. We however place considerable emphasis on proxies like apparent quality of Statutory Auditors, their comments on the adequacy of control systems, and any obvious instances of failure of internal controls (for instance, lapses in deposit of statutory dues).

Impact on Credit Ratings

To what extent are corporate governance attributes reflected in the credit ratings assigned?

ICRA does not have any cut-and-dried benchmarks to decide the extent to which the "base level" rating, so to speak, can be notched up/down to reflect positive/negative governance practices. In most cases, it is the "severity" of the negatives for the company in question that is the deciding factor. For instance, while a track-record of related-party transactions involving cash outflows to ailing group companies may normally be expected to bring down the ratings of the candidate company, in case ICRA's cash flow analysis shows that the candidate's debt servicing is unlikely to be impacted even under adverse assumptions of such cash outflows, the ratings may not suffer.

Generally speaking, corporate governance issues are usually of greater relevance for companies at the lower end of the investment grade; their ability to weather shocks induced by below-par governance practices is significantly lower than for entities fundamentally stronger, with superior business and financial risk profiles.

Here, it must be admitted that currently, research on the impact of corporate governance practices on credit risk is limited, although there are a number of empirical studies pointing to a positive correlation between governance practices and equity prices. Nonetheless 'to the extent that shareholders as well as creditors and others have confidence that proper systems of management accountability and incentives are in place, they can have greater confidence in the present management of the company.[2]

What do we view as key negatives from a corporate governance perspective in the Indian context?

Sometime back, ICRA, in association with Moody's, had carried out a survey of several large family-owned companies.[3] The survey showed that the key governance concerns pertaining to these entities include: (a) leadership transition risks; (b) transparency of ownership and control; (c) related-party transactions; and (d) independence of Directors. The lack of a Board nomination committee in many of the companies suggests that succession planning is not fully deliberated upon with sufficient involvement of Independent Directors. Leadership transition—whether to the next generation of the family or to professional managers who are "outsiders"—is a key governance and credit risk for family firms because such transitions typically accompany changes in family ownership as well. Lack of clarity on ownership and opaqueness on the financial position of non-listed, family-controlled holding companies (which may have raised significant amounts of debt to fund the group) are material credit weaknesses. Thus, a listed company may appear debt-free, but its controlling unlisted parent, which it supports through upstreamed cash flows, may have raised considerable amounts of debt to fund the group. It can thus be difficult to assess accurately the consolidated financial profile of many Indian conglomerates solely on the basis of publicly-available information. Also, in the absence of active nomination committees, the true independence of Directors remains untested—a major corporate governance challenge.

ICRA's Corporate Governance Ratings/Assessments

While on the subject, it may be relevant to mention that ICRA also offers a service specifically designed to evaluate the corporate governance practices of business entities. ICRA's Corporate Governance Rating/Assessment (CGR) is meant to indicate the relative level to which an organisation accepts and follows the codes and guidelines of corporate governance practices.

ICRA's CGR focuses on a company's business conduct and practices and the quality of its disclosure standards—whether they are fair and transparent for its financial stakeholders while meeting the regulatory requirements. The emphasis of ICRA's rating/assessment process is on "substance" over "form". However, ICRA does not carry out audit of the corporate entity being rated, and ICRA's CGR is not to be interpreted as an indicator of statutory compliance by the rated entity, its future financial performance, or its stock market price.

ICRA's CGR framework seeks to understand the interaction amongst the different participants in an organisation such as the Board, management, shareholders and other financial stakeholders, and the rules and procedures laid down and followed for making decisions on corporate affairs. Accordingly, ICRA's framework is designed to analyse the following key variables while arriving at the CGR for a corporate entity:

- Ownership Structure
- Governance Structure and Management Processes
- Board Structure and Processes
- Stakeholder Relationship
- Transparency and Disclosures
- Financial Discipline
- Ethical Practices

ICRA believes this rating/assessment service helps companies project an objective and credible opinion on the quality of their corporate governance practices and responsiveness to the interests of all financial stakeholders. Empirical research has shown that corporate governance is one of the important factors influencing corporate valuations, and superior governance practices can facilitate access to fresh capital, often on more favourable terms. Further, a Corporate Governance Rating/Assessment can enable a company benchmark itself against the best practices prevailing, thereby giving it an opportunity to raise the bar higher.

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[1] *Moody's Findings on Corporate Governance in the United States and Canada, October 2004*
[2] See Moody's Investor Service Rating Methodology " US and Canadian Corporate Governance Assessment
[3] *Corporate Governance and Related Credit Issues for Indian Family Controlled Companies*