



Corporate governance in Brazil, Chile, Colombia, Mexico and Peru

The determinants of risk in corporate debt issuance

Georgina Núñez
Andrés Oneto
(Coordinators)



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Preface

The sustained growth of corporate debt securities issues (both international and domestic) over the past few years is providing tremendous opportunities for financing business expansion in the countries of the region. The economic scenario in Latin America makes it likely that the proliferation of such instruments will encourage businesses to use them more. This new reality calls for a detailed analysis of this trend and its potential within the framework of good corporate governance.

The regulatory and institutional frameworks underpinning corporate governance in some countries of the region have seen significant advances. There have been changes in ownership structure, management practices and public policy and, more recently, in some key areas for the growth of capital markets. One of these is the role of institutional investors.

Some of these changes were in response to new market requirements and (given the experience of recent years) to certain excesses that cast doubt on the system's ability to monitor the performance of some market agents who endangered the stability of the financial system. But regulatory and institutional changes impact all businesses in a country, not just the large publicly listed ones, and so will be felt across the entire business spectrum.

For Latin American companies, family structure, high ownership concentration and the role of boards of directors are key issues to face when seeking to ensure transparency of information and corporate accountability.

The assessment based on the studies set out herein —prepared by acknowledged regional experts— will help to further progress in this area. This study builds on the *Corporate governance and development of capital markets in Latin America* report published by CAF-development bank of Latin America and the Economic Commission for Latin America and the Caribbean (ECLAC), which looked at the regulatory framework related to the principles of corporate governance in the region and assessed its contribution to the development of capital markets.

This book complements the previous study and is the result of a joint effort by CAF, the Inter-American Development Bank (IDB) and ECLAC to identify the key elements of corporate governance for determining debt instrument issuance risk in potential conflicts of interest arising from relationships among shareholders, executives and bondholders.

The conclusion is that changes in business culture and effective governance practice are needed, as is a comprehensive view of business that gives equitable weight to company decision-making bodies

(particularly boards of directors and corporate committees involved in the issuance of debt: investment, audit, risk and finance).

Adjustments to regulations governing the issuance of bonds are needed as well. The case studies herein look at regulatory frameworks and highlight the importance of identifying the key committees that should act and the specific role they should play. Taking international corporate governance standards as a benchmark would improve businesses' bottom line and go beyond mere compliance.

The conclusions of the book are aimed at improving management in corporate governance through prudential risk management and risk measurement and control in local, regional and international investment projects that ultimately result in effective and efficient debt securities issues. Responsible governance is key to financial stability, to attracting productive investment and to accessing financing and ensuring sustainable economic growth.

We believe that the findings and conclusions presented in this book, written in the framework of ECLAC-IDB-CAF cooperation, will help businesses in the region that are willing to implement responsible corporate practices take advantage of the market opportunities provided by the current economic climate. This will enable them to operate and meet their financing needs more efficiently and respond to the needs of developing countries, helping to improve the business environment in the region and regain the confidence of market players.

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Foreword by Mario Marcel¹

This book is hugely important and relevant for the development of markets in Latin America. Improving the quality of corporate governance is essential to bring down risk levels, boost competition, develop financial markets and ensure public trust in a region historically characterized by family businesses that are either large or are part of conglomerates or economic groups.

Given the limited development of stock markets in the region, addressing the issue from the perspective of the corporate bond market is a very appropriate choice. It gives this book considerable practical relevance with valuable implications for institutional investors who continue to expand their investment portfolios in Latin America.

By developing a specific methodology for evaluating the quality of business governance in corporate debt issuance, this book makes a specific contribution to the design and implementation of public policies in this sphere. Applying this methodology to the evaluation of a group of companies in three countries of the region shows the practical feasibility of the proposed instrument while providing relevant information on the most vulnerable areas of corporate governance in the countries reviewed. This will no doubt be of great value to stocks and securities market regulators, and institutional investors (insurance and pension funds).

For the vast majority of businesses in the region, substantive separation of ownership and management of smaller enterprises is non-existent and impossible. But for medium-sized and larger companies in Latin America, which are well on the road to internationalization, the potential for expansion could be limited by the heightened risk that arises from weak corporate governance.

The methodology proposal is a fundamental part of the book, since it includes a framework for assessing the quality of corporate governance that is then applied to companies in Brazil, Chile, Colombia, Mexico and Peru. This section is very well structured and could be enriched with a more thorough look at the components of the bond market, including other sources of corporate financing such as capitalization levels and bank loans; with more background information on the experiences of specific companies or sectors that were affected by the crisis; with more emphasis on the importance of greater cohesion among the committees identified as key in debt issuance ; with a broader look at

¹ Senior Director, Governance Global Practice at the World Bank.

economic conglomerates (especially those made up of companies with differing ownership and legal structures); and, finally, with more emphasis on aspects of corporate governance that have required regulatory changes. Among these is remuneration of directors and executives—a keystone in reforming the financial system of the United States.

The case studies herein are very useful for testing the applicability of the proposed measuring instrument and for illustrating specific corporate governance problems in the countries of the region. The assessment is enhanced by encompassing other actors in the financial system, such as rating agencies, institutional actors and investment banks.

For a subsequent phase of this project it would be worthwhile to take a separate look at parastatal and majority State-owned companies, especially because of their growing importance for the development of these countries and, indeed, because of the challenges in adapting some corporate structures in extreme cases of ownership dilution. It is no coincidence that the OECD has differentiated corporate governance standards for private and State-owned enterprises. A review of these three cases in a chapter devoted to State-owned enterprises would fit in nicely with the ongoing discussion of “State capitalism” in emerging countries.

Foreword by Alejandro Werner¹

This book represents an important contribution to the literature on the sources of financing for Latin American corporates. The topic is of extreme relevance and very timely, given that in the last few years corporate bond issuance, both in local and international markets, has skyrocketed. This has been the result of multiple factors, among them the deleveraging of bank balance sheets, the search for yield by investors in a low interest rate scenario and the improvements in credit ratings by many emerging market corporates. However, there is the fear among many analysts that this boom in corporate issuance might be creating some vulnerabilities such as foreign exchange mismatches, excess leverage and the mispricing of risk.

The book focuses on key issues to address conflicts of interests, asymmetry of information and corporate accountability that are crucial for the development of a healthy corporate debt market.

First, the book develops a set of indicators to measure corporate governance risk in areas relating to debt issuance that allows the evaluation of corporate governance across firms and countries and over time. These indicators address both the strength of the legislation and how it is implemented by corporates. This has been a key weakness throughout the region and therefore the development of a quantitative tool for evaluation is long overdue.

Second, the book looks at the role of investment banks and institutional investors as two additional actors that can potentially contribute to screening companies and setting the right incentives for corporates to strengthen their governance structure.

Third, the book covers, yet again, the role of rating agencies as another player that should be a key piece in generating market discipline and reducing informational asymmetries.

Fourth, the book contains several country and corporate case studies that are extremely useful to understanding the details of corporate governance in each of the countries covered. It also illustrates some of the recent corporate credit events that highlight areas where corporate governance have failed.

This work is an excellent tool that complements the analysis of corporate vulnerabilities in emerging markets that has been done by the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) and should be read by everybody that is interested in the development of corporate debt markets in Latin America. Additionally, to assess the strength of the corporate governance of the multiplicity of firms tapping the bond market, investors and regulators should use the analytical tools developed in this work.

¹ Director, Western Hemisphere Department at the International Monetary Fund.

Abbreviations and acronyms

ADR	American Depositary Receipt
AFORES	Retirement fund management companies
AFP	Pension Fund Administrators
AMIB	Mexican Association of Stock Traders
ANBIMA	Brazilian Financial and Capital Markets Association
ANDI	National Manufacturers' Association (Colombia)
ANDIMA	Brazilian Association of Open Market Institutions
ANEFAC	National Association of Finance, Management and Accountancy Executives
ANH	National Hydrocarbons Agency (Colombia)
ANIF	National Association of Financial Institutions
ASM	Alternative Securities Market
BCP	Peruvian Credit Bank
Banamex	National Bank of Mexico
BANOBRAS	Banco Nacional de Obras Públicas
BBVA	Banco Bilbao Vizcaya Argentaria
BIC	Banco Industrial Colombiano
BIS	Bank for International Settlements
BMV	Mexican Stock Exchange
BM&FBOVESPA	São Paulo Securities, Commodities and Futures Exchange
BNDES	Brazilian Development Bank
BRC	Bank of the Republic of Colombia
BVC	Colombia Stock Exchange
CAF	development bank of Latin America
CCE	Business Coordination Council
CEMEC	Capital Markets Study Centre
CETIP	Securities Custody and Financial Settlement Department
CFE	Federal Electricity Commission

CIEPLAN	Economic Research Corporation for Latin America
CJRL	Corporación José R. Lindley S.A.
CMN	National Monetary Council
CNBV	National Banking and Securities Commission
COFIDE	Financial Development Corporation
CONASEV	National Supervisory Commission for Companies and Securities
CONSAR	National Retirement Savings Commission
CRH	Cement Roadstone Holdings
CVM	Securities Commission
DANE	National Administrative Department of Statistics (Colombia)
EBITDA	Earnings before interest, taxes, depreciation and amortization
ECLAC	Economic Commission for Latin America and the Caribbean
ETF	Exchange Trade Funds
FED	Federal Reserve
FIDC	Credit Rights Investment Fund
FONACOT	National Fund for Employee Consumption
FONAFE	Fund for the Financing of Public Sector Companies
FOVISSSTE	Housing Fund for State Workers
FRC	Financial Reporting Council
GDF	Global Development Finance
IBGC	Good corporate governance index
IBGC	Brazilian Institute of Corporate Governance
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IMSS	Mexican Social Security Institute
INDECOPI	National Institute for the Defense of Competition and Intellectual Property Protection
INFONAVIT	National Workers Housing Fund Institute
KNOC	Korea National Oil Corporation
LSAR	Retirement Savings System Law
MILA	Latin American Integrated Market
Moody's	Moody's Investor Services Inc
NAFINSA	Nacional Financiera
OCENSA	Oleoducto Central S.A.
OECD	Organisation for Economic Co-operation and Development
OTS	The Office of Thrift Supervision
PRISMA	Integrated System of Evaluation and Internal Oversight Methods
RMBS	Residential Mortgage-Backed Securities
RMC	Ready Mixed Concrete Ltd
RNAMV	National Register of Stock Market Traders
RNVE	National Register of Securities and Issuers
RVNE	National Securities Register
SAR	Retirement Savings System
SBIF	Superintendency of Banks and Financial Institutions of Chile
SBS	Superintendency of Banks, Insurance and Pension Fund Administrators

SEC	Securities and Exchange Commission
SENER	Secretariat of Energy
SFH	Sociedad Financiera Hipotecaria
SMV	Superintendency of the Stock Market
SND	National Liabilities System
SP	Superintendency of Pensions
STRPM	Petróleos Mexicanos Workers' Union
SOX - SARBOX	Sarbanes-Oxley Act
SVS	Superintendency of Securities and Insurance
S&P	Standard & Poor's Financial Services LLC
TCAC	Tax Credit Allocation Committee
UDIS	Investment units (inflation-linked accounting unit)
VIF	Variance inflation factor
WACC	Weighted average cost of capital
WaMu	Washington Mutual Bank

Introduction¹

This book is part of the “Corporate governance and capital market development in Latin America” project. This multi-stage project has been a joint effort by several institutions —not only multilateral ones (CAF, IDB, OECD and ECLAC) but government institutions as well, such as superintendencies of securities and pension fund managers, along with development banks and private organizations such as stock exchanges, international and national credit rating agencies, investment banks and brokerage houses operating in Brazil, Chile, Colombia, Mexico and Peru (the countries covered by the project).

This book looks at some aspects of corporate governance development in these countries and how they are linked to risk assessment for international corporate debt issuance. It also examines the role of investment banks and rating agencies in determining the costs of corporate debt issuance and the growing importance of institutional investors as administrators of substantial resources, making for more efficient controls on the part of oversight agencies.

We view this as a relevant approach and have sought to add to it by analysing the role of each of the players (besides the companies themselves) in determining the cost of issuance and in capital market development. As underwriters, investment banks are responsible for structuring the securities to be issued and for identifying potential buyers, thereby encouraging capital market growth. Their operations also contribute to the development of the secondary market for debt securities when they use their capital to buy them. Rating agencies play an essential and irreplaceable role by flagging the potential for companies to default; they thus impact borrowing costs for the companies themselves. The interaction of all these stakeholders determines the final cost of bond issues, which consists of the primary spread and the underwriting fee as noted by Avendaño and Nieto-Parra in chapter III.

A broader definition of corporate governance is proposed, encompassing the role of companies’ internal control bodies in issuing such instruments. The contribution of corporate governance to transparency, accountability and the adoption of appropriate risk assessment methods is examined in order to further the deepening of capital markets in the region. And business operating parameters are defined in order to improve the design of public policies targeting institutional frameworks at the national level. Corporate governance encompasses three dimensions of business organization:

¹ The coordinators would like to thank Germano M. de Paula, Pedro Espinosa, Héctor Pérez Galindo and Héctor Lehuende for their comments.

ownership structure, management and senior management practices and public policies geared toward business, including issues related to public-private cooperation.²

Accordingly, a more substantive definition of corporate governance considers all of the entities that regulate the relationship between the actors who actually control and manage businesses under a power structure and thus become guardians of the rights of shareholders and others who invest their resources in them. These entities are public and private, formal and informal.

Some authors hold that the idea of corporate governance would only be relevant for companies whose shares are traded on the stock market and who are seeking to raise more capital by selling new shares or bonds. In developing countries (especially in Latin America) not many enterprises place shares or debt securities on the stock market, so it would logically follow that corporate governance would be of little relevance or would at least be limited to a small group of large companies.

The business perspective and tacit behaviours are generally very useful for identifying the actual everyday business practices that will influence the growth of capital markets in the region, regardless of enterprise size. Small enterprises account for more than 80% of all companies in the region, so there is no doubt that their behaviour impacts the overall corporate image and, therefore, the strengthening of capital markets.

Charles Oman, in his essay in the first book under this project, *Gobernabilidad corporativa, responsabilidad social y estrategias empresariales en América Latina* (2005),³ says that efficient corporate governance systems are more important for long-term economic growth than is generally recognized. For Oman himself (2001), good business practices include good performance on the part of institutions: “the core idea is that good corporate governance practices require good political governance, and vice-versa; meanwhile, economic development depends on both”.⁴ In short, if businesses in a developing region like ours are to be strengthened, they must, very early on, learn and apply appropriate corporate governance practices so as to improve the terms on which they access the capital they need to grow.

Accordingly, although the main changes in the institutional framework for corporate governance are geared above all towards large and medium-sized companies that are listed on the stock exchange and issue debt securities on organized markets (and are therefore able to cover any issuance costs), enterprises of all sizes should comply with the applicable regulations.

There are factors working for and against appropriate corporate governance in the countries of Latin America. Among the former is the growing importance of institutional investors such as pension funds. This is already driving a change in funding strategy for the business community in the region, because institutional investors manage a high volume of resources and are subject to more stringent oversight restrictions. Granting more robust guarantees for accessing these resources requires greater transparency and accountability in the conduct of governing bodies, enhancing corporate governance.

Among the unfavourable factors is concentrated ownership structure. In Latin America, family structure, high ownership concentration and the ineffective role played by boards of directors are blocking business information transparency and accountability, making it difficult to enforce even regulations that are already in place. Much of the current debate on the link between corporate governance and debt issuance falls under “agency conflict”, which concerns the relationship between shareholders, executives and bondholders. This is especially important in firms with a dispersed ownership structure, such as in the United States. But in Latin America, where concentrated ownership structures predominate, “expropriation” conflict is more relevant in that it sets the interests of majority shareholders against those of minority shareholders.

² Germano Mendes de Paula, João Carlos Ferraz and Georgina Núñez (comps.) (2005), *Gobernabilidad corporativa, responsabilidad social y estrategias empresariales en América Latina*, Bogota, Mayol Ediciones, 2005.

³ Charles Oman, “Gobierno corporativo para el desarrollo económico”, *Gobernabilidad corporativa, responsabilidad social y estrategias empresariales en América Latina*, Bogota, Mayol Ediciones, 2005.

⁴ Charles Oman, “Corporate governance and national development”, *Technical Paper*, No. 180, Paris, OECD Development Centre, 2001.

Any progress requires changes in the business culture of the countries and the effective implementation of best corporate governance practices. Although many of the countries of the region have seen significant improvements in the corresponding regulatory and institutional frameworks (some of which are associated with capital market reforms), there are, overall, still many weaknesses in compliance and performance at the company level. Some of the advances have been only partial, often due to the lack of a more integrated business approach giving equitable weight to the role of each of the decision-makers involved in corporate governance: the board of directors and corporate committees (investment, audit, risk and finance). None of the existing regulatory frameworks identifies or defines the role of specific committees involved in debt issuance.

In order to evaluate corporate governance performance in corporate debt issuance it is important to refer to international standards, most of them voluntary, as a way to go beyond mere compliance with applicable regulations and legislation.

