Corporate Governance of Banks: A Credit Rating Agency’s Approach

presented by Janet Holmes

Moody’s Investors Service
Overview

- Introduction
- Meaning of credit ratings
- Moody’s general approach to corporate governance analysis
- Moody’s Bank Financial Strength Ratings: Global Methodology
- Moody’s corporate governance analysis of banks
Meaning of credit ratings
What a Credit Rating Is

- An opinion about the relative future credit risk of an instrument or entity
  - Credit risk is the risk that an entity might not meet its contractual, financial obligations as they come due

- Moody’s credit ratings are opinions about expected loss
  - Expected loss = (probability of default) x (severity of default)
... and What It Is Not

- Credit ratings do **not** address any other risk, including (but not limited to) the instrument’s:
  - Liquidity risk
  - Market value risk
  - Price volatility

- Credit ratings are **not** statements of current or historical fact

- Credit ratings are **not** recommendations to buy, sell or hold any securities

- Credit rating agencies are **not** gatekeepers
Moody’s Credit Rating scale

Long-Term Rating

Investment Grade
- Aaa
- Aa1
- Aa2
- Aa3
- A1
- A2
- A3
- Baa1
- Baa2
- Baa3

Non-Investment Grade
- Ba1
- Ba2
- Ba3
- B1
- B2
- B3
- Caa1
- Caa2
- Caa3
- Ca
- C

Minimal credit risk

Watch list = under review

Outlook = likely direction

In default, little prospect of recovery
Moody’s General Approach to Corporate Governance Analysis
Moody’s Corporate Governance Specialists

- Subset of a larger group of specialists, who work side-by-side with credit analysts
  - Accounting specialists
  - Risk management specialists
  - Complex financial instruments specialists
  - Corporate governance specialists

- Expertise leveraged through training for Moody’s credit analysts
  - Enhances the ability of credit analysts to identify, analyze & incorporate governance analysis into their credit analysis
Moody’s Approach to Corporate Governance Analysis

- **Integrate governance analysis into overall credit rating**
  - How does a firm’s governance affect its ability & willingness to honor its obligations?
  - Is governance a ratings driver?

- **Increase transparency of governance analysis**
  - Incorporate analysis into Credit Opinions and Credit Analyses
  - Publish Issuer Comments if appropriate
  - Publish Special Comments to help investors identify and analyze credit-relevant corporate governance issues and trends
    - Sector comments (e.g. governance trends in banking industry)
    - Thematic comments (e.g. executive pay)

- **Geographic scope**
  - To date, principal focus has been North American companies
  - Global banking methodology incorporates governance analysis
Moody’s Approach to Corporate Governance Analysis

- **Qualitative emphasis**
  - Not a “check-the-box” approach

- **Bondholder perspective**
  - Like shareholders, concerned about agency issues & adequacy of controls
  - But risk appetites differ between bondholders & shareholders

- **We evaluate governance in terms of:**
  - Quality of governance practices
  - Degree to which the board & management have shown that they effectively balance shareholder and bondholder interests

- **Context-specific assessments**
  - Linked to broader view of creditworthiness
  - Take into account ownership structure, market discipline & regulatory environment
Integrating governance into ratings analysis

- Governance can be an important ratings factor
- Even in large issuers, governance has been a material rating factor about 20% of the time (10% positive, 10% negative)
- For lower-rated, smaller issuers, governance can be a more important factor in ratings
- Can provide additional insight into management quality, event risk & strategy

Governance is rarely a central ratings issue; but often serves as a “tipping point” factor
We Characterize Governance in Five Categories

<table>
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<tr>
<th>Impact on Ratings</th>
<th>Very Good</th>
<th>Very Weak</th>
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<tr>
<td>+</td>
<td>Governance is a credit strength</td>
<td>Governance is a credit challenge that could constrain future ratings improvements</td>
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<tr>
<td>Neutral</td>
<td>Governance strengths outweigh some weaknesses</td>
<td>Governance weaknesses outweigh strengths</td>
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<td>Neutral</td>
<td>Corporate governance is neither a positive nor negative rating factor</td>
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Moody’s Supports Good Governance Principles

- Appoint independent, effective directors
- Establish independent, technical committees
- Set strong values
- Adopt clear lines of accountability
- Maintain strong, independent control functions
- Ensure oversight of complex organizations, financial instruments
- Ensure high quality governance transparency
- Adopt long-term compensation structures
Disclosure about Governance

- **Board structure** (e.g. bylaws, size, membership, selection process, qualifications, other directorships, criteria for independence, committee membership, charters and responsibilities) and senior management structure (e.g. responsibilities, reporting lines, qualifications and experience)

- **Basic ownership structure** (e.g. major share ownership and voting rights, beneficial owners, major shareholder participation on the board or in senior management positions, shareholder meetings)

