Assessing Corporate Governance As A Ratings Driver For North American Financial Institutions

Summary Opinion

Moody's implemented a series of initiatives intended to strengthen the quality of our fundamental credit analysis and surveillance, following the large number of corporate defaults in 2001-2002. These initiatives included the hiring of specialists and the launching of the Enhanced Analysis Initiative (EAI). As part of EAI, Moody's has conducted systematic corporate governance reviews on more than 400 of the largest debt issuers in North America, including over 120 financial institutions.

As we have published our findings, we have tracked the degree to which corporate governance has been a key driver to an issuer's credit rating. In our recently published special comment, “Lessons Learned in Moody's Experience in Evaluating Corporate Governance in Major North American Issuers” (April 2006, 97401) we highlighted the overall frequency of corporate governance as a ratings driver.

In that report, we pointed out that governance has been more of a ratings driver for financial institutions (FIs) than for corporates. This trend reflects that FIs are relatively confidence-sensitive and that all of the FIs reviewed were investment grade.

However, we have seen variation by sector within the overall FI universe. This comment describes the major factors that directed our overall categorization of companies, refining it by industry.

Our key findings include the following:

- Governance practices are heavily influenced by the ownership structures in each sector. The mutual company structure in the insurance industry, for example, presents governance issues that are different from those associated with the family-ownership control structures so prevalent in the real estate investment trust (REIT) sector.
- The level of regulatory burden faced by financial institutions varies significantly across sectors, and higher levels tend to support higher quality governance.
- Board composition is characterized by the way the various industries in financial sectors have evolved in the last decade. For example, banks typically still appoint customers and affiliated directors to their boards, even as they grow more complex through acquisitions.

For several financial institution sectors, we have published detailed commentaries on the distinctive governance issues we have seen (see Appendix 1).
Overview

As noted in earlier special comment, we have sought to categorize the impact of an issuer’s governance—relative to its credit rating—in one of five ways:

- Governance is a credit strength
- Governance strengths from a creditor standpoint outweigh some weaknesses, but governance is not a ratings driver at this time
- Corporate governance is neither a positive nor negative factor in our rating at this time
- Governance weaknesses from a creditor standpoint outweigh strengths, but concern on governance is not a ratings driver at this time
- Governance is a credit challenge that could constrain future ratings improvements

Below, we show the frequency with which we have placed issuers in these categories by sector, and comment on the major factors driving our determinations.

Banking

As shows in Chart 1, for almost two-thirds of the 38 North American banks Moody’s has reviewed, governance was considered relatively strong or neutral as a ratings driver. For the remainder, governance was seen as being a relatively weak ratings factor. For eight banks, however, governance was believed to be a potential constraint on the bank's rating.

We have commented previously on some of the major governance features within banking. However, compared with other sectors, the overarching factors that affected our views on this industry’s governance were the following:

- **Strong regulatory framework provides solid foundation for governance.** Banking regulators focus heavily on controls and governance, and they set minimum requirements that go beyond those of most other sectors. Tough enforcement powers enable regulators to seek fast—and sometimes extensive—remedial action, where required.

- **A number of banks have faced control failures and regulatory problems.** A surprising number of banks experienced control failures over the past few years, despite a strong regulatory framework. These failures included a range of issues, such as weak compliance with anti-money laundering requirements, mutual fund trading irregularities, and accounting problems.

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In many of those cases, regulators mandated numerous companywide changes relating to risk management and controls, which we factored into our analysis as we weighed the strengths of subsequent improvements in these areas. Litigation settlements, mainly in banks’ capital markets activities, also highlighted weak governance and control structures.

- **Less-than-ideal board composition due to tradition and industry consolidation.** Bank boards, on average, are larger than boards in other sectors. In Moody's view, smaller boards are more effective. One reason for the size of bank boards was the appointment of “constituent” or related directors, representatives of corporate clients and, often, local real estate developers or lawyers.

