Supporting CG Scorecard Development in Colombia

Pricing SME corporate governance standards in bank credit risk assessment

Corporate Governance Standards Practice Group
Vienna, May 17-18, 2012
Overview

✓ Background: SMEs & CG in Colombia
✓ The normative framework in Colombia
✓ Towards deepening the implementation of CG standards – The Confecamaras-CIPE-SECO project
✓ The concrete challenge: developing a pricing model with CG scorecards for the commercial banking sector
Background – SME Corporate Governance issues (1)

25'000 registered SMEs in Colombia, 77% of which being family businesses, employing 75% of the formal work force while accounting for 33% of GDP.

95% of family businesses in Colombia do not have any detail regarding the functioning of the company in their legal status. Among family businesses, only 13% have established a family protocol, and only 47% comply with minimum legal requirements regarding the treatment of minority shareholders.

CG problems are associated with at least 30-40% of company liquidation and bankruptcies among SMEs. Among the most prominent weaknesses were the lack of transparency in management and family conflicts.
Only 30% of family businesses succeed in their transition from the first generation to the second generation.

SME loans accounted for 25% of the loan portfolio of commercial banks.

According to commercial banks, heterogeneity in SME activities, informality, unavailability and unreliability of financial statements, low managerial capacity of owners, and their family-owned nature complicate creditworthiness assessment and increase transaction costs.
The CG normative framework in Colombia

- Reform of the listing rules for large companies
- Capital market law (Law 964 of 2005)
- "Código País" regarding best corporate practices
- Colombian corporate governance guidelines for family & closed capital businesses
- Annual reporting requirements of Superintendencia de Sociedades
The project

➔ To strengthen company management & performance, and therefore enhance survival and reduce liquidation rates among SMEs
➔ To facilitate access to financing for SMEs and foster sustainable growth opportunities
➔ To strengthen the corporate governance culture among Colombian SMEs, as an important dimension of the overall investment climate

Pillar 1 – Local knowledge Management in Corporate Governance

- Design of training modules of corporate governance for Colombian SMEs & training of trainers
- Implementation of the CG training modules in at least 80-100 clients among SMEs nationally
- Strengthen the academic training curriculum on CG
Pillar 2 – Awareness Raising

- Organization of semi-annual information sessions for SMEs on the “Colombian Guide” in the 10 largest Colombian cities
- Organize two annual international fora of Corporate Governance,
- Form a “CG company circle” of the most successful SME companies
- Building a media and marketing strategy to promote good corporate governance practices at the SME level

Pillar 2 – Develop new incentives in the financial sector linked to CG

- Develop a concrete methodology for pricing corporate governance standards in credit risk analysis
- Information workshops with local Private Equity Fund Managers, Institutional Investors, and Commercial banks’ Risk Departments
The pricing pilot

The objective is to develop a pilot pricing product with the leading local commercial bank Bancolombia to be made available to the rest of the banking industry through ASOBANCARIA (Colombia’s banks association) as a public good.

The nature of the pilot pricing product to be developed would be similar to a “score card” focusing on various corporate governance dimensions taken from the “Colombian corporate governance guidelines for family & closed capital businesses” and would be integrated in the scorecard system used in standard credit risk analysis.

Module 1 – Management controls
Module 2 – Board organization
Module 3 – Board of Directors
Module 4 – Information Disclosure
Module 5 – Family businesses matters
The purpose is NOT to add one further requirement for getting access to credit, but to be able to positively discriminate potential clients exhibiting superior CG standards, recognizing that superior CG standards lower the risk of credit default and therefore lower the costs/risks of collateral foreclosure enforcement.
CG Scorecard(s) Development Process

- Create Project Working Group
  - Credit, Risk Management, Marketing, Information Technology + International expert

- Determine Scoring Strategy
  - Identify target group/segment & business growth objective

- Review & Identify Data Sources
  - Portfolio data, Access to external data bases (Superintendencia de sociedades)

- Select and Build Scorecard Type
  - Judgmental, Statistical, Hybrid Select and weigh risk factors

- Pilot Test Scorecard
  - Test on historic, hypothetical / new cases

- Deploy Scorecard in Software Platform
  - Integrate scorecard to credit risk process + streamline internal training and controls
Specific Challenges in building CG Scorecard(s) for Credit Risk Analysis

- Generic Check-List versus Discretionary Qualitative Assessment
- Highly heterogeneous Target Group (SMEs, closed capital Firms, family firms)
- Relevant CG Risk Factors and Weighting depend on Company Size and Type of Company/Market
- Risk Weighting and Risk Modeling
- Training & Communication

- 1 or several scorecard(s)?
- How to insure flexibility yet avoiding discretion?
Previous experience in CG Scorecard(s) for Credit Risk Analysis

Academic Methodology Development (2010), CEF Argentina

<table>
<thead>
<tr>
<th>Level</th>
<th>Weak</th>
<th>Medium</th>
<th>High</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level 1 – COMPLIANCE (normative framework &amp; regulations)</td>
<td>0</td>
<td>0.5 - 1</td>
<td>2 - 3</td>
</tr>
<tr>
<td>Level 2 – ORGANIZATION (Conflict prevention &amp; resolution)</td>
<td>0</td>
<td>0.5 - 1</td>
<td>2 - 3</td>
</tr>
<tr>
<td>Level 3 – BASIC PROCESS (internal control mechanisms)</td>
<td>0</td>
<td>0.5 - 1</td>
<td>2 - 3</td>
</tr>
<tr>
<td>Level 4 – COMPLEX PROCESS (advanced internal control mechanisms)</td>
<td>0</td>
<td>0.5 - 1</td>
<td>2 - 3</td>
</tr>
</tbody>
</table>

Bancol Real (M.Lubrano)
Others?
Next Steps

- Analyze Bancolombia’s credit risk assessment system       June 2012
- Draft International Consultancy TORs                      June-July 2012
- Recruit International Consultant                           August 2012
- Develop scorecard & pricing model                           December 2012
- Pilot testing                                              Q1 2013
- Banker’s Association Presentation                          Q2.2013
- Deployment & Monitoring                                    Q2-Q4 2013
Thank you!

Thierry Buchs
Head of Economic Cooperation
Embajada de Suiza
Cra. 9 N°74-08, Oficina 1203
A.A 251957 Bogotá, Colombia
Tel. + 571 349 72 30
Fax. + 571 349 71 95