



FINANCIAL MARKETS SUSTAINABILITY SUSTAINABLE FINANCE OPPORTUNITIES

Corporate Governance Finance

Why corporate governance?

Good corporate governance—well-defined shareholder rights, strong internal controls, high levels of transparency and disclosure, and an empowered board of directors—can improve a company's performance and profitability, and make it more attractive to investors and lenders. For this reason, corporate governance has become a hot topic in the business world, especially in emerging markets where governance improvements can improve a firm's access to capital and access to international markets. Financial institutions can offer corporate governance-targeted finance aimed at strengthening client business performance while enhancing credit quality and bottom line portfolio returns. This market has great potential and IFC specialists are uniquely qualified to help banks access it.

What are the opportunities for financial institutions in corporate governance finance?

- **Access to large market with high growth potential:** Financial institutions can extend corporate governance finance to any client company—including family-owned businesses, listed, newly-privatized companies, and small enterprises (SMEs)—making this a large potential market.
- **Lower credit risk:** Good corporate governance improves the management and credit-worthiness of companies, leading to stronger operational performance and reducing the risk of non-performing loans. An ABN/AMRO study showed that Brazilian firms with above-average corporate governance had ROEs that were 45% higher and net margins that were 76% higher than those with below-average governance practices¹.
- **Improved portfolio strength:** By improving the performance of client companies, financial institutions can strengthen their own bottom line portfolio performance. Rating agencies see institutions with good governance in a better light, which may lower the cost of capital for banks too.
- **Market differentiation:** Financial institutions well-acquainted with best practice corporate governance projects have value-added appeal to companies seeking to improve performance in competitive regional and international markets. Finance in this area may attract new business while acting as a cross-selling tool to serve existing clients with a more sophisticated product package.
- **Increased brand value:** Financial institutions can enjoy the reputational benefits associated with practising good corporate governance and promoting the same high standards with clients to increase their brand value with shareholders, customers, and policy makers.



“Better business performance, better credit quality, and better ratings show that **good governance pays**”

Good corporate governance attracts premium valuations:

- A 2002 McKinsey survey² showed that institutional investors would pay premiums to own well-governed companies, averaging 30% in Eastern Europe and Africa, and 22% in Asia and Latin America.

Companies with good governance perform better:

- A 2004 study of S&P 500 firms by Deutsche Bank³ showed that companies with strong or improving corporate governance outperformed those with poor or deteriorating practices by about 19% over a two-year period.

Good governance improves client credit risk:

- A report by FitchRatings⁴ found a statistically significant relationship between a firm's corporate governance and its credit quality, with stronger and weaker governance practices resulting in higher and lower credit ratings, respectively.

Good governance improves a bank's credit ratings:

- IFC spearheaded corporate governance improvements with Romania's Banca Comerciala Romana (BCR) to bring the bank into line with European Union standards. In 2005, FitchRatings and S&P upgraded BCR's ratings, citing improvements in corporate governance and risk management as the major reasons.

What are the key issues—questions to ask?

- **Portfolio profile:** What is the bank's existing portfolio profile? What types of companies could be a focus for corporate governance-targeted lending? What is the potential for market sizing? Are any client companies already adhering to best practice corporate governance standards?
- **Client capacity:** Can client companies meet the necessary corporate governance requirements (e.g. audited financial statements, business program, and succession planning)? What is their level of awareness and current corporate governance practices, if any? What level of technical assistance may be necessary to help client companies meet eligibility and performance requirements?

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- **FI products and processes:** What internal resources exist to support corporate governance-targeted lending? What is the current availability of medium-to long-term financing, and at what terms? How will loan size, pricing, segmenting and structure vary for corporate governance lending?
- **Monitoring and evaluation:** What is the bank's level of understanding of best practice corporate governance practices? Is technical assistance needed for internal training and institutional capacity building to implement this type of lending? How will the bank process and monitor this component of lending to clients, and over what timeframe? What actions will the bank take in case of default or non-improvement in corporate governance performance by a client?

How can IFC help?

IFC is developing corporate governance lending with leading banks in Brazil, Colombia, Mexico, Peru, and South Africa. IFC's offering includes:

- **Global expertise in corporate governance:** IFC is a leader among multilateral financing institutions in integrating corporate governance into all phases of the investment process. IFC works with partners across the financial spectrum to implement international corporate governance standards.
- **Flexible financing:** IFC offers medium- to long-term credit lines to support financial institutions to implement corporate governance-targeted lending to clients aimed at improving credit risk and business performance.
- **Corporate governance methodology:** IFC provides the methodological framework for financial institutions to implement corporate governance projects with clients. Adapted to banks' needs, IFC's framework measures client company management commitment, accountability and transparency over an agreed period at escalating performance levels.
- **Technical Assistance:** IFC can provide customized training and assistance to financial institutions during project implementation. In addition, IFC may be able to provide corporate governance technical assistance to banks' client companies.

References:

1. Corporate Governance in Brazil: Is There a Link Between Corporate Governance and Financial Performance in the Brazilian Market?, Bruno Erbiste, ABN AMRO Asset Management, July 2005.
2. McKinsey's Global Investor Opinion Survey, 2002.
3. Beyond the Numbers—Corporate Governance: Implications for Investors, Grandmont, Renato; Grant, Gavin; and Silva, Flavia, Deutsche Bank, April 1, 2004.
4. Evaluating Corporate Governance: The Bondholder's Perspective, Credit Policy, Special Report, FitchRatings, April 12, 2004

Deal Highlight: Corporate Governance Credit Line, Brazil

Purpose	US\$25 million credit line to support a Brazilian bank in extending corporate governance finance to clients
Financial institution	Leading commercial bank in Brazil
Borrower	Middle-market companies
Eligibility	Eligible firms meet predetermined corporate governance thresholds and agree to improve performance within an agreed timeframe (18 months)
Repayment	7 years
IFC role	Beyond financing, IFC worked with the bank to develop a flexible corporate governance methodology to evaluate client company performance
Project impact	Corporate governance has been such a popular business line that the bank approached IFC for additional financing in 2005. IFC's total sustainability credit line with the bank (including environmental projects) now stands at \$100 million.

Who to contact at IFC?

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