SCOPE

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The European Rating Agency

Corporate Ratings – Corporate Governance Aspects

Corporate Governance (CG):

- Guidelines laying out rules for corporate behavior and how corporations monitor and enforce these rules
- Good CG reduces risk, builds trust, improves access to capital markets, stimulates performance, enhances the marketability of goods and services, improves leadership, and demonstrates transparency and social accountability. (CIMA)
- Rating agency to check and monitor CG standards in the interests of bondholders (and in relation to shareholders)

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Advantages for successful corporate governance:

Increased access to external financing by firms	Can lead to greater investment, higher growth, and greater employment creation.
Lower cost of capital	Makes firms more attractive to investors, leading to growth and more employment.
Better operational performance	Through better allocation of resources and more effective management decision making.
Financial crises less likely	Important, as highlighted again recently, given the large economic and social costs of crises.
Better relationships with all stakeholders	Improves social and labor relationships and aspects such as environmental protection, and can help further reduce poverty and inequality.

Source: Adapted from Claessens and Yurtoglu (2013).

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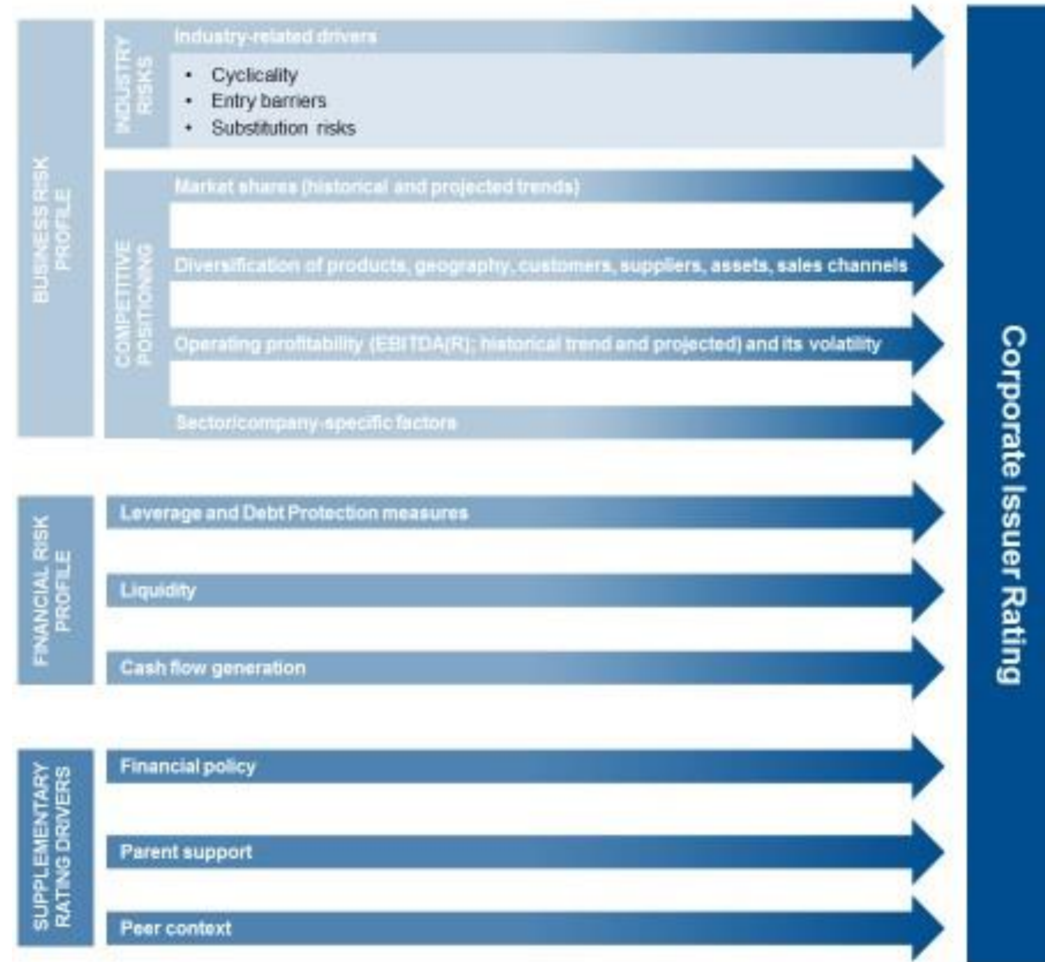
Scope Rating Grid