- **Organizational structure** (e.g. general organizational chart, business lines, subsidiaries and affiliates, management committees)

- **Incentive structure of the firm** (e.g. short and long term compensation policies, director and executive compensation, bonuses, stock options, key metrics considered in deciding compensation)

- **Firm’s code or policy of business conduct and/or ethics** (including any waivers, if applicable), as well as any applicable governance structures and policies
Moody’s Approach to Analyzing Corporate Governance of Banks
Moody’s Bank Financial Strength Ratings (BFSRs)

- A BFSR reflects Moody’s opinion of a bank’s intrinsic, or stand-alone, financial strength
  - Relative to all other rated banks globally
  - The first step in Moody’s credit rating process
  - But BFSRs are not credit ratings – do not address default risk or severity of loss
  - BFSRs address likelihood that a bank would need assistance to avoid a default

- Moody’s other ratings for banks determined by considering its BFSR plus:
  - Likelihood that bank will receive external support
  - External risk that sovereign actions could interfere with the bank’s ability to honor domestic or foreign currency obligations
BFSR Rating Definitions

- A: Superior intrinsic financial strength
- B: Strong intrinsic financial strength
- C: Adequate intrinsic financial strength
- D: Modest intrinsic financial strength
- E: Very modest intrinsic financial strength
BFSRs – Key Analytical Factors

- Franchise value
- Risk positioning
  - Where corporate governance is considered
- Regulatory environment
- Operating environment
- Financial fundamentals
Sound Controls Support Strong Credits

- Strong franchise and financial fundamentals, plus
- Sound regulatory environment
- Strong risk management
- Robust corporate governance
Moody’s Has Stepped up Its Analysis of Controls

- **Longstanding focus (before 2003)**
  - Regulatory environment
  - Credit/market risk controls

- **Added specialist team support (2003-2007)**
  - Specialist teams led to more systematic analysis of:
    - Governance
    - Risk management
    - Control failures

- **Incorporation into revised BFSR Methodology (2007+)**
  - Dynamic assessment of governance & risk management embedded in analysis
  - Controls history also considered
Factor 2: Risk Positioning

Why it matters

- Majority of revenue for most banks is compensation for taking calculated risks
- Management’s approach to managing risks underpins its strategic decisions & the probability of those decisions succeeding
  - Is risk discipline aligned with bank’s strategy?
  - How integrated is risk management with the bank’s overall operating philosophy?
Risk Positioning Sub-factors

- Corporate governance
- Controls and risk management
- Financial reporting transparency
- Credit risk concentration
- Liquidity management
- Market risk appetite
Corporate Governance – Key Factors

- Ownership & organizational complexity
- Key man risk
- Insider and related party risks

- If an individual factor is not scored as a D or E, the factor is neutral
  - And does not contribute positively or negatively to indicative BFSR
Ownership & Organizational Complexity

- Can be more difficult for board to exert objective, independent oversight if:
  - Ownership is concentrated,
  - Voting control is concentrated in the hands of shareholders with a relatively small economic interest, and/or
  - Ownership structures are complex
    - e.g. multiple, minority ownership interests or pyramid structures

- Large shareholders, particularly family owners, can encourage long-term decision-making
  - But it can be difficult to manage potential conflicts between large owners & minority shareholders
  - Task made more difficult if controlling shareholders hold key management positions
Ownership & Organizational Complexity

- **Factors leading to a D score**
  - Complex ownership structure or
  - > 50% ownership by an individual legal person (including the government) or family

- **Factors leading to an E score**
  - Complex or private ownership as described for “D”, plus either:
    - Complex organizational structure that is hard for board or outsiders to understand, or
    - Family members or government officials dominate management
Key Man Risk

- **Is the bank is highly dependent on a single executive or group?**
  - Could this loss of talent adversely affect the bank’s fundamentals?

- **Factors contributing to a D score**
  - Management lacks depth (e.g. 1-2 individuals dominate management with no apparent successor or succession planning), OR
  - Dominance of a single generation within senior management

- **Factors contributing to an E score**
  - Lack of management depth, AND
  - Dominance of a single generation in senior management
Insider and Related Party Risks

- **Related party (RPT) loans**
  - Strong independent credit approval process is essential to a bank’s creditworthiness
  - Significant extensions of credit to insiders may indicate that underwriting standards are being circumvented (or not being applied consistently)
  - Related party loans can also create credit concentrations that may be harder to handle than other concentrations
  - Related party loans to controlling shareholders, bank executives or persons/entities related to them are of particular concern

- **Low board independence increases bank’s risk profile**
Insider and Related Party Risks

- **Factors contributing to a D score**
  - Total RPT loans between 25% & 40% of Tier 1 capital, OR
  - Less than 25% of supervisory board is independent

