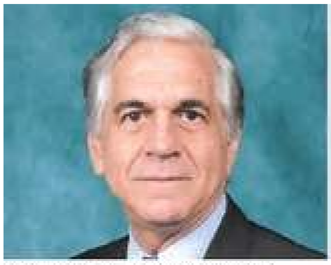

Terrance Martins, Chairman, CariCRIS

Corporate Governance, Investment Analysis & Credit Ratings

By Terrance Martins

“It takes 20 years to build a reputation and 5 minutes to ruin it. If you think about that, you’ll do things differently."

Warren Buffet, CEO, Berkshire Hathaway Corporate Governance-Form or Substance: Corporate Governance matters have been receiving the increasing attention of regulators since the 1990’s, in developed and developing markets alike, supported by the introduction of codes and principles enshrined in the operating standards of global and national regulatory bodies, quasiregulatory bodies, accounting standard setting bodies and related institutions. Celebrated cases of global corporate failures and frauds on an unprecedented scale have only served to heighten the sensitivity and importance of corporate governance standards.

Indeed the potentially punitive provisions for non-executive directors in the event of deliberate misdemeanour, negligence, ignorance and non-performance have serious legal ramifications in many jurisdictions.

In general, and specifically with reference to regulations, particularly in developed

countries, this sensitivity has resulted in a situation where significant time and attention of board and management is required to be devoted to ensuring compliance with the multitude of governance and disclosure standards and laws that may apply.

In the case of entities in developing economies which were hitherto largely subject to only domestic regulations and a relatively easier framework of compliance, as many of them increasingly become integrated with global partners in countries like USA, they confront intricate and elaborate compliance structures and more stringent capital requirements that they now need to conform to, if they are to expand their footprint into these markets.

Yet, despite all of this heightened preoccupation with compliance, much of what is manifest today as corporate governance regrettably goes more by form and less in substance or to support real value creation for shareholders or stakeholders. Some publicly listed companies sometimes overstate the quality and depth of their corporate governance architecture, but the yardsticks they apply do not go beyond the rules specified by regulators and are rarely effectively translated into the business culture of the enterprise.

The essence of the forgoing argument is that compliance with corporate governance guidelines does not by itself constitute good corporate governance. As is the case with most other regulations, laws and regulations governing corporate governance are minimum standards, even though the distance from current practices creates the impression that they are pegged at a very high threshold.

Certain regulations, especially when they seek to fit a square peg into a round hole, and do not take cognisance of the practicability of forced implementation across the board, but are justified in the interest of the “larger good”, can result in exorbitant costs, particularly for small and medium sized enterprises.

Moreover, by extension, those who meet such “exacting” standards are sometimes bestowed the halo of a corporate angel, when indeed the devil in the detail may be conveniently buried under reams of paper and forms declaring compliance.

Essential questions: Corporate Governance & Strategic Management From an interview with Mr. Philip Marshall

- Does the company have a well-defined strategy? Have various alternative strategies been considered? Are the board and senior management wholeheartedly committed to the strategy?

- Is the strategy aligned with its distinctive capabilities to provide sustainable competitive advantage? Are the right people in the right roles to implement it?

- Does the company track its competitive environment on an ongoing basis? Is it in a position to respond to changes in that environment in a timely and effective manner?

- Are the key performance measures and risks to be managed directly derived from the strategy?

- Does the board keep the strategy - and its implementation - under regular review?

- Is the board communicating the strategy successfully to institutional shareholders and other key stakeholders? Are they fully supportive of it?

Corporate Governance and Investment Decisions: What does corporate governance have to do with investment analysis? For a wise and conscientious investor, everything; for a short term speculator, possibly nothing!

Almost a decade ago, based on market statistics, a McKinsey & Co. study revealed that well governed corporations have consistently performed better on the stock markets than those corporations considered lower on the totem pole of corporate governance.

Enlightened corporate governance in all of its manifestations is a potentially enduring source of competitive advantage, and in order to sustain this momentum it must permeate every facet of the corporation's business activities. A meticulous investor should ideally consider several factors and needs a plethora of information before taking a considered investment decision. He or she has to ascertain whether the investment target will perform sufficiently well in the future, to deliver at least expected returns, commensurate with the risk being assumed. Such risk analysis should ideally be grounded on the company's fundamentals – the economy, the industry, the environment, the market position, operating efficiencies, financial and people management. However, one over-arching factor which can override all these tangible factors is the aspect of board and management performance – their competence and more importantly their integrity and transparency.

Trinidad and Tobago boasts of one of the more developed capital markets and stock markets in the Caribbean, with more than 35 stocks listed. It is a destination for regional stocks as well. The market, though, is afflicted by problems flowing from a relatively small stock of floating shares in many companies, illiquidity, and a relatively small and concentrated investor base which creates the potential for illogical price movements.

In an environment where there is more than a fair share of cross-holding between prominent corporations, and a rather high concentration of business ownership, where a few corporate groups account for a dominant share of businesses, including financial sector business, transparency and information disclosure can be considered to be at a premium.