According to the Organisation for Economic Co-operation and Development (OECD), weak corporate governance patterns discourage the use of capital markets as a means of intermediation in the economy; regulations foster more decentralized economic structures and development of capital markets. They also favour transparency and disclosure (the lack of which is an underlying factor in market instability) and contribute to the recovery of confidence.

One public policy recommendation encountered in the three stages of the project is to improve the quality of compliance and prudential controls with regard to best corporate governance practices, regulations and legislation. A useful benchmark for enterprises in the real sector is corporate governance performance at financial institutions —especially banks and pension funds, where the rules are stricter.

In recent years the United States Federal Reserve has reoriented its oversight activities to include a broader systemic approach, taking on new responsibilities as a supervisory authority for non-bank financial institutions.

Information delivery mechanisms such as regular factsheets on good corporate governance practices issued by public and private organizations in a number of countries, regulations such as the Sarbanes-Oxley Act for larger listed companies and differentiated levels proposed by Novo Mercado in Brazil contribute not only to the supply of information but also to transparency, accountability and disclosure.

Traditionally, banks have been considered the main source of short- and medium-term capital for enterprises. But changes in the structure of the financial sector (fewer IPOs) have made the option of issuing bonds, Eurobonds and other securities an attractive financing alternative for companies.⁵ According to figures from the Bank for International Settlements (BIS), Latin America accounted for almost 34% of the total stock of international corporate issues in developing nations in 2013. This points to growth potential in need of attention.

But enterprises in Latin America still face constraints in accessing financing through the capital markets. This does not do much to deepen the capital markets or to reduce information asymmetry for stakeholders.

This project involves building a matrix including the main strengths and weaknesses of corporate governance regulations directly related to the issuance of debt in Brazil, Chile, Colombia, Mexico and Peru. It also defines a number of standards in this regard in the light of regulations and enforcement mechanisms and establishes a benchmark based on corporate governance principles to strengthen bond issues and, when applied, generate market incentives and a legal regime that promotes the expansion of debt markets. The overall aim is an information delivery system that enhances issuance risk assessment by credit rating agencies.

⁵ Organisation for Economic Co-operation and Development (OECD), *The Role of Banks, Equity Markets and Institutional Investors in Long-Term Financing for Growth and Development. Report for G20 Leaders*, Paris, 2013.

From a corporate governance standpoint, debt issuance risks relate mainly to three aspects: (i) issuing company operations (management risks and risks related to the business environment); (ii) structure and workings of corporate governance and related corporate committees; and (iii) the interaction dynamic between the board of directors and committees and between both and executive managers. Comprehensive risk management requires having: (i) a financial investment committee, for investment policies and the corresponding oversight mechanisms; (ii) an audit committee, responsible for the internal control system; (iii) a risk committee to monitor the performance and risk of financial investments and financial instruments as well as internal control risks; and (iv) a corporate finance committee in charge of designing mechanisms and instruments.

The proposed methodological framework is focused on determining the feasibility of applying the corporate governance standards defined in the base document to selected enterprises in the five countries covered by the project. This exercise makes it possible to evaluate the processes and mechanisms for generating and transmitting internal information, to identify a structure for avoiding conflicts of interest between executives and corporate committees and, finally, to improve businesses' internal compliance mechanisms and external operations so as to limit issuance risks.

The book has 10 chapters, including the introduction and conclusions. Chapter I describes the methodological framework and proposes a set of standards aimed at improving performance at the main levels of corporate governance (board of directors and corporate committees) of enterprises that issue debt securities, as well as the risks they take on and those that are inherent to the securities issued. The purpose of the analysis is to propose a way to improve issuance ratings and thereby bring down the cost of corporate financing.

Pérez Galindo looks at the role of debt markets in corporate financing in some countries of the region, recommending that greater attention be paid to their development. A key reference point for this examination is the 2008 subprime mortgage crisis in the United States, which impacted debt markets elsewhere in the world, including Latin America. The author highlights two key points in this regard: (i) control systems in companies should inform internal governance bodies of overlaps between investment and finance and the risks they pose; and (ii) the models used by rating agencies for debt issues should include all the elements for a comprehensive assessment of the risks assumed by the issuers. This leads to the question of what factors of corporate governance and internal control systems at the enterprise level should be considered in order to accurately disclose debt issuance risks.

As for corporate governance and debt issuance, the author defines the role and structure of the board of directors (choice of internal and external board members) and identifies the relevant corporate committees (audit, financial asset investment, corporate finance and risk) and the part that each plays. The selection and definition of the standards proposed for each corporate governance category are based on a review of international standards. This new structure could certainly result in higher costs for businesses, but it could also mean greater medium- and long-term benefits in terms of more efficient capital markets that meet the growth needs of the economies of the region.

Lastly, Pérez Galindo and Pedro Espinosa Langle (author of the Mexico case study) defined an index based on a set of corporate governance standards that made it possible to structure metrics to help better reflect future debt issuance risks. This aspect is what sets the proposed approach apart from others. It also takes into account a number of elements such as the role of corporate governance and the impact of internal control systems on corporate debt issuance, which tend to fall outside traditional risk assessment measures. This calls for parameters that cover these aspects and make it possible to identify risk factors with significant repercussions vis-à-vis a company's future performance. The information gathered is consolidated by applying the indicator to three of the five selected countries in the region: Brazil, Colombia and Mexico.

Mendes de Paula, De Souza Ribeiro Silva de Almeida round out the analysis conducted by Pérez Galindo. They pick up on the description of the methodological framework and use the indicator

to qualitatively evaluate the performance of selected companies issuing debt in Chile and Peru at the main levels of corporate governance, the risks they assume and the risks inherent to those issues.

Applying the indicator to the cases in Chile and Peru, in addition to ensuring comparability of results with Brazil, Colombia and Mexico, allows for an assessment of processes and mechanisms for generating and transmitting internal information; identifying a structure that reduces the conflict of interest between executives and corporate committees; and enhancing internal enforcement mechanisms and external business operations in order to limit issuance risks. Including Chile, Colombia and Peru in the project is very timely because they became part of the Latin American Integrated Market (MILA) in mid-2009. Mexico joined recently.

In chapter II, Mendes de Paula and others add to the analysis of the corporate governance and debt issuance indicator by looking at the role of three key players in corporate debt issuance: rating agencies, investment banks and institutional investors.

The authors examine recent trends in international corporate debt issuance against the backdrop of corporate governance practices and improving issues ratings in order to bring down the cost of corporate financing. They compare this process with the development of debt markets in other regions of the world; their role in corporate finance in developed and developing countries and by geographic region; and the role of the three agents mentioned earlier. The chapter stresses that the growing value of corporate debt issues in recent years calls for paying more attention to the evolution of these markets. International issues in the region are concentrated in Mexico and Brazil, which together accounted for 66% of the total in 2011-2013. The same applies to domestic-market issues, where the two countries made up 88% of the total for the region during the same period.

In chapter III, Rolando Avendaño and Sebastián Nieto-Parra⁶ analyse the determinants of the costs of issuing corporate bonds in emerging countries during 1991-2009, based on underwriter (investment bank) reputation and placement spreads associated with debt issuance risk (rating agencies). Within the sample of firms that make up the base, Latin America accounts for about half the number of issues and some 40% of the total value issued. The authors conclude that the bond market has shown significant growth in recent years and is seen as a potential source of funding for companies. That is why more effort should be put into structuring more efficient corporate governance practices in order to support the development of these markets.

In chapter IV, Mendes de Paula, De Souza Ribeiro and Silva de Almeida review the debt securities issuance process in Brazil within a governance framework. Brazil's bond market has grown substantially in recent years and is viewed as a potential source of funding for companies. This is due mainly to positive factors such as economic stability after the Real Plan, business financing needs, a banking system that has limits as a source of long-term financing, and appropriate infrastructure for debt market operations. Other factors that are not as positive include the demand for sovereign debt securities which, by the way, adversely impacts the Brazilian corporate bond market. To compensate for this, the Brazilian Development Bank (BNDES) has entered the market by purchasing securities in public offerings. This has enhanced its role in the expansion of financing for companies and in deepening the secondary market.

Mendes de Paula and others examine six Brazilian companies to show how corporate governance has furthered risk management and debt securities issuance. Thanks to the creation of differentiated segments of the Brazilian Securities, Commodities and Futures Exchange, including the Novo Mercado segment, the concept of corporate governance has permeated much of Brazil's business community, although it is also recognized that much remains to be done.

It will be a while before corporate governance becomes a major driver of capital markets. But the creation of these levels has made it possible to identify companies that adopt good corporate governance practices; this is leading to greater confidence in the market. The authors regard corporate governance

⁶ OECD Development Centre analysts.

as an appropriate tool for optimizing the relationship between principal and agent, and between them and bondholders. It also boosts the availability of information, which helps creditors assess the actual operating risks of the business.

In chapter V Alvaro Clarke documents the case of Chile, tracking the development of the capital market (including the bond market) as it evolved along with changes in the corporate governance framework. The author delves into corporate governance legislation and standards as well as debt market dynamics. He stresses the role of the board of directors and the election of a majority of directors, including independent ones (many of them backed by institutional investors) in creating a more effective control environment within the board of directors and the general meeting of shareholders, which is responsible for a company's borrowing decisions.

In addition to capital market reforms, other elements arising from regulations have impacted corporate governance. Among them are wider financial system intermediation margins that encourage long-term indebtedness, as well as the increased presence of institutional investors. Chile's international corporate debt stock was equivalent to 10.3% of GDP in 2012, the highest ratio in the region. The same is true of its stock of domestic corporate debt, which was equivalent to 38.3% of GDP in 2012. The indices for the selected Chilean companies were relatively high (at least 72% of the benchmark). The four subject companies showed good legal and regulatory compliance; the State-owned company stood out because it made the largest effort to structure support committees (in the areas of projects, financing and auditing).

In chapter VI, Eulalia Sanin and Santiago Arteaga analyse capital market development in Colombia, including the bond market, which is still constrained by the concentration of ownership. They identify improvements arising from a combination of favourable micro and macro factors, regulation, low interest rates and wider intermediation margins in the financial system that encourage long-term borrowing, and the increased presence of institutional investors. They note the contribution of bond issues to capital market deepening as they increasingly become a financing alternative for medium-sized and large enterprises in Colombia. However, this opening is still concentrated in the stock market. The debt market is still focused on AAA and AA+ rated bonds issued by large companies,

Progress in the field of corporate governance has been grounded in the Country Code and in Law 964, as well as in the mandatory annual Country Code survey, which provides the market with information on corporate governance.

In chapter VIII, Espinosa Langle documents the Mexico case study. Despite major advances in the corporate governance regulatory framework, the standards display a certain bias that is mainly due to a concentrated, family-capital structure. The author notes that the 2008 international financial crisis exacerbated agency issues between creditors and shareholders, as seen in two of the documented cases. In this context, corporate governance came to play an important role (albeit a voluntary one because of a number of incentives and the influence of regulations from foreign countries like the United States). To the extent that corporate governance facilitates the harmonization of interests of different groups around a company's performance, it is more cost-effective and self-sustaining.

As in the other cases, the Mexican corporate debt market has shown steady growth that is increasingly impacting the capital market and the way that firms finance their investment projects. However, it still represents barely 16% of the market and thus stands in contrast to the government debt market and the equity market. Since 2001 senior bonds have been the most widely-used instruments; the main buyers are institutional investors, specifically for paper rated AAA.

Espinosa, however, sees corporate governance as a necessary but not indispensable condition for the success of a debt issue and concludes with the list of recommendations drawn up by Hull (2007). The latter stresses the importance of not dodging the obvious precepts of a culture of foresight, such as setting clear and unambiguous risk limits, penalizing going over limits on increases and decreases, holding to the criterion of business and investment portfolio diversification, constantly reviewing positions in a

scenario context, monitoring the position evaluation function of model risk and monitoring liquidity risk, especially in financial crisis conditions.

Chapter IX looks at Peru. Jorge Echeandia shows how recent corporate governance regulatory framework and financial market reforms have meant significant progress in terms of providing enterprises with financing at competitive rates. The factors contributing to this new scenario in Peru include economic growth, improved regulatory frameworks, macroeconomic policies, local-currency stability and equal treatment of domestic and international investors. One concrete result is the growing stock of international corporate debt in Peru in recent years, which reached the equivalent of 6.1% of GDP in 2012; the stock of domestic corporate debt stood at 9.3% of GDP in 2012.

Peru's Stock Exchange has developed special mechanisms such as the Alternative Securities Market (MAV) for small and medium-sized enterprises to enter the stock market and thus boost their potential for accessing cheaper funding, although requisites and reporting requirements are initially lower. The average corporate governance indicator values were satisfactory, exceeding 50%. As will be seen later on, in all cases the board of directors played an active role as the body responsible for authorizing the issuance of corporate bonds specifically approved by the general meeting of shareholders, which also sets the limits on board of directors autonomy. As in Chile, the company posting the best performance according to the proposed indicator was the State-owned one.

The closing chapter sets out the main considerations regarding the contribution of the five countries to the overall corporate governance index presented herein, which substantively validates the instrument in terms of the increasing volume of corporate issues and the strength of the regulatory and institutional corporate governance frameworks in these countries.

I. Corporate governance and risk identification for debt instrument issuance in Brazil, Colombia and Mexico: a methodological proposal

Héctor Pérez Galindo, D. Eng.¹

A. Project background and scope

The Economic Commission for Latin America and the Caribbean (ECLAC), CAF-development bank of Latin America and the Inter-American Development Bank (IDB) have set out together to continue the work begun in 2008-2009 and take a deeper look at corporate governance and capital market development² in Latin America and their impact on the development and growth of capital markets. This stage of the project focuses on issuance of corporate debt securities —particularly the identification of issuance risks in the framework of corporate governance practices and how they shape those risks. To that end, documented cases of companies and experiences with corporate governance regulation and oversight in three countries (Brazil, Colombia and Mexico) were reviewed. The review was subsequently expanded to Chile and Peru.

Corporate governance has improved not only in terms of regulatory frameworks in the countries of the region, as can be seen in ECLAC-CAF documents (Nuñez, Oneto and Mendes de Paula, 2009), in the OECD-World Bank Group report (OECD/WBG, 2009) and in the comparative study on corporate governance regulations and practices in Argentina, Brazil, Chile, Colombia, Mexico, Panama and Peru conducted by OECD/IFC (2010). There have also been significant efforts to standardize corporate governance practices by designing international, regional, subregional and national codes of best practices, many of which are widely recognized by the market as a whole as the main benchmark for corporate governance. Some examples are the OECD Principles of Corporate Governance (2004), the CAF Guidelines for an Andean Corporate Governance Code (2006), the Code of Best Business Practices of the Business Coordination Council of Mexico (CCE, 2010), the Code of Best Corporate

¹ The author would like to thank Manuel Gerardo Flores at the OECD in Mexico and the other participants in the expert workshop held in Mexico City in September 2011 for their comments. Any errors or omissions are the sole responsibility of the author.

² For the purposes hereof, corporate governance shall mean the board of directors and the board committees.

Governance Practices of the Brazilian Institute of Corporate Governance (IBGC, 2009) and the Code of Best Business Practices of Colombia (Superintendency of Finance, 2007). And there is substantial work under way at the international and national level to design metrics for showing progress on the issue and identifying strengths and weaknesses in the workings of corporate governance.

This analysis focuses on a review of widely accepted corporate governance principles and agency conflicts surrounding debt issuance, which is gaining ground as a way for companies in the region to fund their investment projects. There will also be a discussion of matters related to mandatory corporate governance regulations and to rating debt security issues.

Selected case studies in Brazil, Chile, Colombia, Mexico and Peru examine key aspects of corporate governance that are directly related to debt security issuance, taking as a reference international standards that will be discussed herein.

In line with the above and with the findings of the case studies from these countries, a proposal for designing standards aimed at improving performance in the main areas of corporate governance in the issuance of debt instruments will be analysed in order to provide a more accurate picture of the risks inherent in securities issuance. The goal is, in addition to improving corporate governance, to have a positive impact on issue ratings and thereby bring down the cost of corporate financing.

Following this introduction, this chapter is divided into sections as follows. The second section provides a context by describing the size and importance of debt markets as a source of financing for companies and the solvency challenge that some companies face immediately after issuing investment-grade debt. Such challenges, by the way, arose during the 2008 subprime mortgage crisis. There is a brief overview of trends in international and domestic corporate debt securities markets in the region from 2001 to 2011 using figures from the Bank for International Settlements (BIS) on the main Latin American issuers. Debt market trends through 2013 will be discussed in more detail in the chapter by Mendes de Paula, de Souza Ribeiro and Silva de Almeida.

The third section provides a summary of the causes of the 2008 crisis and how it affected debt issuance, where credit risk rating agencies played a crucial role. In the next chapter, Mendes de Paula and others take a more detailed look at rating agencies.

The fourth section sets out an analytical framework for corporate governance guidelines and standards whose adoption leads to upgrades of debt instrument issues. These standards aim to serve as benchmarks for more complete risk ratings by expanding the range of risks assumed by issuing companies.

The fifth section provides a set of indicators intended to reflect corporate governance risk in areas directly related to debt issuance.