This practice, albeit less common today, has limited a board’s ability to round out its director skill sets. It has also translated into a lack of relevant industry and large public-company executive experience. The appointment of directors who are former executives of acquired companies has also eroded the independence levels of boards in this industry.²

**Insurance**

Governance practices in the insurance sector varied significantly, as we have noted previously.³ Our evaluations of 28 North American insurers were generally positive, with almost 22 being viewed as having positive or neutral governance, as shown in Chart 2. However, for four insurers, governance was viewed as a potential constraint on their rating.

The key factors that influenced Moody’s view on governance in the industry included these:

- **Regulatory problems suggested problems with general governance.** The industry has faced a broad range of regulatory investigations in recent years. These investigations, which range across a number of areas and have been led by a disparate group of regulators, have made it difficult for Moody’s to assess the quality of each firm’s governance and culture. Many of the investigations focus on matters that are arguably tangential to corporate governance, such as the use of finite reinsurance and sales practices; nevertheless, the nature of the allegations have raised relevant questions about potential problems with individual corporate cultures, in our view.

- **The ownership structure of mutually held insurance companies has been interpreted as meaning good governance for bondholders.** The presence of mutual companies among the largest U.S. insurers distinguishes the industry from other sectors, where the public traded company model is dominant. The lack of any shareholder constituency means that executives of these companies are under limited pressure to pay out dividends and are under no pressure to generate market-level returns similar to those of publicly traded companies. Mutual insurers tend to have better capital cushions and retained earnings as a result. Moreover, independent directors can design compensation plans that discourage higher-risk growth strategies. On the other hand, concerns exist about director credentials compared with those of public companies and the relative insularity of these firms raise questions about a timely board response to any potential threats to the business.

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². Moody’s employs a narrower definition of director independence than the major U.S. stock exchanges, which typically consider a former manager independent after three to five years of retiring from their post. We usually deem these directors as less than fully independent.

³. See Moody’s “No Assurance of Good Governance: Observations on Corporate Governance in the U.S. Insurance Sector”, October 2005 (94705s)
Real estate finance and Government Sponsored Entities (GSEs)

Real Estate Investment Trusts (REITs)
Moody’s has highlighted previously the distinct governance features of real estate investment trusts (REITs). The key factors influencing our view on governance within the 15 U.S. REITs reviewed included the following:

- **A high proportion of large individual or family shareholders.** The presence of these shareholders was seen to help bondholders, due to a closer alignment of managerial and long-term shareholder interests, which we believe to benefit bondholders. Several REITs have remained under the control of the founding family or individuals, which highlights a strong, long-term commitment to the underlying financial health of the REIT. This alignment of interests between management and shareholders, which is patently less prevalent in more widely held firms, has provided stability and has enabled management to focus on long-term growth, thus protecting the interests of debtholders.

- **Higher-than-average presence of insider directors has revealed potential board challenges.** The presence of insiders (former management) or controlling family members on the board often constrained board independence, in Moody’s view. It also created oversight challenges for independent directors and could have dissuaded criticism of past strategies. The board’s influence on the CEO’s succession planning was seen as being more limited, in certain cases.

- **More formal, robust governance practices.** A number of REITs have improved governance by rounding out director skill-sets and structuring their board practices more efficiently. These improvements included the addition of independent directors and directors with financial expertise, as well as the appointment of a lead independent director. These changes have led to a higher level of board engagement on strategy and have strengthened audit and internal controls.

Government Sponsored Entities (GSEs)
Within the real estate finance portfolio, we also reviewed the four largest Government Sponsored Entities (GSEs). Two distinct factors influenced our views of the governance of these entities:

- **Fannie Mae and Freddie Mac suffered significant accounting, control and governance failures in recent years.** The extent of the problems was broad, with subsequent, wholesale changes in management and governance practices. The wide scope of the problems is best illustrated by the extended restatement periods and continued management turnover. Regulatory and other investigations are ongoing.