- **Factors contributing to an E score**
  - Total RPT loans > 40% of Tier 1 capital, OR
  - No one on supervisory board is independent
Moody’s Governance Analysis is Broader than BFSR Scores

- BFSR scorecard for “governance component” of 2\textsuperscript{nd} factor limited to 3 key indicators
- Risk governance also considered as part of risk management assessment (RMA)
  - Considered as part of analysis of 2\textsuperscript{nd} factor
- **Indicative BFSR score can be adjusted**
  - as part of rating committee process to take into account qualitative factors (including governance)
- **Ongoing governance analysis is more expansive:**
  - Executive pay / director pay
  - Board practices / whether outside directors actively involved
  - Director skills
  - Director independence
  - Ownership dynamics
  - More nuanced look at executive succession
Risk Management Assessment (RMA) Also Considers Governance

- Four pillars of RMA methodology
  - Risk governance at board & senior management level
    - Dynamic involvement of board in setting firm’s risk appetite
    - Chief risk officer reports directly to CEO and board
    - Risk management holds veto power
    - Effective alignment of risk with corporate & financial objectives
  - Risk management
  - Risk measurement
  - Risk infrastructure
Some Moody’s Publications on Governance
Governance Special Comments: General

- Assessing Corporate Governance in Family-Controlled Companies from a Debt Holder Perspective, January 2008 (106287)
- Analyzing Unexpected CEO Departures and Severance Payments for Signs of Weak Governance, December 2007 (105930)
- Western European Executive Pay Disclosure Trends Bode Well for Better Credit Analysis, December 2007 (105837)
- Credit Implications of Corporate Governance in Private Equity-Owned Companies, November 2007 (105808)
- DOJ Investigations into Rated Issuers Can Have Significant Negative Ratings Implications, July 2007 (103761)
- Expanding U.S. Shareholder Power Increases Potential Credit Risk to Bondholders, June 2007 (103598)
- Short-Term Shareholder Activists Degrade Creditworthiness of Rated Companies, June 2007 (103433)
- U.S. Directors May Have To Confront Investor Demands To Rethink Executive Pay, January 2007 (101676)
- Update: 11 Issuers See Rating Actions Linked to Option Timing Probes, November 2006 (100524)
Governance Special Comments: General

- Do Boards Of Directors Need More Direct Staff Support, October 2006 (100417)
- Criteria for Assessing Director Independence, October 2006 (100302)
- Best Practices In Audit Committee Oversight of Internal Audit, October 2006 (99909)
- Best Practices for a Board’s Role in Risk Oversight, August 2006 (98545)
- Board Leadership: A Positive View on Non-executive Chairs and Lead Directors, August 2006 (98557)
- Stock Option-Timing: Scrutiny and Risks Increase, July 2006 (98494)
- U.S. Executive Pay Structure and Metrics, June 2006 (97887)
- Stock Options “Backdating”, June 2006 (97760)
- The Downside of Incentive Pay for Directors, April 2006 (97174)
- Assessing Corporate Governance As A Ratings Driver For North American Financial Institutions, April 2006 (97279)
- Lessons Learned in Moody’s Experience in Evaluating Corporate Governance at Major North American Issuers, April 2006 (97104)
- Moody's Response to Rated Companies Receiving SEC Wells Notices, October 2005 (94627)
- Moody’s Findings on Corporate Governance in the United States and Canada, October 2004 (89113)
Governance Special Comments: General

- Stock Options “Backdating”, June 2006 (97760)
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- Moody’s Findings on Corporate Governance in the United States and Canada, October 2004 (89113)
Special Comments: Governance of Financial Firms

- Key Man Risk in Private Equity Firms and Hedge Funds is a Potential Credit Risk for Bondholders, December 2007 (106058)
- North American Insurers Face Three Significant Governance Risks, June 2007 (103269)
- All Change at the Top - The Rating Implications of Future CEO Changes in the U.S. Banking Sector, July 2006 (98179)
- Evaluating The Rating Significance Of Regulatory Actions Against U.S. Banks, April 2006 (97230)
- No Assurance of Good Governance: Observations on Corporate Governance in the U.S. Insurance Sector, October 2005 (94705)
- Don’t Bank on Strong Governance: Observations on Corporate Governance in US Banks, August 2005 (93743)
Other Documents

- Bank Financial Strength Ratings: Global Methodology, February 2007 (102151)
- Incorporation of Joint-Default Analysis into Moody’s Bank Ratings: A Refined Methodology, March 2007 (102639)
Acknowledgments and Contacts

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  - Mark LaMonte, Senior Vice President and Team Leader (mark.lamonte@moodys.com)
  - Drew Hambly, Assistant Vice President-Analyst
  - Christian Plath, Assistant Vice President-Analyst