The closing section groups indicator findings for each of the case studies, sets out some final thoughts and recommendations based on these findings and identifies a number of factors to consider in order to achieve effective adoption of the proposed corporate governance standards, thereby improving company performance in terms of debt issuance.

B. Brief history of corporate debt issuance in Latin America

During the decade from 2001 to 2010, the main issuing countries for corporate debt securities in Latin America (Argentina, Brazil, Chile, Colombia and Mexico) together posted 128.4% growth in such securities outstanding (domestic and international issues combined). With the exception of Argentina, which saw a 39% decrease, the rest of the countries recorded growth during the period. The total outstanding climbed from US\$ 73.7 billion at the end of December 2001 to US\$ 168.2 billion in December 2010 (see figure I.1). Brazil, Chile and Mexico, with US\$ 38.2 billion, US\$ 41.1 billion and US\$ 73.8 billion, respectively; they account for 91% of the total.

Figure I.1
Corporate securities (domestic and international) outstanding as of December of each year, 2001-2010
(Billions of dollars)

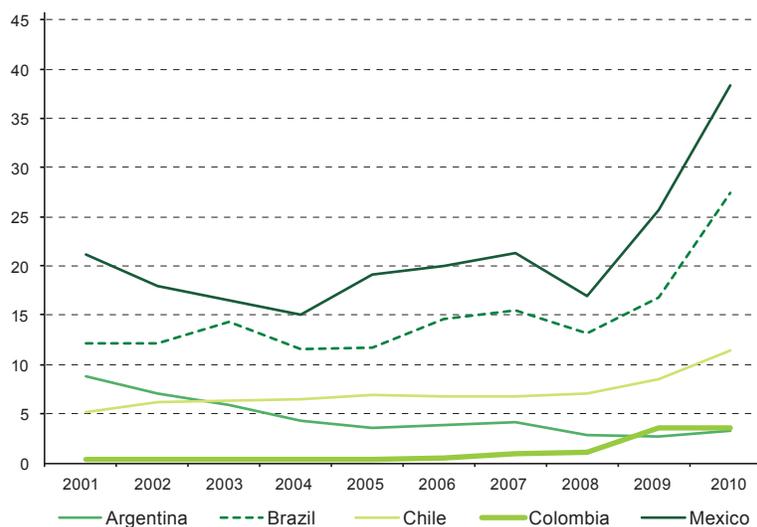


Source: Bank for International Settlements (BIS).

In 2008 the figures dropped off substantially in all of these countries except for Chile and Colombia, coinciding with the subprime mortgage crisis. This decrease can be attributed to market volatility and skepticism vis-à-vis new corporate bond issues. Nevertheless, the years after 2008 saw sustained growth in four of the five countries. The amounts outstanding in 2010 for Brazil, Chile, Colombia and Mexico were well above those posted in 2007. Despite the crisis, then, corporate bond issuance continues to play an increasingly important role in Latin America.

Disaggregating total domestic and international corporate securities outstanding provides a more complete picture. Figures I.2 and I.3 track them over time. During this period, Peru was a major issuer of domestic corporate securities; its balances reported by the BIS topped those of Colombia (US\$ 4 billion) although they are not included in the figures because BIS statistics do not report data on international corporates.

Figure I.2
International corporate debt securities, outstanding as of December of each year, 2001-2010
(Billions of dollars)



Source: Bank for International Settlements (BIS).

Figure I.3
Domestic corporate debt securities, outstanding as of December
of each year, 2001-2010
(Billions of dollars)



Source: Bank for International Settlements (BIS).

There are two major factors to be examined. The first is the contribution of domestic and international corporate debt securities to the total increase in the amount outstanding. The second is what happens when the mix of instruments outstanding changes. The idea is to highlight the growing importance of corporate debt securities.

As of December 2010, total outstanding domestic and international corporate securities were just about the same (US\$ 84.3 billion and US\$ 84.0 billion, respectively). However, domestic securities saw more substantial growth: 223.8% during 2001-2010 (from US\$ 26.0 billion in December 2001); international securities increased by 76.3% over the same period (from US\$ 47.7 billion in 2001). This shows how dynamic domestic corporate securities markets are. Brazil, Chile and Mexico accounted for 13%, 35% and 42%, respectively, of the total value of domestic security issues as of December 2010, and for 33%, 14% and 46% of the total for international securities.

As for the ratio of domestic corporate securities to international corporates and the aggregate increase in both, out of a total increase of US\$ 94.6 billion in 2001-2010, domestic securities accounted for US 58.300 billion and international securities accounted for US\$ 36.300 billion. This means that domestic securities contributed 79 percentage points of the 128% total increase and international securities contributed 49 percentage points of the increase.

A breakdown by individual country yields the following results: Brazil and Colombia posted the largest increase in international corporate securities outstanding; Chile and Mexico showed the largest increase in domestic ones. Argentina recorded decreases in both types of securities; the decline was sharper for international securities.

Table I.1 tracks the mix of domestic and international securities outstanding.

As shown in table I.1, the ratio of total domestic and international corporate debt outstanding is 35% to 65%, respectively, as of December 2001, with a 50%-50% split as of December 2010.

Table I.1
Corporate debt securities (domestic and international) outstanding
as of December of each year, 2001 and 2010
(Billions of dollars and percentages)

	2010				
	Domestic		International		Total
	<i>(billions of dollars)</i>	<i>(percentages)</i>	<i>(billions of dollars)</i>	<i>(percentages)</i>	<i>(billions of dollars)</i>
Argentina	6.5	66	3.3	34	9.8
Brazil	10.7	28	27.4	72	38.2
Chile	29.7	72	11.4	28	41.1
Colombia	1.8	34	3.6	66	5.4
Mexico	35.5	48	38.3	52	73.8
Total for five countries	84.3	50	84.0	50	168.2
	2001				
	Domestic		International		Total
	<i>(billions of dollars)</i>	<i>(percentages)</i>	<i>(billions of dollars)</i>	<i>(percentages)</i>	<i>(billions of dollars)</i>
Argentina	7.3	46	8.8	54	16.1
Brazil	2.8	19	12.1	81	14.9
Chile	6.1	54	5.2	46	11.4
Colombia	0.2	36	0.3	64	0.5
Mexico	9.5	31	21.2	69	30.7
Total for five countries	26.0	35	47.7	65	73.7

Source: Bank for International Settlements (BIS).

The statistics show surging corporate debt issuance in capital markets, especially for domestic securities. This directly impacts corporate financing through the capital markets, specifically the corporate debt markets. This is such a significant trend for the financial markets of Latin America that the following sections will focus on the components of corporate governance that are useful for improving the corporate debt issuance process by reducing real and perceived issuance risk and, therefore, issuance cost. The outcome is stronger capital markets and support for corporate financing through debt.

C. The subprime mortgage crisis and its impact on the issuance of Latin American debt securities

The so-called structured finance products that were engineered and sold in the second half of the past decade were among the causes of the crisis that broke out in 2008 and of the problems with debt securities whose issuers went bankrupt soon after placing them in the market despite an investment-grade rating. It is therefore useful to highlight the main causes of the crisis (even though it is not the main subject hereof) so as to provide a context for the focus of the project: corporate governance in the issuance of private debt securities.

1. Report on the financial crisis of 2007

The report on the investigation conducted by the Permanent Subcommittee on Investigations of the United States Senate (2011) into the causes and origins of the financial crisis that began in 2007—and whose impact is still being felt—was released on 13 April 2011.

Early in the report it is stated that “the crisis was not a natural disaster, but the result of high risk, complex financial products; undisclosed conflicts of interest; and the failure of regulators, the credit rating agencies, and the market itself to rein in the excesses of Wall Street”.

The Subcommittee examined evidence and set out conclusions showing how “high risk lending by U.S. financial institutions; regulatory failures; inflated credit ratings; and high risk, poor quality financial products designed and sold by some investment banks, contributed to the financial crisis”.

According to the report, the root causes of the financial crisis were high-risk lending, inflated credit ratings, regulatory failures and investment bank abuses.³

2. High risk lending and inflated credit ratings

Midway through the past decade a large number of banks in the United States originated low quality (subprime) loans. These loans began to be securitized, giving rise to high risk, low quality financial products called Residential Mortgage-Backed Securities (RMBS) and Collateralized Debt Obligations (CDOs) that paid higher than average market rates because of their risky nature.

Although the RMBS and CDOs were backed by poor-quality loans, between 2004 and 2007 the rating agencies Standard & Poor’s Financial Services LLC (S&P) and Moody’s Investor Services Inc. (Moody’s) handed out investment-grade ratings⁴ to thousands of RMBS and CDOs. These ratings did not reflect the true risk of these products, which were built on subprime mortgage loans. Why did this happen? According to the report, “the Subcommittee identified multiple problems responsible for the inaccurate ratings, including conflicts of interest that placed achieving market share and increased revenues ahead of ensuring accurate ratings”. “Inaccurate AAA credit ratings introduced risk into the U.S. financial system and constituted a key cause of the financial crisis.”

Thanks in part to business practices at several financial institutions that did not disclose the real condition of RMBS and CDOs, coupled with investment-grade ratings and expectations of high yields, these instruments flooded the markets.

From 2004 to 2008 financial institutions issued nearly US\$ 2.5 trillion in RMBS and nearly US\$ 1.3 trillion in CDOs backed by subprime mortgage loans that were sold worldwide. Among the buyers of these high-risk instruments were the issuing banks themselves, specialized financial institutions and industrial and commercial enterprises.

Subprime loans began to turn delinquent in 2006, triggering in turn defaults on the RMBS and CDOs backed by such loans. In July 2007 the RMBS and CDO default rate increased; that same month, S&P and Moody’s downgraded to below investment grade the AAA and Aaa ratings they had given to tens of thousands of these securities in 2006 and as late as 2007. The value of these financial products then collapsed, causing huge losses to banks, companies and investors who had bought them.

3. Regulatory failures and investment bank abuses

The report provides examples of investment banks that, aware of the declining value of subprime mortgages, sold RMBS and CDOs backed by such loans to their customers during 2006 and 2007, without disclosing the imminent loss of value of these structured finance products. Referring to this situation, the report concludes that “investment banks were the driving force behind the structured finance products that provided a steady stream of funding for lenders originating high risk, poor

³ A detailed sequence of the events leading to the financial crisis is described in Núñez, Georgina and Helvia Velloso, “El papel de la gobernanza corporativa en la recuperación y el desarrollo de los mercados de capital en Estados Unidos” (Núñez, Oneto and Mendes de Paula, 2009).

⁴ Investment grade ratings range from AAA to BBB- and Aaa to Baa3 according to the definitions used by S&P and Moody’s, respectively. Any rating below BBB- or Baa3 is considered “below investment grade”.

quality loans and that magnified risk throughout the U.S. financial system. The investment banks that engineered, sold, traded, and profited from mortgage related structured finance products were a major cause of the financial crisis”.

As for regulatory failure, the report notes that inaction by regulatory and supervisory agencies to stop bad practices on the part of financial institutions issuing high risk loans and low quality structured finance products was one of the factors that contributed to the bankruptcy of several institutions and companies that invested in them, and of issuing banks that held such instruments in their own portfolios. As a case in point the report says that “OTS”⁵ failure to restrain Washington Mutual’s unsafe lending practices allowed high risk loans at the bank to proliferate, negatively impacting investors across the United States and around the world. Similar regulatory failings by other agencies involving other lenders repeated the problem on a broad scale. The result was a mortgage market saturated with risky loans, and financial institutions that were supposed to hold predominantly safe investments but instead held portfolios rife with high risk, poor quality mortgages”.

4. Impact of the financial crisis on issuance of debt securities

To what extent did the financial crisis of 2008 (where the key players were subprime mortgages and low quality structured finance products) impact issuance of corporate debt in Latin America and elsewhere?

The boom in RMBS, CDOs and other structured finance products was fuelled by their high credit ratings and by buyer expectations of high yields. Among the buyers were institutional investors and treasury units of commercial and industrial enterprises, whose main failure was not properly assessing the real risks they were taking by investing in these financial products.

Some companies participated as issuers in the financial markets, placing debt securities that were rated investment grade. But these ratings did not accurately represent issuer credit risk because they did not reflect their portfolios of structured finance products backed by subprime mortgages.

The financial crisis in 2008 sent the value of these products plummeting. This resulted in losses for buyer companies, causing them serious solvency problems and eventually pushing them into bankruptcy. For buyer companies that had in turn issued debt securities, this meant that the obligations deriving from these securities were not honoured, triggering a cascade of substantial losses for investors who had bought them.

Here the analysis splits into two broad lines that are the focus of this report:

- (i) The fact that a company invested in high risk financial products and shortly thereafter issued debt securities for funding purposes raises the following question. Did that company’s internal control systems warn its governing bodies of the overlap between investment and funding and of the risks involved? Was there corporate awareness that this was happening in the company? Did the board of directors and its internal committees fail in their due diligence and involvement in the business the company was getting into?
- (ii) Debt securities issued by firms holding high risk structured finance products were rated investment grade by the rating agencies despite their investment portfolio risk. The models used by the agencies to rate bond issues were unable to weigh all of the factors for an accurate assessment of the risks assumed by the issuing companies. What factors related to corporate governance performance and internal control systems should be considered in order to accurately disclose debt issuance risks? What kind of metrics could be used for this?

⁵ OTC (Office of Thrift Supervision) is the United States regulatory agency charged with bank-like financial institutions called “thrift institutions”, several of which issued high-risk loans and packaged them in high-risk, low quality structured finance products.

In connection with these lines of analysis, section D lays out a set of standards to ensure that corporate governance rules apply to the issuance of debt securities. They have to do with factors related to corporate governance performance and internal control system effectiveness that must be considered to ensure accurate disclosure of debt issuance risks.

As for the kind of metrics that could be used, section E suggests a set of parameters and an index for grading areas of corporate governance performance and internal control system effectiveness directly related to debt issuance. Neither the parameters nor the resulting index are geared towards evaluating overall corporate governance performance; they are just a preventive benchmark for identifying components that should be enhanced in order to minimize debt issuance risks and therefore provide an accurate perception of them. This would improve the terms for placing such securities in the market and bring down the costs for the issuing company.

D. Corporate governance standards

Over the past decade the spotlight has fallen on different aspects of corporate governance practices and standards. This section has been drafted bearing in mind the standards, guidelines and best practices that have been extensively analysed by a number of agencies and institutions. The contribution of this review is to highlight those standards that directly impact the risk rating of debt security issues. These standards are complemented by recommendations drawn from the author's direct experience in several companies as a member of the board of directors and board committees, as senior executive and as the person in charge of implementing corporate strategies, operational risk management schemes and internal control systems.

In addition to the above, the standards have been examined and identified on the basis of case histories of Latin American companies that issued debt and fell into default, where there were serious weaknesses in the way that the corporate governance system monitored execution of the business strategy and implementation of effective risk management schemes. The purpose of these standards is precisely to correct these weaknesses —far from a trivial task because in more than a few cases companies comply with internationally recognized standards on paper but not in fact. That is why despite having faced critical situations that drove a number of companies into bankruptcy, some boards of directors would argue that they have implemented appropriate corporate practices.

The indicator was designed on the basis of research on corporate governance guidelines taken as a starting point, and drawing from a range of sources with a general approach. Annex 1 to this chapter contains a comparative analysis between the indicator proposed (the benchmark) and the various initiatives adopted in the United States on corporate governance issues, two of which —Sarbanes-Oxley and Dodd-Frank— arose from financial crises, as well as the Basel provisions on financial institutions. The focus of the indicator is unique in the sense that the standards have been extracted and, in some cases, adapted to target those with direct impact on corporate debt issuance risk. In no case do these standards seek to assess overall corporate governance performance. The proposed standards should be interpreted as identifying those areas of corporate governance to be maintained or improved so as to lower the perceived risk of debt issues.

A company's good performance is related to the business environment in which it operates, and to the components of management. Two of the most important components of management are, first, the corporate governance model and how it works and, second, internal control system structure and effectiveness. Any weakness in either of these two components means that there is no guarantee that good performance will be enough to mitigate future high- impact risks for the company that will inevitably increase business risk. This is a key consideration when a company is weighing the risk inherent to issuance of a debt instrument. We are thereby introducing the basic concept of future risk management.

In this section we set out an analytical framework and establish standards regarding the roles and responsibilities that the board of directors and some of the board committees should take on in order to minimize enterprise risk and, consequently, the risks associated with debt issuance. Compliance will generally favour good corporate governance performance, timely and accurate disclosure of relevant information, effective operation of the internal control system and responsible action when a company issues debt securities. In some of the standards a direct link can be seen, as is the case with how a risk committee works. In others, the relationship is not necessarily direct but is still relevant, as is the case with selecting members of the board of directors: an inappropriate appointment increases the likelihood of a poorly performing debt issue.

Compliance or non-compliance with these standards is a risk indicator for investors and other persons and institutions related to the company, and it provides more complete information on the company's business risks. The proposed indicator has no room for "degrees of compliance". If the proposed standards are not fully met, no value is generated. Compliance assessment is, accordingly, binary: there is either compliance or there is not.