- **The cooperative structure of the FH L Bank System and Farm Credit Administration has let to both governance strengths and weaknesses.** Both systems have unique structures built upon cooperative ownership by system borrowers. These structures provided for an additional level of oversight among the system’s institutions and by their members, to varying degrees. The fact that the system’s banks are jointly and severally liable for the securities issued by the system was seen as a significant benefit for bondholders.

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4. See “Observations of governance in U.S. REITs—some weaknesses but getting better”, September 2005 (94031)
However, by design, these structures labor under the following constraints: (a) limited board independence; (b) no integrated leadership; and, (c) limited systemwide succession planning.

Financial guarantors and mortgage insurers

Governance was not seen as a negative ratings driver for any of the financial guarantors or mortgage insurers that Moody’s has reviewed, as shown in Chart 4. This was not surprising, given the fact the high ratings assigned to these companies are integral to their business models. The quality of governance practices varied, nonetheless. Key factors influencing our overall view included the following:

- **The financial guarantor sector includes a diverse range of ownership and governance structures.** Ownership structures have undergone change at a number of these firms. As a consequence, there was a marked variety in the approach to governance and the degree to which governance practices are embedded across the firm. For the start-up firms, practices were still taking shape and will be doing so for some time. In contrast, the long-standing public companies have had more time to develop and test their processes. The quality of governance for those entities that were subsidiaries of public companies was strengthened by the governance requirements placed on the parent companies. Moody’s took into account differing ownership structures in evaluating governance. However, we had relatively strict expectations of governance practices, given the high ratings assigned to these firms.

- **Conservative management culture has been found to benefit creditor interests, given the importance of credit ratings to strategy.** The importance of financial guarantors’ financial strength to the franchise and underlying value of the business was seen as aligning shareholder and creditor interests more closely. This alignment eased some of our overriding governance concern about management acting in the interests of shareholders, to the detriment of creditor interests. The same is true for the mortgage insurers, albeit to a lesser extent.
This group of 10 companies included a range of subsectors and ownership structures. The key factors influencing our view on the quality of governance included the following:

- **For several finance companies owned by major corporates, the main issue was the degree to which governance structures created some independence from the parent company.** The governance structures for General Motors Acceptance Corp. and Ford Motor Credit Company were relatively distinct, at least when compared to a typical subsidiary in a corporate structure. The governance “independence” helped support our existing view that a rating differential between the ratings of these entities’ and their parents’ ratings is warranted. In contrast, the tight integration of governance and operations between General Electric Capital Corp. and its parent supported our existing view that their ratings are inseparable from a ratings perspective.

- **For a couple of securities firms, succession planning was a critical concern.** Moody’s has reviewed the governance practices in all of the major securities firms, but we have not yet categorized the effect of governance on all of the firms. For two, we have done so: Morgan Stanley and Charles Schwab. In these cases, succession planning was a critical factor influencing our view. This highlights the importance of talent development and retention as key ratings issues in this industry.

- **For many firms in this sector, executive pay plans reflected a strong focus on shareholder returns and incentives linked closely to share price and EPS.** For firms like Capital One and SLM, executive and director compensation was focused heavily on shareholder metrics and concerns. Certain firms use stock options aggressively and earnings per share (EPS) as their chief performance metric for long-term compensation. We believe such shareholder-focused plans can foster a shorter-term management focus, which can conflict with bondholder interests.
Related Research

Rating Methodology:
Rating Methodology: U.S. and Canadian Corporate Governance Assessment, July 2003 (78666)

Special Comments: General
The Downside of Incentive Pay for Directors, April 2006 (97174)
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)
CEO Compensation and Credit Risk, July 2005 (93592)
Takeover Defenses and Credit Risk, December 2004 (89713)
Moody's Findings on Corporate Governance in the United States and Canada, October 2004 (89113)

Special Comments: Sector Specific
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 2004 (94705)
Observations of governance in U.S. REITs - some weaknesses but getting better, September 2005 (94031)
“Don't Bank on Strong Governance: Observations on Corporate Governance in US Banks”, August 2005 (93743)