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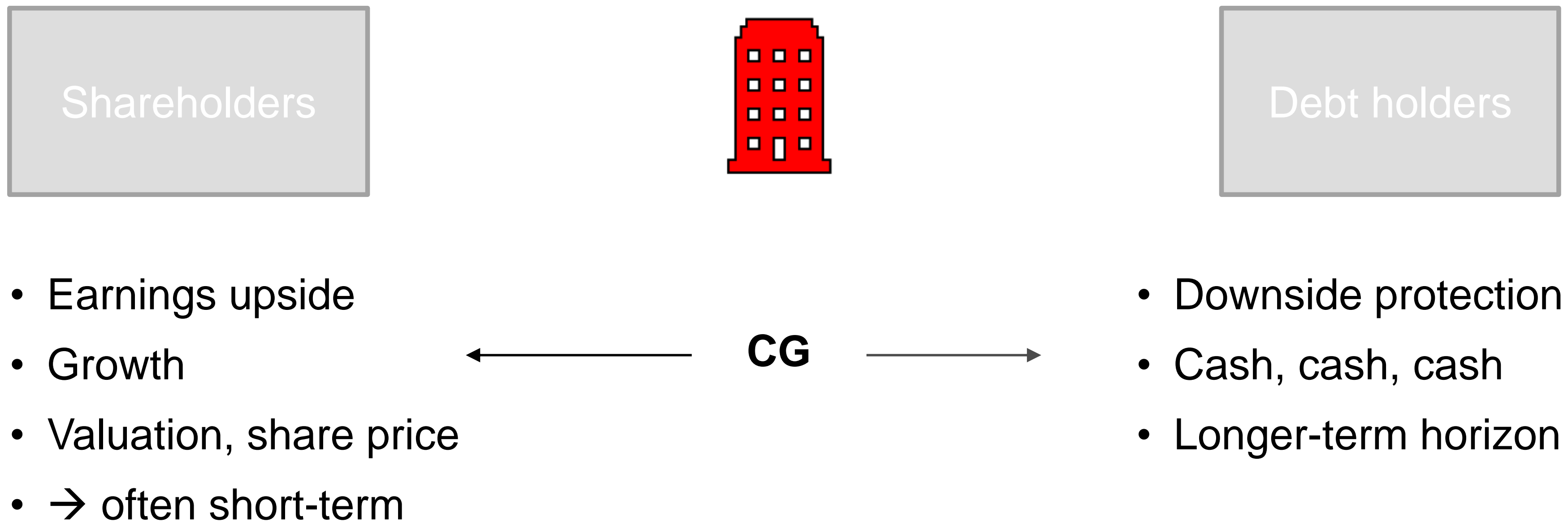
Rating Agency Tasks

A rating agency looks at debt holders interests
shareholders and debt holders might have conflicting goals
(dividends, acquisitions, capital structure, leverage)



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- Challenges for emerging market/newly industrialised countries (EM/NIC):
  - Standards differ from industrialised countries
  - Scope aims to expand coverage and increase transparency for investors
  - Use of local country ratings (with $_{EM}$ subscript) for domestic investors to better capture key factors

Three key factors:

  - Internal Governance
  - External Governance
  - Transparency of Ownership and Control

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1 Internal Governance: Rules for behavior with sanctions

- Makeup and functionality of board of directors
- Committee make-up and mandates to cover corporate governance guidelines
- Effectiveness of management and corporate culture
- Quality of both internal financial reporting and internal control mechanisms

Key for building Scope's opinion for the rating:

- Understanding corporate ownership structures
- Separation of management from ownership
- Quality of oversight
- Tools and sanctions in place

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2 External governance: corporate environment

- Quality of public governance
- Transparency of local financial markets and funding sources
- Accounting frameworks
- Legal aspects (property laws, bondholder rights, exposure to conflicts with regulatory agencies, tax offices, other legal issues)

Key for building Scope's opinion for the rating:

- Legal framework
- Government control and regulations
- Financial Market Development

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3 Transparency of Ownership and Control: Quis custodiet ipsos custodes?

- Scope recognizes the importance of family ownership in EM/NIC
- Scope understands the role that business group affiliation plays
- Professional support and advice for family members
- Independence of board and board members

Key for building Scope's opinion for the rating:

- Transparency of ownership and control
- Transparency of business group affiliation and mechanisms
- Independence of board members with mandated oversight functions (audits)
- Fulfillment of rating guidelines

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- Board independence
- Red Flags
  - Key issues that would clearly negatively impact the ratings
- Benchmarks
  - International guidelines adapted for local requirements

Rating guidelines follow a catalogue of key factors within a framework of best practice corporate governance guidelines to build a measured and qualified opinion on corporate governance

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Scope Corporate Ratings

Case Study – Merck KgaA, Germany

MERCK

Ownership: 70% family (Merck Family), 30% outside shareholders
Family-owned and publicly traded

Regulated by German Stock Exchange rules and German "Corporate Governance Kodex" (Gvmt. Organisation)
Merck Supervisory Board: sufficient external representation**,** promotion of all shareholders' interests
Related party transactions: limited (4% of group assets)

Merck: balancing of both sides – stake-holder orientation

Disclosure based on

- Transparency (capital market standards)
- Separation of (family) ownership and management
- No singular focus on shareholder value

Scope Corporate Ratings

Case Study – Emerging Market

Company XYZ

100% owned by founder

Founder and other family members still in management

Limited information on supervisory board members

Limited information on founder's other interests

Limited transparency on related party transactions

Complicated legal group structure

Questions on liquidity (short-term debt to be matched by available cash and committed bank lines)

Rating agency to evaluate:

- Whether there is a clear separation of family and company (→bond proceeds)
- Whether transparency is adequate to enable rating agency doing its homework (for example: interim reports are delivered on time, liquidity information, covenant definition and tests are understood, sufficient communication to management is established to make sure rating agency knows what is going on)

SCOPE

Public Interest Entity Georgia

What is positive?

Audited IFRS statements

External regulation by Securities Market Law

One independent member is supervisory board

Audit and other Committees to be established

Mandatory publication of annual and interim reports

Restrictions on related party transactions

…

What is still missing?

More explicit protection of bondholders' interests ("ring-fencing of assets")

More timely publication of annual and interim results (1. Oct. is too late for annuals)

No Corporate Governance Code established yet

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