The standards are grouped into the following categories:

- (i) Role of the board of directors
- (ii) Structure of the board of directors
 - (a) Chair of the board of directors
 - (b) Selection of directors
 - (c) Outside directors
 - (d) Inside directors
- (iii) Board of directors committees
 - (e) Audit committee
 - (f) Financial asset investment committee
 - (g) Corporate finance committee
 - (h) Risk committee
- (iv) Evaluating the performance of the board of directors

1. The role of the board of directors⁶

The board of directors is made up of directors and is collectively accountable to shareholders and investors for the company's operations and its success or failure. The board is responsible for setting business and corporate social responsibility goals and for laying out a strategy for achieving them. It is also responsible for monitoring and assessing the performance of the management team and ensuring compliance with established policies. An effective internal control system makes all of this possible.

The board of directors is also responsible for appointing and removing first- and second-tier company executives. Furthermore, it is important that the board itself determine and allocate bonuses, especially if they are monetary.

⁶ Guidelines and general practices on the role of the board of directors are explicitly addressed in the following references: FRC (2011, 2010a, 2008, 2005); BIS (2010); CCE (2010); IBGC (2009), OECD (2004) and Aldama (2003). For structuring the concepts and standards in this section, the references mentioned were analysed and the relevant material taken into account in the case of direct board of directors responsibility in issuing debt securities of the company it represents.

The board of directors should not delegate any of these responsibilities to the chief executive officer. The board may, however, delegate some specific tasks and duties to board committees chaired by one of the directors, provided they have no direct involvement in the management of the company.

The applicable standards are: The board should be supplied with timely information in structure and quality appropriate for it to discharge its duties.

- (i) The board of directors must establish mechanisms to ensure timely and reliable information on all of the company’s investments in financial and non-financial assets as well as on its funding activities.
- (ii) The board may only delegate responsibilities and functions to board committees chaired by an independent outside director.⁷ This applies especially to responsibilities and decisions on the following matters:
 1. The lines of business in which the company will be involved and the risks entailed
 2. The strategy for achieving the purposes of the business
 3. Remuneration of directors and senior executives
 4. Appointment and removal of the general manager and second-tier company executives
 5. Decisions on financial and non-financial asset investments
 6. Evaluation of the performance of directors and senior executives
- (iii) The board of directors shall not engage in management activities of the company; its role is to direct and monitor, not manage.

2. Structure of the board of directors⁸

A “unitary” board of directors is the most common structure; here, the board comprises executive or inside directors and non-executive or outside directors.⁹ A balance between both types of directors is crucial. Some of the key executives of the company are inside directors; the chief executive officer is invariably one of them. Outside directors may be independent or not. An independent outside director, besides having no specific interests in the business of the company, should be selected through a process that prevents conflicts of interest from arising between the director, the other directors and company managers. For an independent outside director to be truly independent, only the other independent outside directors should be able to remove him or her from office.

It is common practice for some shareholders not directly involved in managing the company to sit on the board of directors. Because they are part of the group that owns the company, these director-shareholders have specific interests in the company as such, especially if they have business ties to the company. In any event they shall be regarded as outside, but not independent, directors. Board members of this kind are also called equity directors.

Inside and outside directors are equally accountable to shareholders for the performance of the company. However, inside directors are responsible for company management and operation; outside

⁷ Independent outside directors are discussed in the section on the structure of the board of directors.

⁸ Guidelines and general practices for the structure of the board of directors are explicitly addressed in the following references: FRC (2011, 2010a, 2008); BIS (2010), CCE (2010), IBGC (2009), Financial Superintendence of Colombia (2007), CAF (2006), Aldama (2003). These guidelines were analysed; set out in this section are those considered relevant for a company because of their potential impact on corporate governance responsibility concerning issuance of debt securities.

⁹ There are also “dual” or “two-tier” forms of corporate governance, in which there is one board with inside directors and another with outside directors. The former runs the company; the latter has a monitoring and supervisory role.

directors have a supervisory and interest-balancing role. Because of this difference in functions the challenge lies in combining them to turn the board of directors into a team.

In addition to its composition, the size of the board of directors is a factor to consider. It should be such that the directors can meet each other, contribute and promptly reach effective decisions at board meetings.¹⁰ The board of directors must provide collective leadership. Therefore, a balanced composition and the selection of board members are crucial for building a team.

Standards regarding the structure of the board of directors

- (i) The size of a board of directors should be such that decisions can be made promptly and effectively. At least 50% of the directors should be outside directors. Of them, more than half should be independent directors.
- (ii) The chair of the board of directors should be an independent outside director.

3. Chair of the board of directors¹¹

The chairperson is responsible for the effectiveness of board of directors and its structure. A group of competent people is not enough for a board to be effective. This calls for concerted effort on the part of the group of board members and leadership on the part of the board chair.

The chair, along with the independent outside directors, should establish guidelines for evaluating the performance of the board of directors, its members and the key executives of the company. In the inadvisable event that the chair acts as chief executive officer, then this responsibility lies only in the independent outside directors.

Related standards

- (i) The powers that enable the chair of the board of directors to discharge his or her duties shall be clearly set out in the company by-laws.
- (ii) The chair of the board, together with the independent outside directors, shall establish the mechanism for evaluating the board of directors and key executives; he or she should oversee the evaluation.

4. Selecting board members¹²

The composition of the board and the selection of its members or directors are at the core of its operation. This is the critical factor in how a board of directors works. It will be very hard to enforce or fairly report on compliance with any set of standards and performance criteria for improving the way the board works if the board members are selected only on the basis of specific interests of some shareholders or some executives instead of according to the value they can add to the board. It would be even worse if the directors were selected for the sole purpose of complying with a regulatory provision.

The chair of the board should establish the mechanisms for selecting outside directors on the basis of the value they can contribute.

¹⁰ Reference CCE 2010 explicitly indicates a size between 3 and 15 directors; reference IBGC 2009 mentions a size between 5 and 11 directors.

¹¹ General guidelines and practices relating to the chair of the board of directors are discussed in references FRC (2011); BIS (2010); IBGC (2009); CAF (2006) and Aldama (2003). The only ones set out in this section are those seen as relevant that are directly linked to the responsibility of the chair of the board of directors regarding issuance of debt securities by the company he or she directs.

¹² General guidelines and practices relating to the selection of directors are discussed in references FRC (2010a); BIS (2010); CCE (2010); IBGC (2009); and CAF (2006). The only ones set out here are those seen as having relevant impact on decisions regarding issuance of debt securities by the company they represent.

Related standards

- (i) Directors (inside and outside) should be selected based on the value they can bring to the board of directors.
- (ii) The directors must keep abreast of the needs of the company and its employees.

(a) Outside directors¹³

The strength of the outside directors lies in the fact that the number of independents is balanced by the rest of the directors (non-independent outside directors and inside directors).

Outside directors should provide experience in fields that are different from or broader than the expertise of company executives. This experience, coupled with that of managers, is key in mapping a strategy for the company.

One of the valuable contributions made by independent outside directors is specific support in resolving conflicts of interest. They are naturally in a position to judge situations more objectively because their personal interests are supposedly not directly tied up with the company and they do not represent the interests of shareholders.

Related standards

- (i) Outside directors must be chosen for a real reason: to complement the experience and knowledge of current directors and officers.
- (ii) Outside directors must disclose to the board any conflicts of interest related to the company of which they are aware.
- (iii) The number of independent outside directors should be equal to or greater than the number of other directors.

(b) Inside directors

Internal directors are typically the chief executive officer, the chief audit executive, the chief financial officer and the chief operating officer. The chief risk officer and chief technology or systems officer may also be inside directors. All of these officers are directly responsible for the completeness, integrity and accuracy of the information disclosed by the company, especially the information provided to members of the board.

Related standards

- (i) Inside directors must sign statements making them legally and criminally accountable for the information they generate and disseminate, as well as for any non-disclosure of information to the board.
- (ii) The internal audit director shall be a member of the board and shall report directly to the board or any of its committees.
- (iii) If there is a compliance officer he or she shall be a member of the board and shall report directly to the board.

¹³ General guidelines and practices for defining the duties of inside and outside directors are spelled out in references: FRC (2011); (2010a); BIS (2010); CCE (2010); IBGC (2009); CAF (2006); Aldama (2003) and SOX (2002).

5. Board of directors committees¹⁴

Board committees are important because of their duties and responsibilities.

Their autonomy and independence of action should be clearly defined according to the nature of their responsibilities as set out in the board of directors' by-laws.

The committees may assign specific tasks to company officers but never delegate their responsibilities to them.

Set out below is an explanation of how some committees are directly involved in the issuance of corporate debt, including the information that each of these committees must provide the board of directors and take into consideration so as to properly determine the risks assumed by the company that can directly impact the risk rating of debt issues. The committees described are those that are directly accountable for a company's financial matters. There may be other committees, but they are not discussed in this section because they are not directly responsible for debt issuance.

(a) Audit committee¹⁵

The audit committee is responsible for selecting and engaging the internal auditor and the independent auditor, both of whom report directly to the committee. The internal auditor shall also have a direct reporting line to the chief executive officer.

This committee is also responsible for information and regular reporting on the controls in place in critical areas of the company.

It is responsible for structuring and monitoring the company's internal control system.

Related standards

- (i) The committee shall be chaired by an independent outside director with experience in internal control.
- (ii) The independent auditor shall be engaged by the committee and report directly to it.
- (iii) The committee shall approve the external audit programme.
- (iv) The committee shall approve the internal audit plan.
- (v) The committee shall follow up on internal audit and external audit recommendations.
- (vi) The committee shall approve the design and operation of the internal control system.
- (vii) The committee is responsible for ensuring that an effective reporting system for financial matters, risk control and the performance of the company and its executives is in place as part of the internal control system.
- (viii) The committee shall report regularly to the chief executive officer and the board on compliance with or violations of internal control policies.

(b) Financial asset investment committee

None of the publications reviewed refer to this kind of committee, which exists in some financial institutions that manage investments in financial assets as part of their business strategy. It is not common

¹⁴ For a discussion of board of directors committees in generic terms, see FRC (2010a), BIS (2010), CCE (2010) and CAF (2006).

¹⁵ The audit committee is the most extensively discussed in the references. For explanations with various levels of detail, see FRC (2010a, 2010b, 2008); BIS (2010); IBGC (2009); CAF (2006) and Aldama (2003).

in non-financial companies. Such a committee is recommended for non-financial firms whose treasury unit makes significant investments in financial instruments. The financial asset investment committee shall define the strategy for the treasury unit to follow when investing in financial instruments, and it shall generate information on amounts invested and risks assumed in the financial markets. This recommendation reflects what the 2007 subprime mortgage crisis brought to light: treasurers of non-financial companies with a high level of discretion when investing bought financial instruments without properly identifying the risks, thereby creating liquidity and solvency problems for their companies. This type of committee is recommended when the amounts to be invested by a company's treasury unit are so large that they could jeopardize the company's liquidity and solvency.

Related standards

- (i) The committee shall be chaired by an independent outside director with experience in financial markets.
- (ii) The committee shall structure the strategy for investing the company's cash surplus.
- (iii) The committee shall review the investment strategy as regularly as needed.

(c) Corporate finance committee

As a rule, corporate financing decisions are made by the chief financial officer and/or the chief executive officer, preferably with the knowledge of the board. None of the publications reviewed refer to this kind of committee. Such a committee is recommended for listed companies that issue debt. Decisions regarding corporate financing should preferably be made collectively by this committee instead of exclusively by the chief financial officer or chief executive officer.

The corporate finance committee shall be responsible for analysing and reporting on funding needs and options for meeting them, with a focus on debt issues to be traded in organized markets.

Related standards

- (i) The committee shall be chaired by an independent outside director with experience in corporate finance.
- (ii) The committee shall decide on funding requirements and the mechanisms proposed by management.
- (iii) The committee shall decide on engagement of financial intermediaries as needed by the company to place the financial instruments it issues.

(d) Risk committee

The only explicit mention of the need for a risk committee is in BCBS reference 2010, and just for banks. None of the standards or practices set out in the other publications reviewed refers explicitly to a risk committee, merely noting that risk identification and management should be among the responsibilities of the board of directors. Standards for financial institutions require creation of a risk committee, but there are no similar provisions for non-financial companies. A company whose treasury unit makes significant investments in financial instruments and/or issues debt to be traded in organized markets should have a risk committee.

This committee would have the following responsibilities:

1. The board is responsible for determining the nature and extent of the risks it is willing to take to achieve the strategic objectives of the company. The board should maintain sound risk management and internal control systems. The board may delegate the risk assessment function to the risk committee, but not the decisions as to the risks to be taken.

2. This committee is responsible for analysing and identifying the financial and non-financial risks assumed by the company when investing in financial assets and issuing debt. The most important non-financial risks (operational risks) are usually not measurable and cannot be shown in statistics.
3. This committee is responsible for reviewing the information generated by the company's internal control system.
4. This committee should pay particular attention to the operational risk that arises when lines of authority are not respected, creating high-risk conflicts of interest. Some examples of situations to be avoided are when the independent audit director is engaged by the chief executive officer, or when the compliance officer and the independent auditor report directly to the chief executive officer.

A good internal control system will have control points, parameters and statistics on them. But it should also have a way to identify and mitigate unquantifiable operational risks, which could include lack of staff training, functions with internal conflicts of interest and failure to respect lines of authority.

Related standards

- (i) The committee shall be chaired by an independent outside director with experience in comprehensive risk management.
- (ii) The committee shall engage risk appraisal agencies and receive from them regular assessments of the company's portfolios of financial instruments.
- (iii) The committee shall approve financial risk reports from the financial asset investment committee on the company's portfolio of investments in financial securities.
- (iv) The committee shall report regularly on compliance, effectiveness and deviations from the investment strategy implemented by the company's treasury unit.
- (v) The committee shall approve corporate finance committee reports on the financial risks of the debt securities issued by the company.
- (vi) The committee shall prepare an inventory of relevant financial and non-financial risks to which the company is subject, specifying which are quantifiable and which are not.
- (vii) The committee shall approve the plan for addressing (mitigation, containment or transfer) non-financial risks submitted by the company's senior management.

Standard for all committees

- (i) Each committee shall ensure that the necessary resources are identified and allocated to enable the company to perform in keeping with the standards established for each committee.

6. Evaluating the performance of the board of directors¹⁶

Evaluating the performance of the board of directors and its members is essential for maintaining a continuous improvement process. A good performance evaluation will align board member objectives and minimize the potential for weaknesses.

¹⁶ Evaluating the performance of boards of directors is not widely discussed in the current literature. Because of its nature, this issue can lead to conflicts of interest within the board of directors. Among the references reviewed, this is noted in FRC (2011, 2010a, 2008) and BIS (2010).

Related standard

- (i) The board of directors must conduct a formal and stringent annual evaluation of its performance and that of its committees and individual directors. The way this evaluation is conducted should be well documented.

Proper corporate governance, then, entails costs that not all companies are willing to face. It is therefore important to (1) be clear about the cost-benefit ratio of investments that require the application of standards aimed at improving corporate governance performance; and (2) have a regulatory framework governing the structure, composition and operation of the board and the board committees for companies that issue equity or debt securities to be traded in organized markets. The effectiveness of the regulatory framework in this area of corporate governance must be evaluated in light of the effectiveness of compliance, supervision and regulatory oversight mechanisms.

Effective corporate governance tends to reduce the cost of financing a business. The standards discussed in this section are designed to ensure that a company following them has lower perceived market risk and is therefore in a position to obtain financing (domestic or international) at lower rates and on better terms than would be available if its perceived risk were greater. This will result in higher value for the firm and a benefit to society as a whole. Effective corporate governance thus helps to improve a company's performance in the capital markets.

The starting point is to implement corporate governance standards and best practices that reflect the responsibilities of each area of corporate governance for ensuring the effectiveness of a company's risk management and internal control systems.

Each principle or standard should be followed in its entirety. "Reasonable application of a principle or standard" cannot be regarded as compliance.

The distortion that can occur regarding compliance with corporate governance standards and regulations is compliance in form but not in substance. For example, standards and regulations can require that the independent auditor be selected and engaged by and report to the audit committee. Company by-laws could have the same requirement, thus showing compliance with the standard. But in practice it might be the chief executive officer who selects and engages the independent auditor with the board's knowledge; the latter, in keeping with its powers, likely delegated this responsibility (albeit informally) to the chief executive officer.

How to monitor compliance with corporate governance standards in substance, not just in form? How to identify situations that give a false sense of compliance? Therein lies the challenge for regulators, professional bodies, stock exchanges and stakeholders of a company. Enforcing compliance with corporate governance standards calls for joint effort by regulators, markets and business sectors.

Regarding the role of supervisors in corporate governance, according to BIS (2010) *Principles for Enhancing Corporate Governance*, their key role is to ensure that banks practice good corporate governance. It establishes the following five principles for banks, but they could well apply to non-financial companies issuing securities:

- (i) Supervisors should provide guidance to banks on expectations for sound corporate governance.
- (ii) Supervisors should regularly perform a comprehensive evaluation of a bank's overall corporate governance policies and practices and evaluate the bank's implementation of the principles.¹⁷
- (iii) Supervisors should supplement their regular evaluation of a bank's corporate governance policies and practices by monitoring a combination of internal reports and prudential reports including, as appropriate, those from third parties such as independent auditors.