While compliance in some market sectors is generally not an issue, our laws and regulations, such as the Financial Institutions Act and the Insurance Act, are relatively archaic and are still in the process of being revamped to reflect modern reality. Even so, it is not evident how much the revamped laws will effectively support an improved corporate governance culture. Being the product of a consultative process, the situation is more a reflection of the collective corporate psyche and attitude, rather than the stance of regulators, and this has had the unintended negative consequence of an unduly protracted transformation agenda in the regulatory environment.

Recognising Good Corporate Governance: In the case of publicly listed companies, which seek participation by common investors and are expected to have a sense of accountability to the public at large, investors will do well to examine whether the following orderly and positive traits are at work within the organisation:

- The governance architecture is built around the following core principles

- Fairness

- Transparency

- Accountability

- Responsibility

- Professionalism

- The Board, being at the top of the management pyramid, decides and approves the policies and strategies which drive the organisation, consistently follows their implementation, and ensures alignment with the risk profile and strategic imperatives of the institution. In this effort, the Board should be assisted by specialised structures such as Audit Committees, Compensation Committees, Risk Committees, Governance Committees and HR committees, which bring to bear the requisite technical expertise and give life to the execution of their oversight role and responsibility.

- The Board includes sufficient independent directors, who can be truly independent, not so much by the virtue of their lack of executive function or pecuniary interest in the company, but more by virtue of their reputation of integrity, known competencies, ability to speak their minds without fear or favour, and their stated postures on relevant issues. This requires an investment in time and focus by the directors which goes beyond the existing parameters of attendance at board meetings. As with the executive management, the performance of the board must be subject to continuous evaluation and the selection of its membership must reflect the desired range of qualities and competencies.

- The executive management develops on the policies and strategies approved by the Board, and plans, directs and monitors their actual implementation. Depending on the size and complexity of the Trinidad & Tobago Chamber of Industry and Commerce • **www.contact-tt.com** organisation, there is then appropriate devolution of powers in this execution role, with appropriate checks and balances also introduced to ensure that accountability and performance measurement goes hand in hand with responsibility.

- Where subsidiary or associate companies are part of the landscape, the requirement to craft an appropriately balanced corporate governance architecture which ensures the effective discharge of the roles and responsibilities of both parent and subsidiary boards is very important.

While all of the above may not necessarily exist in a fully fleshed out manner in all companies, it would be instructive for any diligent investor to be satisfied that internal processes of the organisation are evolving towards the above ideals, and that whilst the board takes its oversight role seriously, a balance is struck which allows management creativity to flourish and risk to be mitigated.

Credit Ratings and Corporate Governance Armed with the knowledge that abounds today as to what technically constitutes good corporate governance, an investor can definitely examine whether the prospect is compliant with applicable guidelines and regulations. With some degree of effort, an investor can determine whether a particular board and management team attains an acceptable threshold of corporate governance.

If corporate governance ratings or scorings such as those introduced by rating agencies like Standard & Poor's worldwide, or CRISIL in India, or as proposed to be introduced by CariCRIS in the

Caribbean, are accessible, then the investor is afforded an additional decision tool, although these governance scorings have their limitations. Nevertheless, to the extent that such analysis from independent and credible agencies is available in the public domain, it can be beneficial for a prospective investor.

Credit ratings, a more widely used financial market instrument, can answer several questions for an investor with respect to corporate governance. Although credit ratings speak specifically to debt servicing ability, the underlying analysis is relevant for a wider audience.

The analysis typically reveals the board and management's risk appetite and track record.

More importantly, the very act of going public with a credit rating is a powerful statement.

Any company which discloses its credit rating, particularly when it is not due to mandatory regulations, is essentially taking a stance that it is willing to subject itself to an independent scrutiny which comprehensively addresses aspects relating to the impact of the environment as well as that of its own management, on the enterprise's performance.

And once a rating is in the public domain, performance is continuously analysed and benchmarked for the benefit of investors, irrespective of whether it's positive or negative. In other words, it reflects a courageous, enlightened and transparent board and management.

It is also relevant to note that good corporate governance and good enterprise risk management systems are two sides of the same coin. Ultimately good governance should seek to identify in advance, the impact of potential corporate actions, in terms of risks and returns, which includes not just risks in the commonly recognised financial sense, but also in terms of reputation risk. In this sense too, to the extent that credit ratings reflect how well an organisation is placed from a risk perspective, it can be a critical input for an investor.

As corporations globally find their way through several challenges of operating in an ever-evolving business environments and changing moral values, it is increasingly evident that good corporate governance will demand a premium from not just investors but all stakeholders. In the years to come, it is reasonable to expect that the yardstick may no longer be the form but real substance, as can be manifest in aspects like environment friendly investing and growth and true evidence of socially responsible performance.

Indeed, on reflection, the following age old proverb seems to apply to corporations as well: When wealth (profits, financial performance) is lost, very little is lost; when health is lost (an unviable business model or plan), something is lost; but when character (integrity) is lost, everything is lost. Investors will do well to remember this.