¹⁷ Refers to the 14 principles of corporate governance set out in the document cited.

- (iv) Supervisors should require effective and timely remedial action by a bank to address material deficiencies in its corporate governance policies and practices, and should have the appropriate tools for this.
- (v) Supervisors should cooperate with other relevant supervisors in other jurisdictions regarding the supervision of corporate governance policies and practices. The tools for cooperation can include memorandum of understanding, supervisory colleges and periodic meetings among supervisors.

E. Constructing an index¹⁸

To assess a company's credit risk associated with a debt issue, the first thing to consider is the maturity of the issue; this will define the time horizon that the evaluation will cover. The second thing is to include financial and non-financial indicators that reflect the expected future performance of the company, specifically its payment capacity over the entire period.

Traditional measures based on financial ratios consider accounting information that, at best, reflects the past performance of the company. They do not include future benefit factors over the medium or long term but might provide some information on the short term. Other indicators can estimate financial flows from core business activities taking account of the maturity of the corporate debt to be issued. But these indices do not reflect all of a company's risks in issuing debt. This is because they do not consider the risks associated with company operations that are not part of its business strategy. Nor do they consider the risks associated with company management quality, which directly depend on internal control system effectiveness.

The role of corporate governance and the impact of internal controls on the issuance of debt securities by a company are matters that tend to be left out of traditional measurements of risk. That is why it is necessary to have parameters that take these factors into account and serve as predictive indicators of the potential risks that, if they materialize, can have negative consequences for the future of the company and, therefore, its payment capacity.

Structuring preventive indicators for matters related to the corporate governance of companies issuing financial instruments is of particular interest to international organizations. In 2011 the OECD published a report on strengthening corporate governance in Latin America, setting out policies and recommendations for companies and institutions issuing financial instruments in general (OECD, 2011). Since debt securities are a subset of financial instruments, these recommendations are perfectly appropriate for issuers.

As for defining corporate governance indicators for issuing companies,¹⁹ chapter 3 (*Recommendations to strengthen policy and good practices*), section 3.3 (*Formalizing and disclosing the policies of institutional investors related to corporate governance of investee companies*) of the report reads “...IIs [institutional investors] should clearly formulate their policies regarding corporate governance, including the policies and procedures they have in place to take into consideration corporate governance of the companies in which they invest. Such policies and the II's compliance with them should be communicated to the market and potential clients to ensure transparency of the investors' activities. Transparency of an II's consideration of governance issues could be supported by developing and approving a corporate governance code or guidelines that define the specific investor's views and expectations in terms of governance of their potential clients. Meeting these standards/guidelines could also be the necessary pre-condition for the [issuing] company to qualify for an investment from the

¹⁸ The matrix of benchmarks was constructed and the index was defined in conjunction with Pedro Espinosa Langle, author of the Mexico case study.

¹⁹ The report refers to “investee companies”, which are companies issuing financial instruments or securities in which institutional investors invest.

institutional investor. Moreover, such codes are a useful general benchmark for companies wishing to improve their governance practices. ...”

Set out below are a matrix of standards and an index constructed on the basis of these standards, fully aligned with these recommendations.

These standards are to be used for a preventive assessment of the guidelines for issuance of debt securities that the governance bodies of the issuing company should follow to ensure disclosure of the risks inherent in these issues and to reduce them.

The corporate governance standards laid out in section D were the starting point for defining specific standards with identifiable effects, direct or indirect, on corporate debt issuance processes. These standards were then weighted, and an index was constructed. The methodology is explained below.

1. Methodology for defining and weighting standards and quantifying an index

(a) Purpose

To have a quantitative tool that reflects the level of corporate governance and internal control risk specifically related to the processes whereby a company issues debt securities.

(b) Steps:

- (i) Identify the main activities, at the aggregate level, involved in issuing corporate debt. Listed below are the general activities involved in issuing corporate debt in which corporate governance has a direct role to play. As will be seen, specific internal control activities are present in all of the other activities described. The order in which they are presented is not indicative of any particular precedence.



Source: Prepared by the author.

- (ii) Define the corporate governance standards that impact the processes involved in debt issuance. The proposed standards are grouped under the categories set out in section D.
- (iii) Define the criteria for determining the importance of the specific standards listed above.

Table I.2 sets out criteria in terms of actions to avoid in issuing debt, as well as the factors that directly impact these processes and the parties responsible for these actions. This provides the basis for weighting or benchmarking each corporate governance standard. The standards are numbered in keeping with in step 2.

Table I.2
Importance of corporate governance standards in issuing corporate debt

Stage in the debt issuance process	Parties directly responsible	Actions to avoid	Standard No.	Relative weight of the standard
Determine funding requirements. Approve selected intermediaries for placement of issue.	Corporate finance committee, chair and members	Corporate financing decisions made individually by chief financial officer or chief executive officer. Conflicts of interest in selecting intermediaries for placing the issue.	14	15.08%
Identify and monitor bond issue risks.	Risk committee, chair and members	Incomplete determination of risks, made individually by the chief financial officer. Risks not monitored.	15	15.08%
Authorize bond issues and gather information on use of funds and leverage implications.	Board of directors	Company officers carry out company bond issues without board of directors authorization, without fully disclosing the implications to the board, or both.	1	15.08%
Structure internal control and reporting systems to provide timely information on the effectiveness of the company's risk controls and the performance of its managers.	Audit committee	Lack of information on risks assumed by the company and performance of its managers. This aspect is a key factor for determining relevant risks assumed by the company issuing debt securities.	12	18.85%
				64.09%
Indirect factors with significant impact on the issuance process				
Stage in the debt issuance process	Parties directly responsible	Actions to avoid	Standard No.	Relative weight of the standard
Appointment of appropriate inside and outside directors.	Board of directors chair, shareholders and chief executive officer.	Selection of directors without regard for the criterion of value contributed to the company and non-involvement in debt issuance.	6 7	7.57%
Objective and responsible action of outside directors.	Board of directors chair, shareholders and chief executive officer.	Failure to flag potential conflicts of interest in debt issuance.	8 9	5.67 %
Responsible action of inside directors.	Board of directors chair and chief executive officer.	Failure to formalize in writing inside directors' responsibilities regarding debt issuance.	10 11	7.55 %
Role of the chair of the board of directors.	Board of directors chair.	Poor choice of inside and outside directors, and improper make-up of board committees. Board chair is also chief executive officer.	4 5	5.66%
Structure of the board of directors.	Board of directors chair, shareholders, chief executive officer.	Size of the board of directors does not allow for responsive and effective performance in successful creation of committees or making them accountable for issuance as appropriate.	3	0.94%
Board of directors delegates functions to committees chaired by an independent director.	Chair of the board and inside and outside directors.	Board of directors does not authorize bond issues and is unaware of their implications.	2	5.67%
				33.06%
The following situation is not directly related to the debt issuance process, but should be considered in determining enterprise risk:				
Define strategy for investing cash surpluses as a complementary activity to determining the company's funding requirements.	Financial asset investment committee, its chair and members.	Decisions on investing cash surpluses are made individually by the treasurer, the chief executive officer or the chief financial officer.	13	2.85%
				2.85%

Source: Prepared by the author.

2. Structuring the matrix of benchmarks and defining the index

The standards and weightings from step 3 were used to define specific standards applicable to bond issuance, which shall be called “standards for bonds” and are presented as objections in order to determine compliance. The weightings assigned in step 3 were distributed to each of these specific standards. The matrix of benchmarks shows the distribution. The name reflects the fact that each of the assigned weightings represents a standard to be achieved for each of the specific standards.

This matrix should be applied on the basis of a binary criterion: complies or does not comply. That is, full compliance with the standard is graded at full value; otherwise the grade is zero. The sum of all benchmark values is 10 with full compliance with standards; this sum represents the compliance “index”.

The index has the advantages and disadvantages of a weighted average. That is, a single number can give an idea of compliance with the standard, but each grade for each standard for bonds in the matrix should be taken into consideration in order to obtain specific information on particularly relevant aspects.

Each column in the matrix of benchmarks is interpreted below.

- (i) Categories – The general categories shown in step 2.
- (ii) Standards – The standards defined in step 2 with direct impact on the process of issuing corporate bonds. Standards for bonds – Specific, targeted standards that should be part of the debt issuance process.
- (iii) Benchmark value for bonds – The relative weight or importance of each of the standards for bonds in the debt issuance process. The different stakeholders and their responsibilities in the process of issuing bonds were taken into account for determining these values.

Table I.3
Detailed matrix of benchmarks for the corporate governance index
in terms of debt securities issuance

Categories	Standards	Standards for bonds	Weight
The role of the board of directors	1. The board of directors shall establish mechanisms to ensure the collection of timely and reliable information on all the investment (in financial and non-financial assets) and funding activities conducted by the company.	1.1 Does it authorize the issuance of bonds, whether or not the regulator requires a placement memorandum?	0.377
		1.2 Does the bond prospectus comply with the regulator’s requirements for public offerings?	0.377
		1.3 Is there information on resource use, both in the business strategy and per project and/or debt restructuring?	0.377
		1.4 Are the implications and actions relating to the company’s issues and leverage levels known factors?	0.377
	2. The board of directors may delegate responsibilities and functions in board committees chaired by an independent outside director.	2.1 Are the design and analysis of the issue delegated to the corporate finance committee?	0.189
		2.2 Is the analysis of the financial risks of the issue delegated to the risk committee?	0.189
		2.3 Is the responsibility of management reports on issuance information delegated to the audit committee?	0.189

Table I.3 (continued)

Categories	Standards	Standards for bonds	Weight
The structure of the board of directors	3. The size of the board of directors shall be appropriate for prompt decision-making.	3.1 Does the board have between 8 and 15 directors?	0.031
		3.2 Does the board have at least 50% outside directors?	0.031
		3.3 Are more than half of the outside directors independent?	0.032
The role of the chair of the board of directors	4. The chair of the board of directors shall establish the mechanisms for selection of outside directors on the basis of the value they can contribute.	4.1 In the selection of some outside directors, is priority given to their expertise in finance, particularly in corporate financing?	0.189
	5. The chair of the board of directors shall be an independent outside director.	5.1 Is the chair of the board of directors an outside, independent director?	0.377
The role and selection of executive (inside) and non-executive (outside) directors	6. The directors (inside and outside) shall be selected on the basis of the value they can bring to the board of directors.	6.1 Do more than 50% of the directors have sound and updated knowledge of finance and corporate financing?	0.095
		6.2 Do more than 50% of the outside directors have sound and updated knowledge of finance and corporate financing?	0.095
	7. The directors shall stay abreast of the needs of the company and its employees.	7.1 Is there a systematic training programme for directors?	0.189
		7.2 Do they have certifications in financial matters on which they make decisions?	0.189
		7.3 Is the performance of each outside director regularly reviewed?	0.189
	8. Outside directors shall disclose to the board of directors any conflict of interest in relation to the company of which they are aware.	8.1 Do the outside directors flag conflicts of interest in the bond issuance process?	0.189
	9. The number of independent directors shall be equal to or greater than the number of other directors.	9.1 Are there three or more outside directors for each inside one?	0.189
		9.2 Are the outside directors selected by a committee of independent directors?	0.189
	10. The inside directors shall sign affidavits making them legally and criminally accountable for the information they generate and disseminate, as well as for non-disclosure of information to the board of directors.	10.1 Do the inside directors sign off, as legally and criminally accountable, on disclosures concerning a bond issue and its implications for the financial position of the company?	0.377
	11. The internal audit director shall be a member of the board of directors and report directly to the board or one of the board committees.	11.1 Is the internal audit director a member of the board?	0.189
		11.2 Does the internal audit director report directly to the board or the audit committee?	0.189
Audit committee	12. The committee shall be chaired by an independent outside director with experience in internal control.	12.1 Is the audit committee chaired by an independent director?	0.377
		12.2 Is the independent auditor engaged by the audit committee, and does it report to the committee?	0.377
	(i) The independent auditor shall be engaged by the committee and report directly to it.	12.3 Does the audit committee approve the internal and external audit programmes?	0.377
	(ii) The committee shall approve the internal and external audit programmes.	12.4 Is there an effective reporting system on corporate financing?	0.377
	(iii) The committee shall follow up on the internal and external audit recommendations.	12.5 Does the committee prepare regular reports to the board and to general management on compliance with internal control policies on the use of financial resources for financing?	0.377
(iv) The committee shall approve the design and operation of the internal control system, whose main function is the production of reports. The committee shall be responsible for maintaining a system of timely generation of reports, especially on financial matters, risk management and performance of the company and its managers.			
(v) The committee shall submit regular reports to the CEO and the board of directors on compliance with or violation of internal control policies.			

Table I.3 (concluded)

Categories	Standards	Standards for bonds	Weight
Financial asset investment committee	13. The committee shall be chaired by an independent outside director with experience in financial markets.	13.1 Is the investment committee chaired by an independent director?	0.095
	(i) The committee shall structure the strategy for investing the company's cash surpluses.	13.2 Does the chair of the investment committee have proven experience in investment strategies?	0.095
	(ii) The committee shall review the company's investment strategy with appropriate frequency.	13.3 Does the committee meet at least once a month?	0.095
Corporate financing committee	14. The committee shall be chaired by an independent outside director with experience in corporate financing. The committee shall decide on funding needs and mechanisms proposed by general management.	14.1 Is the committee chaired by an independent director?	0.377
		14.2 Does the committee chair have proven experience in corporate financing?	0.377
	(i) The committee shall approve the selection and engagement of financial intermediaries required by the company for placing the financial securities it issues.	14.3 Is this the committee that defines the funding requirements of the company and how to meet them?	0.377
		14.4 Is this the committee that selects the financial intermediaries to place bonds issued by the company?	0.377
Risk committee	15. The committee shall be chaired by an independent outside director who has experience in comprehensive risk management.	15.1 Is the risk committee chaired by an independent director?	0.377
	(i) The committee shall engage rating agencies and receive from them regular reports on the company's portfolio of financial instruments.	15.2 Does the committee chair have proven experience and expertise in comprehensive risk management?	0.377
	(ii) The committee shall rule on reports of financial and credit risks related to the company's portfolio investments in financial securities, carried out by its risk unit.	15.3 Is it the risk committee that is responsible for ruling on reports on the financial risks faced by the company?	0.377
	(iii) The committee shall report regularly on compliance with or deviation from the investment strategy on the part of the company's treasury unit.	15.4 Is it the risk committee that explains the company's bond issuance risks?	0.377
	(iv) The committee shall submit regular reports to general management and the board of directors on the effectiveness of the investment strategy.		
	(v) The committee shall prepare an inventory of the relevant non-financial risks for the company and specify which are quantifiable and which not.		

Source: Georgina Nuñez and Andrés Oneto (coords.), *Gobernanza corporativa en el Brasil, Colombia y México. La determinación del riesgo en la emisión de instrumentos de deuda corporativa*, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC)/CAF-development bank of Latin America/Inter-American Development Bank (IDB), 2012.

F. Applying the matrix of standards from the index to companies in Brazil, Chile, Colombia, Mexico and Peru

The criteria in the matrix of standards and the index discussed in the previous section were applied to companies in Brazil, Chile, Colombia, Mexico and Peru. This section sets out the average figures and some general conclusions from applying the matrix of standards. A detailed analysis will be included in each of the case studies.

The values obtained for the indicators (which will be compared against the benchmarks in the matrix of standards) were determined based on public information on the companies reviewed. In some cases further interviews with officers and directors were conducted.

The range of values obtained for each of the standards included in the matrix and for the index is shown below. The mean and mode for each standard and for the index was calculated. This was done in the aggregate considering all the companies in the five countries.

This information will be used to identify the areas in need of enhancement, and pertinent recommendations will be issued.

Brazil has the lowest values; the Chilean companies have the highest (at least 70% of the benchmark) and convergent indices. This shows good legal and regulatory compliance at the four companies reviewed. In general there is a high incidence among companies regarding bringing in directors who have knowledge, training and experience in the areas of investment, finance and risk. But these companies do not properly structure the committees that support these functions.

Only one Chilean company has structured a finance committee, because of the scope of its projects. Two of them have structured an investment committee, because of the scale of their operations. The Chilean State-owned company has a better performance and score than the rest because it makes a better and stronger effort to structure support committees, especially in the area of projects (investments) and finance and audit. This company is the only one that has a separate unit for selecting outside directors, and it is the only one that has company employees on the board of directors.

Table I.4
Aggregate information for Brazil, Chile, Colombia, Mexico and Peru:
benchmark values by category of standards

Categories	Standards	Benchmark	Maximum	Minimum	Average	Median	
Role of the board of directors	Authorization of issues and access to information	1.1	0.377	0.377	0.000	0.302	0.377
		1.2	0.377	0.377	0.377	0.377	0.377
		1.3	0.377	0.377	0.000	0.364	0.377
		1.4	0.377	0.377	0.000	0.352	0.377
	Delegation of functions to committees	2.1	0.189	0.189	0.000	0.060	0.000
		2.2	0.189	0.189	0.000	0.098	0.095
		2.3	0.189	0.189	0.000	0.098	0.095
Structure of the board of directors	Appropriate size	3.1	0.031	0.031	0.000	0.027	0.031
		3.2	0.031	0.031	0.000	0.027	0.031
		3.3	0.032	0.032	0.000	0.012	0.016
Role of the chair of the board of directors	Mechanisms for selecting directors	4.1	0.189	0.189	0.000	0.142	0.189
	Chairperson is outside director	5.1	0.377	0.377	0.000	0.032	0.000

Table I.4 (concluded)

Categories	Standards	Benchmark	Maximum	Minimum	Average	Median	
Role and selection of directors (inside and outside)	Selection of directors based on the value they contribute	6.1	0.095	0.095	0.000	0.052	0.095
		6.2	0.095	0.095	0.000	0.065	0.095
	Directors keep up to date	7.1	0.189	0.189	0.000	0.079	0.000
		7.2	0.189	0.189	0.000	0.110	0.189
		7.3	0.189	0.189	0.000	0.095	0.000
Outside directors	Disclosure	8.1	0.189	0.189	0.000	0.158	0.189
	Number of independent outside directors	9.1	0.189	0.189	0.000	0.158	0.189
		9.2	0.189	0.189	0.000	0.016	0.000
Inside directors	Formal acceptance of responsibilities	10.1	0.377	0.377	0.000	0.132	0.000
	Audit director is member of the board	11.1	0.189	0.189	0.000	0.019	0.000
		11.2	0.189	0.189	0.000	0.129	0.189
Audit committee	Make-up and responsibilities of the committee	12.1	0.377	0.377	0.000	0.214	0.189
		12.2	0.377	0.377	0.000	0.094	0.000
		12.3	0.377	0.377	0.000	0.289	0.377
		12.4	0.377	0.377	0.000	0.251	0.377
		12.5	0.377	0.377	0.000	0.283	0.377
Financial asset investment committee	Make-up and responsibilities of the committee	13.1	0.095	0.095	0.000	0.011	0.000
		13.2	0.095	0.095	0.000	0.056	0.095
		13.3	0.095	0.095	0.000	0.037	0.048
Corporate finance committee	Make-up and responsibilities of the committee	14.1	0.377	0.377	0.000	0.019	0.000
		14.2	0.377	0.377	0.000	0.189	0.189
		14.3	0.377	0.377	0.000	0.207	0.377
		14.4	0.377	0.377	0.000	0.063	0.000
Risk committee	Make-up and responsibilities of the committee	15.1	0.377	0.377	0.000	0.013	0.000
		15.2	0.377	0.377	0.000	0.201	0.377
		15.3	0.377	0.377	0.000	0.188	0.189
		15.4	0.377	0.377	0.000	0.201	0.377
	Total		10.000	9.307	1.351	5.217	6.038

Source: Prepared by the author.

1. Some thoughts about the indicator

Of the 10 categories identified as making up the indicator, the following stand out for their importance according to the assigned weighting.

Table I.5
Matrix of benchmarks for the corporate governance index
in terms of debt securities issuance

Categories	Weights
Role of the board of directors I	2.075
Structure of the board of directors	0.094
Role of the chair of the board of directors	0.566
Role and selection of directors IV, V, VI	2.079
Audit committee VII	1.885
Financial asset investment committee	0.285
Corporate finance committee IX	1.508
Risk committee X	1.508
Total	10.00

Source: Prepared by the author.

The standards for these categories are those considered most relevant for issuing corporate debt securities. Compliance will result in a more accurate determination of the risks inherent to issuance.

Again, compliance or non-compliance with the standards set out in the matrix of standards does not reflect overall corporate governance performance. The findings should be interpreted as preventive indicators of areas that a company would have to strengthen to ensure that issuance of debt securities is carried out with full knowledge of those responsible for conducting the strategy and of the risks involved.

Several of the standards are geared towards better overall corporate governance performance. But the values obtained by applying the matrix and the index are only relevant for the process of issuing debt. Therefore, focusing efforts on meeting the standards for these categories would substantially decrease a company's issuance risks.

Applying the matrix of standards and calculating the indices for each of the companies reviewed leads to the conclusion that, with average indices of 4.31 (Brazil, Colombia and Mexico) and 5.22 (Brazil, Colombia, Chile, Mexico and Peru) compared with the target value of 10.000, there are areas of opportunity for adhering to the suggested standards.

Table I.6 shows average 80% compliance (five countries) for the categories concerning the role of the board of directors. This indicates that corporate governance practices pertinent to the board of directors are being implemented well by companies. But compliance with the standards relating to the role and selection of directors and the audit committee averaged 49% and 60%, respectively. These percentages show that performance concerning corporate governance practices in these categories is in the area of half of the benchmark.

Table I.6
Average findings for the main categories of the corporate governance indicator

Category	Benchmark	Average		Average/benchmark	
		(Brazil, Colombia and Mexico)	(Brazil, Colombia, Chile, Mexico and Peru)	(Brazil, Colombia and Mexico)	(Brazil, Colombia, Chile, Mexico and Peru)
Role of the board of directors	2.075	1.54	1.65	74%	80%
Structure of the board of directors	0.094	0.06	0.07	69%	71%
Role of the chair of the board of directors	0.566	0.16	0.17	29%	31%
Role and selection of directors (inside and outside)	2.079	0.92	1.01	44%	49%
Audit committee	1.885	0.89	1.13	47%	60%
Financial asset investment committee	0.285	0.09	0.10	33%	36%
Corporate finance committee	1.508	0.30	0.48	20%	32%
Risk committee	1.508	0.35	0.60	23%	40%
Total	10.00	4.31	5.22	43%	52%

Source: Georgina Nuñez and Andrés Oneto (coords.), *Gobernanza corporativa en el Brasil, Colombia y México. La determinación del riesgo en la emisión de instrumentos de deuda corporativa*, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC)/CAF-development bank of Latin America/Inter-American Development Bank (IDB); Álvaro Clarke, "La gobernanza corporativa y la emisión de deuda corporativa en Chile", 2014, unpublished; Jorge Echeandía, "La gobernanza corporativa, los inversores institucionales y la determinación del riesgo de emisión de instrumentos de deuda en el Perú", 2014, unpublished.

The highest scores were in the category referring to the role of the board of directors, averaging 1.65 compared with the benchmark of 2.075 for this category. In other words, boards of directors have information on company investment and funding activities (80% compliance=mean/standard).

The results set out in table I.7 indicate poor compliance, too, with the standards for the corporate finance committee, the financial asset investment committee and the risk committee, primarily because the companies reviewed do not have such committees. This could be because there are no standards recommending their existence, while there are for audit committees and, to a lesser extent, for risk committees and director selection committees.

Table I.7
Grades for corporate governance standards applied to companies

Concept associated with a standard	Standards	Brazil, Colombia and Mexico	Brazil, Colombia, Chile, Mexico and Peru
The board of directors has information on bond issues	1.2, 1.3, 1.4	Good	Good
The size of the board is appropriate	3.2	Good	Good
Outside directors flag conflicts of interest	3.1	Average	Good
The board authorizes issuance of bonds	8.1	Average	Good
The performance of outside directors is regularly reviewed	1.1	Average	Good
Appropriate audit committee structure and approval of audit plans	7.3	Average	Average
	12.1	Average	Average
	12.3	Average	Good
There are directors with sound knowledge of finance and funding	4.1	Average	Good
	6.1, 6.2	Poor	Average
Appropriate number and selection of outside directors	9.1	Average	Good
	9.2	Poor	Poor
Functions and responsibilities of inside directors	10.1	Poor	Poor
	11.1	Average	Poor
Delegation of functions to the audit and risk committees	2.1	Poor	Poor
	2.2, 2.3	Poor	Average
Audit director reports to the board or the audit committee	11.2	Poor	Average
More than 50% independent outside directors	3.3	Poor	Poor
The chair of the board of directors is an independent director	5.1	Poor	Poor
Directors keep up to date	7.1, 7.2	Poor	Average
Selection of the independent auditor and effective reporting system	12.2	Poor	Poor
	12.4	Poor	Average
Effective reporting by audit committee	12.5	Poor	Good
Operation of corporate finance committee	14.1, 14.4	Poor	Poor
	14.2, 14.3	Poor	Average
Operation of risk committee	15.1	Poor	Poor
	15.2 to 15.4	Poor	Average
Operation of investment committee	13.1, 13.3	Poor	Poor
	13.2	Poor	Average

Source: Prepared by the author.

Some of the aspects related to the role of chair of the board of directors (31%), the corporate finance committee (32%), the financial asset investment committee (36%) and the risk committee (40%) require special attention by the companies in the study because they are the farthest away from the benchmark for these categories. Besides, these percentages show that corporate governance performance in these categories comes in at less than half of the benchmark.

A more detailed analysis of the values for each relevant category will determine which areas need to be strengthened or addressed. For example, compliance with the standards regarding the role and selection of directors and the audit committee averaged 44% and 47%, respectively. These percentages show that corporate governance performance in these categories stands at less than half of the benchmark, compared with the scores including Chile and Peru.

Taking good performance to be more than 70% compliance with standards, average performance to be greater than 40% and less than 70%, and poor performance to be less than 40% compliance, the following table refers to companies to which the matrix of standards was applied.

From the above it follows that the companies reviewed have areas of opportunity for improving their debt issuance performance. These areas are listed below.

- (i) Selection of inside and outside directors, defining their functions and formalizing their responsibilities. There should be mechanisms for assigning responsibilities to inside directors for generating information on debt issuance.
- (ii) Composition of the audit committee and adherence to standards that have not yet been met. It is significant that the companies reviewed do not have effective internal control systems including efficient mechanisms for reporting on company risk management.
- (iii) Structure and operation of the corporate finance committee, which is not in place at some of the companies reviewed. This crucial committee is responsible for expert analysis of the implications of funding options.
- (iv) Structure and operation of the risk committee, whose functions are not defined and may not even be carried out according to established standards. Disclosure of the risks facing the company is the only way to establish effective mitigation measures. Disclosing them to the market will generate positive expectations about the company's performance.

G. Final recommendations

- (a) In light of the findings from the case studies, it is suggested that companies issuing debt securities carry out a preventive review of compliance with the proposed standards discussed herein that have been evaluated for a sample of 22 companies in Brazil, Chile, Colombia, Mexico and Peru that issue corporate debt. The findings concerning corporate governance areas in need of attention and reinforcement may be indicative of the situation at other companies. Therefore, applying the proposed indicator to debt issuers will yield an assessment of compliance with the key standards defined herein. An examination of each of the categories will make it possible to map out specific courses of action. The aim is to improve the risk exposure of corporate debt issues.

Why improve corporate governance in debt issuance? The OECD²⁰ addresses the concept of governance risks and makes the following recommendation to regulators and institutional investors: “Legislators and regulators should enact measures that enable or encourage IIs to efficiently include governance analysis in their investment appraisal processes ... regarding the specific solutions that country regulators may devise to encourage IIs whose portfolios are subject to regulatory limitations ... by restricting investment in companies that don't meet minimum standards of corporate governance, or by permitting proportionally greater investment in companies that meet certain higher corporate governance and disclosure requirements.”

It also notes that “IIs should identify and allocate larger portions of their portfolios to companies with better corporate governance ... since better governance creates value for all shareholders in the long term. To do this, evaluation of governance risks and opportunities should be integrated into the IIs' overall due diligence process and analysis of potential clients”.

- (b) In the case of State-owned enterprises CAF (2010) notes that in Latin America the State still owns large enterprises operating in key sectors such as energy, transport, communications, financial services and water. These companies often have problems such as lack of consistency between their goals and their mandate, lack of clarity regarding the responsibilities of the board, lack of procedures for selecting directors and situations that point to conflicts of interest. It is therefore important to strike a balance between the responsibility of the State to perform its duties as owner and as the party responsible for the direct management of these companies. This makes

²⁰ See chapter 3 “Recommendations to strengthen policy and practices”, Section 3.2, Distinguishing better-governed companies for investment purposes (OECD, 2011).

corporate governance transparency and accountability even more critical. The case studies on three of the five countries focus on three State-owned companies in the extractive sector (specifically, oil); their corporate governance in debt issuance was examined. This revealed major management differences between them concerning corporate governance performance. These differences are set out in in box I.1.²¹

Box I.1

Comparison of corporate governance at Petrobras, Ecopetrol and Pemex: three different realities and interests

Petróleo Brasileiro SA (Petrobras), Colombia's Ecopetrol, S.A. and Petróleos Mexicanos (Pemex) are the largest companies in their respective countries in terms of their contribution to GDP. Petrobras ranks second worldwide. Two of these companies date back nearly 50 years; the oldest is Pemex, which was created more than 70 years ago. All of them are in the business of exploration and production, refining, marketing of oil and other hydrocarbons, biofuels and basic petrochemicals. Petrobras also distributes electricity and other sources of renewable energy. In each case the State is the main controlling shareholder.

These companies underwent significant expansion and restructuring processes in the 2000s and carried out major placements and bond issues. They have also substantially amended their corporate governance by-laws. All three companies took care to improve the performance of their boards of directors in strategic management.

Although each company had its own reasons for restructuring, they all sought to develop expansion strategies in order to position themselves internationally. In the case of Colombia, the changes were aimed at making Ecopetrol a public stock corporation. To this end it changed its organizational structure and voluntarily adopted good corporate governance practices, looking to become a world-class player in the hydrocarbon industry. At Petrobras the major concern has been internal controls and the creation of committees to improve risk management, financial controls to assess the performance of company executives and support for the board of directors. Pemex is a special case since it operates as a holding company through its subsidiaries and affiliates, while its foreign operations (including placements) are performed through Pemex Internacional (PMI). As a decentralized entity it has no share capital or shareholders; because it is wholly State-owned it is not listed. This is unlike Petrobras and Ecopetrol (which are publicly traded and have private minority shareholders through IPOs that required high corporate governance standards).

Over the years all three companies conducted major share and bond issuance processes. BNDES (Brazilian Development Bank) played a very important role in Petrobras's first bond issue in 1998. The next two were public offerings, out of concern over increasing fragmentation of supply. In 2007 Ecopetrol successfully sold shares equal to 10.1% of its share capital on the stock exchange of Colombia, which was oversubscribed by 150%. In 2008 it placed ADRs in New York; in 2009 the trust it had earned helped it to issue unsecured and unsubordinated external corporate bonds. In 2010, it issued public debt in the local market; the issue was oversubscribed by 300%. Pemex bond issues are classed in the corporate segment; it is the second largest issuer of local debt and ranks first among Mexican companies issuing Eurobonds (47% of the total). Its Eurobonds have a sovereign debt rating and the highest rating in the local market.

Ecopetrol's board of directors has four committees: audit; compensation and payroll; business; and corporate governance. The audit (internal and external) and business (investment projects and leverage) committees are key in the issuance of debt instruments. In 2004, Petrobras launched the Integrated Assessment and Internal Control Methods System (Prisma), which strengthened corporate governance and compliance with the Sarbanes-Oxley Act (SOX). A risk management committee was created under Prisma and involves employees and executives from all of the corporate and business areas. In 2010, with the new corporate governance model, the financial integration committee was created to replace the risk management committee. The new committee is coordinated by the finance board, which is made up of all the executive managers of the finance area.

Pemex has exhaustively defined the powers of its board of directors. With a recent corporate governance reform the number of directors was increased to 15 with the addition of 4 professional directors proposed by the executive branch and ratified by Congress.^a Representatives of the labour union (one of the most powerful in the country) still carry considerable weight. There are seven committees, not including any additional ones proposed by the board of directors: audit and performance evaluation; strategy and investment; compensation; acquisitions, leasing, projects and services; environment and sustainable development; transparency and accountability; and technology research and development. There is an accountability committee to reinforce the oversight structure at Pemex and its subsidiaries; it is made up of the commissioner of the board of directors, the internal control unit, the internal auditor, the independent auditor and the office of the auditor general of the Federation.

Source: Prepared by the author on the basis of the information provided by the case studies.

^a More details on the impacts of the reform are discussed in chapter VII of this book.

²¹ The information in Box I.1 was taken from the matrix of standards for Brazil, Colombia and Mexico.

- (c) One of the critical aspects of corporate governance is selecting the members of the board of directors. Issuing companies should pay particular attention to the standards related to the role and selection of directors (this recommendation can be extended to all companies).

The OECD (2011), in its report to institutional investors, recommends that they “... should contribute to the improvement of the functioning of the Board of Directors of investee companies where possible and cost-effective for IIs. The most effective way of doing this is by influencing the composition of the Boards. This is particularly important in Latin America due to the high concentration of ownership, allowing the controlling shareholder to appoint all or the majority of directors. IIs should seek that the Boards of their investee companies have a sufficient number of non-executive and independent directors... ”²²

- (d) The credit rating agencies (whose role will be examined in greater detail in the following chapter) should add compliance with the proposed standards to their methodologies for assessing debt issuance risk. This way, their reports would include information not only on the issuing company’s payment capacity but also on those areas of risk of non-compliance with corporate governance standards that are related to corporate debt issuance.

The OECD (2011) considers that “the regulators in Latin America should ensure that the operations of these institutions [credit risk rating agencies, corporate governance rating agencies, and providers of consulting services] are properly overseen...”. “Such agencies should take steps to ensure separation of ratings analysis from other consulting services. Being paid by the clients whom these agencies rate may create incentives to give more positive ratings than are merited in order to attract more business”.²³

It also notes: “While ... some rating agencies [in some countries around the world] have developed corporate governance analytical criteria to be applied as a component of their credit analysis and rating, in most Latin American countries such rating agencies do not or have only just started to take corporate governance issues into consideration in their analysis. In Latin America, traditional rating agencies could play a stronger role by considering corporate governance issues in their ratings, especially in a region in which low liquidity and tight groups of control represent a higher financial risk for minority shareholders”.

- (e) It is important for the institutions that make up the market infrastructure and have the authority to self-regulate (stock exchanges and clearing houses), as well as the regulators, to establish effective mechanisms that enable them to identify de facto compliance with corporate governance standards and regulations. In-form compliance with standards can mean including them in by-laws, regulations and internal manuals but not meeting them in practice.

In some of the case studies there was no detailed public information on corporate governance performance. But more exact information on the actual operation of corporate governance systems was obtained through interviews and other sources. This leads us to believe that the reason for the lack of public information often lies not in the company but in the requestor.

- (f) One area that this book touches on in part is the “agency problem”. The standards in section D include some that have to do with evaluating the board and, as part of the board, the inside and outside directors. This area is broader in scope than the standards developed for corporate governance and its role in the issuance of debt securities.

- (g) In closing, adopting standards and policies aimed at improving corporate governance is not a trivial matter. Corporate inertia can be difficult to change and calls for strong leadership by the board of directors and resources for effectively implementing the necessary changes. The resulting decrease in risk is well worth implementing standards and improving management practices. And there is no doubt that the additional resources and effort required for doing so will result in a positive cost-benefit balance if effectively implemented.

²² See chapter 3 “Recommendations to strengthen policy and practices”, Section 3.2, Distinguishing better-governed companies for investment purposes (OECD, 2011).

²³ See chapter 4 “Additional steps: strengthening market forces”, Section 4.2, The role of media, credit rating agencies, and advisory services (OECD 2011).

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Annex I.1

Comparative analysis between corporate governance and debt issuance indicator categories and provisions covered under Sarbanes-Oxley, Dodd-Frank and Basel

Structure and role of the board of directors and board members	
Standard ECLAC-CAF-IDB	Legal reference
<p>Standard 1: <i>The board shall establish mechanisms to ensure they receive up to date and reliable information about the investment activities (financial and non-financial assets) and financing activities of the company</i></p>	<p>Basel III.C.8.94: Information should be communicated to the board and senior management in a timely, complete, understandable and accurate manner so that they are equipped to make informed decisions. III.C.9.101: The bank should maintain sound control functions, including an effective compliance function... and ensure that deviations are reported to an appropriate level of management and, in case of material deviations, to the board.</p>
<p>Standard 2: <i>The board may only delegate responsibilities and functions to committees presided over by an independent, outside member of the board</i></p>	<p>Sarbanes-Oxley Section 301: In order to be considered to be independent, a member... may not, other than in his or her capacity as a member of... the board of directors, or any other board committee: accept any consulting, advisory, or other compensatory fee from the issuer; or be an affiliated person of the company or any of its subsidiaries. Basel III.A.1.22: The Board should approve and oversee the implementation of the [company's]:</p> <ul style="list-style-type: none"> • overall risk strategy • policies for risk, risk management and compliance • internal controls system • corporate governance framework, principles and corporate values, including a code of conduct or comparable document; and • compensation system <p>III.A.3.47: To increase efficiency and allow deeper focus on specific areas, boards in many jurisdictions establish certain specialized board committees. III.A.3.54: In order to achieve the needed objectivity, membership should be composed of non-executives and to the extent possible, a majority of independent members.</p>
<p>Standard 3: <i>The size of the board shall be such as to allow it take actions quickly and effectively</i></p>	<p>Basel III.A.3.42: The board should structure itself in a way, including in terms of size, frequency of meetings and the use of committees, so as to promote efficiency, sufficiently deep review of matters, and robust, critical challenge and discussion of issues.</p>
<p>Standard 4: <i>The chair shall establish methods for the selection of outside board members on the basis of the value they bring to the board</i></p>	<p>See Standard 6</p>
<p>Standard 5: <i>The chairman of the board should be an independent, outside member</i></p>	<p>Dodd-Frank Title 9: Directs the SEC to adopt a new rule requiring reporting companies to disclose whether the same person or different persons holds the positions of CEO and Chairman of the Board. In either case, the company must disclose its reasons for doing so. Basel III.A.3.46: To achieve appropriate checks and balances, an increasing number of banks require the chair of the board to be a non-executive... Where a bank does not have this separation... it is important for the bank to have measures in place to minimize the impact on the bank's checks and balances of such a situation (such as, for example, by having a lead board member, senior independent board member or a similar position).</p>

Structure and role of the board of directors and board members	
Standard	Legal reference
ECLAC-CAF-IDB	
Standard 6: <i>Inside and outside members shall be selected on the basis of the value they bring to the board</i>	<p>Sarbanes-Oxley</p> <p>Sec. 101: Sarbanes-Oxley establishes the Public Company Accounting Oversight Board (PCAOB) as a nonprofit corporation to oversee the audit of public companies. The law stipulates that this Board shall have 5 members, appointed from among prominent individuals who have a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audits with respect to such disclosures. Two members, and only 2, of the Board shall be or have been certified public accountant. <i>These high standards may serve as a model for the selection of Board members in private companies.</i></p> <p>Dodd-Frank</p> <p>Title 9: Affirms that the SEC has authority to adopt a proxy access rule the right or ability of shareholders to place their own nominees for the corporate board directly on the company's proxy card at company expense.^a</p> <p>Basel</p> <p>III.A.2.35: The board should possess, both as individual board members and collectively, appropriate experience, competencies and personal qualities, including professionalism and personal integrity.</p> <p>III.A.3.53: Proposes that a <i>nominations/human resources/governance committee</i> may exist to provide recommendations to the board for new board members and members of senior management.</p> <p>III.A.2: Board members should be and remain qualified, including through training, for their positions.</p> <p>III.A.2.36: The board collectively should have adequate knowledge and experience relevant to each of the material financial activities the [company] intends to pursue.</p> <p>III.A.2.37: The board should ensure that board members have access to programs of initial...and ongoing education.</p> <p>III.A.3.43: It is a good practice for the board to carry out regular assessments of both the board as a whole and of individual board members.</p>
Standard 7: <i>Members of the board shall stay up-to-date on the needs of the company and its employees</i>	<p>Basel</p> <p>III.A.1.24: The members of the board should...[engage] actively in the major matters of the bank and [keep] up with material changes in the bank's business and the external environment</p>
Standard 8: <i>Outside board members should disclose to the board any potential conflicts of interest related to their role at the company</i>	<p>Sarbanes-Oxley</p> <p>Section 101: For the Public Company Accounting Oversight Board, each member of the Board shall serve on a full-time basis, and may not, while serving on the Board, be employed by any other person or engage in any other professional or business activity. No member of the Board may share in any of the profits of, or receive payments from, a public accounting firm (with certain exceptions). <i>Such high standards may serve as a model for Board members in private companies.</i></p> <p>Also, if 1 of the 2 members on the PCAOB, as established by SARBOX, that are CPAs is the chairperson, he or she may not have been a practicing certified public accountant for at least 5 years prior to his or her appointment to the Board. <i>This was done to reduce or eliminate potential conflicts of interest between the Oversight Board and the registered public auditing firms it was created to oversee/regulate.</i></p> <p>Section 402: Makes it unlawful for companies to extend, maintain, or arrange for the extension or renewal of credit in the form of a personal loan to or for any director or executive officer (certain exemptions apply).</p> <p>Section 403: Requires company directors and officers to file a statement detailing the amount of all equity securities that they are the beneficial owners of, and any changes in such ownership.</p> <p>Dodd-Frank</p> <p>Title 9: Increases the scope of insider trading regulations by prohibiting company asset purchases from insiders and asset sales to insiders.</p> <p>Basel</p> <p>III.A.3.55: The board should ensure that policies to identify potential conflicts of interest are developed and implemented and, if these conflicts cannot be prevented, are appropriately managed.</p> <p>III.A.3.56: The Policy should include:</p> <ul style="list-style-type: none"> • A member's duty to avoid to the extent possible activities that could create conflicts of interest or the appearance of conflicts of interest • A member's duty to disclose any matter that may result, or has already resulted, in a conflict of interest.

Structure and role of the board of directors and board members	
Standard	Legal reference
ECLAC-CAF-IDB	
Standard 9: <i>The number of outside board members should be greater than or equal to the number of inside and executive board members</i>	<p>Dodd-Frank</p> <p>Title 9: Requires that at least half of the board of directors of credit rating agencies (CRAs) must be comprised of independent directors, with a portion of the directors to include users of ratings. Independence is based on not receiving any consulting, advisory or compensatory fee or status as an associated person of the CRA. Independent directors will serve for a fixed, non-renewable term not to exceed five years, with compensation not linked to the business performance of the CRA.</p> <p>Basel</p> <p>III.A.2.38: The bank should have an adequate number and appropriate composition of board members. ... Board perspective and the ability to exercise objective judgment independent of both the views of executives and of inappropriate political or personal interests can be enhanced by recruiting members from a sufficiently broad population of candidates. ... Independence can be enhanced by including a large enough number of qualified non-executive members...</p>
Standard 10: <i>The inside board members shall sign documents certifying their legal and criminal responsibility for the information they generate and disseminate, as well as for the omission or withholding of relevant information from the board</i>	<p>Sarbanes-Oxley</p> <p>Section 302, 404, 906: The CEO and CFO must certify in each annual and quarterly report that:</p> <ul style="list-style-type: none"> • the signing officer has reviewed the report; based on the officer’s knowledge, the report does not contain any untrue statement of a material fact or omit a material fact based on such officer’s knowledge, financial information included in the report fairly presents the financial condition and results of operations of the company • the signing officers: <ul style="list-style-type: none"> - are responsible for establishing and maintaining internal controls - have evaluated the effectiveness of the internal controls within 90 days prior to the report; and - have presented in the report their conclusions about the effectiveness of internal controls • the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer. • the signing officers have disclosed to the issuer’s auditors and the audit committee: <ul style="list-style-type: none"> - all significant deficiencies and material weaknesses in the design or operation of internal controls - any fraud • the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses. <p>SEC. 404: Each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer.</p> <p>Section 304: If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, the CEO and CFO will forfeit:</p> <ol style="list-style-type: none"> (1) any bonus or other incentive-based or equity-based compensation received during the 12-month period following the first public issuance or filing of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period. <p>Basel</p> <p>III.C.9.101: The board and senior management are responsible for the preparation and fair presentation of financial statements...in accordance with applicable accounting standards in each jurisdiction, as well as the establishment of effective internal controls related to financial reporting.</p>
Standard 11: <i>The director of internal auditing should be a member of the board and should report directly to the board or to one of its committees</i>	<p>Basel</p> <p>III.C.9.100: The board and senior management can enhance the ability of the internal audit function by:</p> <ul style="list-style-type: none"> • Promoting the independence of the internal auditor, for example, by ensuring that internal audit reports are provided to the board and the internal auditor has direct access to the board or the board’s audit committee • Engaging internal auditors to judge the effectiveness of the risk management function and the compliance function, including the quality of risk reporting to the board and senior management

Structure and role of the board committees

Standard	Legal reference
<p>Standard 12: The Audit Committee</p> <p><i>The Committee shall be led by an independent outside board member with experience in internal control</i></p> <p><i>The contracted external auditor will report directly to the committee which shall:</i></p> <ul style="list-style-type: none"> • <i>approve internal and external auditing programs</i> • <i>monitor the results of internal and external audits</i> • <i>approved the design and operation of the system of internal control</i> • <i>ensure the effectiveness of reporting mechanisms, especially those pertinent to financial matters, concerning risk control, company and manager performance.</i> • <i>generate periodic reports for the CEO and the Board on the successes and/or failures of internal control policies</i> 	<p>Sarbanes-Oxley</p> <p>SEC. 103: The Public Company Accounting Oversight Board shall establish auditing and attestation standards, quality control standards, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports. The Board in the auditing standards that it adopts will require that each registered public accounting firm:</p> <ul style="list-style-type: none"> • prepare and maintain audit work papers • provide a concurring or second partner review and approval of such audit report by a qualified person associated with the public accounting firm other than the person in charge of the audit, or by an independent reviewer • describe in each audit report: <ul style="list-style-type: none"> – the scope of the auditor’s testing of the internal control structure and procedures of the issuer – the findings of the auditor from such testing – an evaluation of whether such internal control structure and procedures: <ul style="list-style-type: none"> - include maintenance of records that accurately reflect the transactions and dispositions of the assets of the issuer - provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements - and that receipts and expenditures of the issuer are being made in accordance with authorizations of management and directors of the company; – and a description of material weaknesses in such internal controls, and of any material noncompliance found. <p>Section 201: Makes it unlawful for a registered public accounting firm that performs for any issuer any audit to provide to that issuer, simultaneously with the audit, several non-audit services (e.g. bookkeeping services, appraisal or valuation services, actuarial services). A registered public accounting firm can engage in a non-audit service not prohibited in this section for an audit client only if the audit committee of the company approves the activity in advance.</p> <p>Section 202: All auditing services and non-audit services provided by an auditor shall be preapproved by the audit committee of the issuer (with certain exceptions). Approval by an audit committee of a non-audit service to be performed by the auditor shall be disclosed to investors in periodic reports. The audit committee of an issuer may delegate to 1 or more designated members of the audit committee who are <i>independent directors of the board of directors</i>, the authority to grant preapprovals.</p> <p>Section 301: Prohibits national securities exchanges and national securities associations from listing any security of a company that is not in compliance with the following:</p> <ul style="list-style-type: none"> • The audit committee shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the issuer. The registered public accounting firm shall report directly to the audit committee. • Each member of the audit committee shall be a member of the board of directors of the issuer, and shall otherwise be independent. • Each audit committee shall establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters. • Each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary. Each issuer shall provide for appropriate funding, as determined by the audit committee, for payment of compensation to registered public accounting firms employed by the issuer and to any advisers employed by the audit committee <p>Section 407: Requires the company to disclose in its periodic reports (i) the number and names of persons that the Board has determined to be “audit committee financial experts” that serve on the audit committee and (ii) whether these “financial experts” are independent. If the company does not have an “audit committee financial expert” it must disclose why not. Financial experts have:</p> <ul style="list-style-type: none"> • an understanding of GAAP and financial statements; • experience in the preparation or auditing of financial statements of generally comparable issuers; and • experience with internal accounting controls; and • an understanding of audit committee functions. <p>Basel</p> <p>III.A.3.50: The audit committee is responsible for the financial reporting process; providing oversight of the [company’s] internal and external auditors; approving, or recommending to the board or shareholders for their approval, the appointment, compensation and dismissal of external auditors; reviewing and approving the audit scope and frequency; receiving key audit reports; and ensuring management is taking necessary corrective actions in a timely manner to address control weaknesses, non-compliance, and other problems identified by auditors.</p> <p>III.A.3.51: It is advisable that the audit committee consist of a sufficient number of independent non-executive board members. It is beneficial for the appointment or dismissal of external auditors to be made only by a decision of the independent, non-executive committee members. At a minimum, the audit committee as a whole should have recent and relevant experience and should possess a collective balance of skills and expert knowledge...in financial reporting, accounting and auditing.</p>

Structure and role of the board committees	
Standard	Legal reference
<p>Standard 13: <i>The Financial Assets Investment Committee</i> <i>The Committee shall be led by an independent, outside board member with financial markets experience</i> <i>The Committee will formulate an investment strategy for the company's surplus capital</i> <i>The Committee shall revise the investment strategy periodically as necessary</i></p>	<p>Sarbanes-Oxley Section 401: Each annual and quarterly financial report required to be filed with the Commission shall disclose all material off-balance sheet transactions, arrangements, obligations, and other relationships of the issuer that may have a material current or future effect on financial condition of the issuer. <i>The Financial Assets Investment committee should oversee these off-balance sheet areas and report them to Board for the purposes of maintaining adequate internal control.</i></p> <p>Dodd-Frank Section 6: Establishes the Volcker Rule, which limits the ability of bank and bank-related companies to engage in proprietary trading, hedge fund and private equity fund investing up to 3% of the company's Tier I capital. Systemic nonbank financial companies not covered by the Volcker Rule require the Federal Reserve Board to add additional capital requirements and quantitative limits on proprietary trading, investments, and private fund activities. <i>Such requirements may spur the proliferation of Financial Assets Investment Committees so that firms may be able to monitor their compliance with the Volcker Rule.</i></p>
<p>Standard 14: <i>The Corporate Finance Committee</i> <i>The Committee shall be led by an independent, outside board member with experience in corporate finance</i> <i>The Committee shall determine the firm's financing requirements and propose plans for their fulfilment</i> <i>The Committee shall approve the selection and hiring of financial intermediaries/under writers for the issuance of company financial securities</i></p>	<p>Dodd-Frank Title I The Financial Stability Oversight Council (FSOC) may make recommendations to the Federal Reserve Board of Governors to require any nonbank financial company and bank holding company supervised by the Board of Governors to maintain a minimum amount of contingent capital that is convertible to equity in times of financial stress. The Board of Governors shall require a bank holding company with total consolidated assets equal to or greater than \$50 billion or a nonbank financial company supervised by the Board of Governors to maintain a debt to equity ratio of no more than 15 to 1 after such company has been designated as systemic. The FSOC may make recommendations to the Board of Governors to require short-term debt limits for bank holding companies and nonbank financial companies. Allows appropriate Federal banking agencies to establish minimum leverage capital requirements and minimum risk-based capital requirements on a consolidated basis for insured depository institutions, bank holding companies, and nonbank financial companies supervised by the Board of Governors. <i>Such capital and leverage requirements and restrictions could spur a greater proliferation of corporate finance committees among companies, especially bank holding companies and nonbank financial companies.</i></p>
<p>Standard 15: <i>The Risk Committee</i> <i>The Committee shall be led by an independent, outside board member with experience in financial risk management</i> <i>The Committee shall hire rating agencies and will receive periodic ratings of the company's portfolio of financial instruments</i> <i>The Committee shall prepare reports on the company's financial risk and on the credit risks of the company's investment portfolio</i> <i>The Committee shall report periodically fulfillments of and deviations from the company's investment strategy on behalf of the company's treasury</i> <i>The Committee shall report periodically to company executives and the board on the effectiveness of the investment strategy</i> <i>The Committee will take an inventory of non-financial risks to which the company is subject, specifying which of these risks are quantifiable and which are not</i></p>	<p>Sarbanes-Oxley Section 408: Requires the SEC to regularly review disclosures made by publically traded companies in their periodic reports. The Commission shall consider:</p> <ul style="list-style-type: none"> • issuers that have issued material restatements of financial results; • issuers that experience significant volatility in their stock price as compared to other issuers; • issuers with the largest market capitalization; • emerging companies with disparities in price to earnings ratios; • issuers whose operations significantly affect any material sector of the economy; <p><i>Heightened surveillance by the SEC in these areas may prompt more companies to establish risk committees to assess the company's equity volatility, the systemic risk posed by the company to the broader economy, and other aspects of company risk.</i></p> <p>Dodd-Frank Title 1: Dodd-Frank requires a separate risk committee for:</p> <ol style="list-style-type: none"> (1) Nonbank financial companies supervised by the Board of Governors that are publicly traded companies; (2) Certain bank holding companies that are publicly traded and have total consolidated assets of not less than \$10 billion. The Board of Governors may require a publicly traded company with total consolidated assets of less than \$10 billion to establish a risk committee to promote sound risk management practices. <p>According to Dodd-Frank, a risk committee shall:</p> <ol style="list-style-type: none"> (a) Be responsible for the oversight of the enterprise-wide risk management practices of the nonbank financial company supervised by the Board of Governors or bank holding company; (b) Include such number of independent directors as the Board of Governors may determine appropriate, (c) Include at least 1 risk management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms. --- <p>Establishes the FSOC, a council of regulators to monitor the financial system for systemic risk.</p> <ul style="list-style-type: none"> • Has the power to request information from companies to determine their systemic risk significance, including from nonbank companies.

Structure and role of the board committees	
Standard	Legal reference
	<ul style="list-style-type: none"> • Has the capacity to designate nonbank financial companies as systemically significant. • May require systemic bank holding companies or systemic nonbanks to submit reports elaborating on the financial conditions of the companies and their capacity to disrupt the stability of the financial markets and the United States economy. • Required to establish prudential standards in risk-based capital and leverage limits, liquidity requirements, overall risk management, resolution plans, credit exposure reporting, and concentration limits. In addition, the Fed can establish the prudential standards in other areas, such as contingent capital, enhanced public disclosures, short-term debt limits, and others. • Supports systemically significant companies to evaluate market conditions and acquire risk profile, capital adequacy, and risk management capabilities <p>Recommends the implementation of standardized risk regulators, also known as prudential regulators. These will be applied to United States bank holding companies and foreign bank holding companies in the United States with total assets valued at \$50 billion or more, as well as United States nonbank financial companies and foreign nonbank financial companies operating in the United States, as determined by the FSOC. These prudential standards help avoid or minimize the risks that threaten the financial stability of the United States.</p> <p>The Fed must conduct an annual stress test of systemically significant companies. The systemic companies will also have to conduct an internal stress test on a semi-annual basis. All other financial companies with assets of more than \$10 billion that are supervised by the federal regulatory agency should conduct an annual stress test.</p> <p>Basel</p> <p>III.A.3.52: The risk committee is responsible for advising the board on the bank's overall current and future risk tolerance/appetite and strategy, and for overseeing senior management's implementation of that strategy. This should include strategies for capital and liquidity management, as well as for credit, market, operational, compliance, reputational and other risks.</p> <p>III.D.9.105/106: Compensation systems contribute to bank performance and risk-taking, and should therefore be key components of a bank's governance and risk management. In practice, however, risk has not always been taken into account in determining compensation practices, with the result that some long-term risks may have been exacerbated by compensation incentives, such as those to boost short-term profits. In recognition of this, the FSB issued the FSB Principles in April 2009 and the accompanying FSB Standards in September 2009 to assist in their implementation. In addition, the Committee issued in January 2010 a document on <i>Compensation Principles and Standards Assessment Methodology</i>. Banks should fully implement the FSB Principles and Standards, or the applicable national provisions that are consistent with the FSB Principles and Standards.</p> <p>III.D.11: An employee's compensation should be effectively aligned with prudent risk taking: compensation should be adjusted for all types of risk; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment.</p>

Source: ECLAC, 2012.

^a On August 25, 2010, the SEC adopted Rule 14a-11, which will require companies to include in their proxy materials, alongside the nominees of the incumbent board, the nominees of shareholders who own at least three percent of the company's shares and have done so continuously for at least the prior three years. A shareholder may not use the rule to change control of the company. Instead, the shareholder is limited to putting forward a short slate consisting of at least one nominee or up to twenty-five percent of the company's board of directors, whichever is greater.

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II. Corporate governance and corporate debt issuance in Latin America: institutional investors, investment banks, rating agencies and new empirical evidence¹

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A. Introduction

The development of capital markets over the past few decades has spurred changes in the financing decisions that companies make. Traditional bank lending is giving way to other sources. Among the options are the issuance of variable-income securities (shares) and debt capital (debt securities), which have become increasingly attractive alternatives for meeting business needs, especially for financing long-term projects.

With expanding international financial integration and increasingly dynamic capital markets have come lack of transparency, information asymmetry and conflicts of interest within companies. Corporate scandals (like AIG in the United States, Aracruz in Brazil and Comercial Mexicana in Mexico) leading to massive losses for some market players have shown the need for practices that prevent, or at least mitigate, these problems. Corporate governance has thus become essential for capital market development, because it aims to provide boards of directors and management with appropriate incentives for pursuing goals that are in the interest of each company and its shareholders, and to facilitate effective supervision.

One of the most recent examples of trouble in the capital markets arose during the global financial crisis of 2008-2009, which originated in the United States and tore through the economies of

¹ The authors would like to thank Hugo Luis Caneo Ormazábal, Sebastián Nieto-Parra, Andrés Oneto, Georgina Núñez and other participants in the expert workshop held in Santiago, Chile, in June 2014. Any errors or omissions are the sole responsibility of the authors.

developed and developing countries alike. Clearly, the impact of the crisis could have been blunted if better governance practices and structures had been in place. In the wake of the crisis the spotlight has fallen on corporate governance weaknesses, on regulatory changes and on ways to better implement corporate governance standards in order to strengthen the capital markets.

To address this issue, the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), CAF-development bank of Latin America and the Inter-American Development Bank (IDB) have gone deeper into how corporate governance has shaped the development of capital markets in the region since the middle of the past decade. Earlier phases of the project looked at existing regulation mechanisms in Latin America, good corporate governance practices and experiences in selected countries and then reflected on the benefits and costs of adopting good corporate governance practices (Núñez, Oneto and De Paula, 2009; Núñez and Oneto, 2012). These studies showed that, in addition to reducing information asymmetry (by allowing for more equitable treatment of minority shareholders and defining the relationships between the board, executives and shareholders) and agency conflicts, good corporate governance performance facilitates access to the capital markets and thereby improves business performance and corporate image among investors and stakeholders.

For the final phase of the ECLAC-CAF-IDB project, the priority was to examine corporate governance areas relevant to the issuance of debt securities in Latin American countries. The previous chapter of this book laid out an index that measures corporate governance quality in terms of the issuance of corporate debt securities. This indicator was applied to companies in various economic sectors and five countries of the region: Brazil, Chile, Colombia, Mexico and Peru. The findings pointed to a number of corporate governance weaknesses that should be reviewed by market players with a view to improving conditions for the issuance of debt, highlighting the need for committees charged with decisions on financing and investments as well as internal controls and the identification and supervision of business risks.

This chapter examines the importance of relevant new players: institutional investors, investment banks (as underwriters) and rating agencies. The goal is a more comprehensive understanding of the role of corporate governance in the enlargement of the debt issuance market. This approach is relevant because each of these actors has a key role in determining the cost of issuance and the development of capital markets. Investment banks, as underwriters, structure the securities to be issued and seek potential buyers, thereby stimulating the growth of capital markets. Investment banks also contribute to the development of the secondary market for debt securities when using their capital to purchase those securities. Rating agencies, in turn, flag the potential for companies to default and thus influence borrowing costs for the companies. The interaction between all of these players determines the final issuance transaction cost, which consists of the primary spread and the underwriting fee.

The study analyses corporate governance quality in relation to debt issuance, using the same indicator to ensure comparability of data across the five selected countries. Including experiences in Chile, Colombia and Peru is very timely because since mid-2009 these countries have been part of the Latin American Integrated Market (MILA). Mexico formally joined MILA in June 2014.

In addition to this introduction, this chapter consists of four sections. The first section discusses the relationship between the concepts of corporate governance, institutional investors, investment banks and rating agencies. The second provides a brief context for development of the debt market in Latin America, as well as an overview of statistical information on debt issuance in developed and developing countries in general and the region in particular. The third section takes up the structure of the corporate governance indicator and the findings from applying it to enterprises in the five countries, together with consolidated data on the five countries. The conclusions are set out in the closing section.

B. Relationship between corporate governance and corporate debt and institutional investors, investment banks and rating agencies

1. Institutional investors

Institutional investors are organizations that have a legal obligation to invest part of their assets in the financial market. Pension funds, insurance companies, private equity firms and investment funds are the main representatives of this group; they move large amounts of funds. In many situations, they are key players in strengthening the capital markets in different regions of the world, including Latin America.

Institutional investors overshadow other participants in the global financial markets. In 2010, they held nearly half of the world's equities, with a total market value of US\$ 26 trillion. This represents an increase of about 40% compared with 1995. Institutional investors' share of the free float is probably much larger (Isaksson and Çelik, 2013). More recent data show that, in 2012, assets managed by institutional investors were equivalent to 196% of GDP in the United States and 91% in Chile (OECD, 2013b).

Institutional investors have a high availability of funds and often invest in stocks and bonds. When they decide to buy shares, they can actively participate in investee organizations, exercising their right to vote, continuously monitoring investee management, contributing to decision-making and seeking to reduce information asymmetry.² In looking for safe investments, institutional investors tend to channel their resources towards companies that have the highest corporate governance standards or at least commit to adopt such practices in the near future. However, there is no consensus as to the role of institutional investors.

Romano (2001), for example, stresses that institutional investors are actively engaged in supervising the management of investee companies. This can mitigate some of the risks, because an active stance in investee management is likely to improve corporate governance and boost the firm's economic performance (OECD, 2009).

Gillan and Starks (2003) note that the number of institutional investors that actually play an active role in companies is small, due to the costs associated with monitoring. It is therefore more likely that large institutional investors (that can generate economies of scale and reduce monitoring costs) are the only ones that can monitor firms through their investment portfolio. For Kahn and Winton (1998), the decision to supervise and participate in investee management depends on the benefits for institutional investors. They may therefore choose to take a passive role, or they may actively participate in the decisions of corporations when so doing yields additional benefits.

Çelik and Isaksson (2013) hold that the degree of engagement varies widely among categories of institutional investors (pension funds, mutual funds and insurance companies), with substantial differences in behaviour within each category. These differences regarding activism arise from a number of factors, such as economic incentives related to different business models, investment strategies and business practices. Where engagement is not central to a given model, voluntary standards and public policies aimed at enhancing institutional investor engagement in order to improve corporate governance tend to be of limited impact.

Clarke (in chapter five of this book) examines the Chilean experience and notes that while a majority of the members of the board of directors of a publicly traded company are usually elected with the votes of the controlling group, a group of independent directors is also appointed by the shareholders with the backing of institutional investors. This creates a more effective control environment within the board of directors and in the general meeting of shareholders—a body with considerable authority to decide on, among other matters, the company's borrowing policies.

² OECD (2011a) has analysed the role of institutional investors in promoting improvements in corporate governance in general, by examining the Australian, Chilean and German experiences.

Clarke also highlights the positive role of Chilean institutional investors, particularly the Pension Fund Administrators (AFP) in improving investee corporate governance. By law, Chilean AFPs may hold no more than 7% of the capital of any single issuer; these caps significantly reduce the potential impact of individual pension funds on governance and make it impossible for them to become controlling shareholders. On the other hand, the collective impact of AFPs is powerful because the law expressly allows them to coordinate their votes and use cumulative voting to reach the 12.5% of votes needed to ensure the election of one member of a seven-member board of directors.

Over the past decade, institutional investors have changed their investment strategies and have begun to allocate fewer resources to equities while opting for additional investment in debt securities (OECD, 2013a). This shift is impacting the funding strategies of firms, because they are responding to the demand for large volumes of bonds, but are subject to greater control and restrictions imposed by institutional investors. To capitalize on this demand, companies must ensure the transparency of their behaviour and strengthen their corporate governance structure. Institutional investors can, then, be key to the development of corporate governance through the purchase of bonds.

Because they are responsible for managing third-party funds, institutional investors do indeed tend to demand greater safety in investments and select debt securities by analysing (a) the existence of independent directors; (b) how the issuer makes its investment and financing decisions; (c) standards that improve corporate governance; and (d) the presence of company policies covering behaviours for resolving potential conflicts of interest between issuers and institutional investors (Núñez and Oneto, 2012).

The active role of institutional investors in supervising management decisions can improve the operation of the capital market, optimize issuer yield and value and help to improve corporate governance, especially in countries with concentrated ownership (OECD, 2009). In other words, institutional investors can play a crucial role in the performance of issuers when they demand better corporate governance practices that tend to reduce risk for their investments.

In chapter three of this book, Avendaño and Nieto-Parra examine emerging-country corporate securities issues in international markets between 1991 and 2009. The values were not disaggregated by region, but the conclusions set out in the chapter may well be applicable to the Latin American experience because the region accounts for approximately half of the number of issues in the sample and about 40% of total value issued. The authors conclude that the capital cost of these debt securities depends on a combination of macroeconomic factors and characteristics of individual issuers and issues. In particular, the perception of credit risk on the part of rating agencies and the variables resulting from interaction between issuers and underwriters help to determine issuance cost.

While the corporate spread depends on macroeconomic variables (including sovereign risk rating), a company's variables are more useful for explaining the underwriting fee, which is a decreasing function of the reputation of the banks underwriting the bonds and the rating agencies' perception of the issuer. This finding suggests that institutional investors (which determine the price or primary spread of the securities issued) pay less attention to the financial sustainability of issuers than do investment banks (which determine the underwriting fee).

2. Investment banks

It is important to emphasize the contribution of investment banks to improving company operations, both in meeting financing needs and in enhancing the capitalization process (Lameira, 2003). These institutions subscribe and distribute debt securities issued by companies and seek to ensure that their securities have attractive features for investors (Weston and Brigham, 2000). Through this practice, called underwriting, investment banks intermediate issuer operations; that is why they call for greater transparency and monitor business decisions. They offer safety for companies (by making it more likely they will place their securities in the market) and for investors (by signalling the degree of investment risk) (Fang, 2005).

Investment banks also reduce information asymmetry in the debt securities issuance process. These banks need to gather additional information that is as complete as possible because they run the risk that the issuer will not fulfill its obligations and, therefore, default. In this process, Fang (2005) and McCahery and Schwienbacher (2010), among others, note that banks with a good reputation in the market tend to be associated with lower-risk issuers. Similarly, debt securities underwritten by investment banks with good credibility tend to be more reliable and are, therefore, expected to be less risky.

Reinforcing this argument, Fang (2005) emphasizes how important it is for investment banks to maintain their reputation. Dishonesty (which can even generate profits in the short term) entails loss of credibility and, consequently, lower future profits. The potential for loss of reputation makes reputable banks choose the most reliable issues, which are less risky for investors.

To avoid loss of reputation, underwriters seek to obtain as much information as possible about their customers, in order to identify potential problems that could increase issuance risk. These analyses are critical in determining which issues are underwritten: investors tend to have greater confidence in securities underwritten by banks with the best reputation. It is harder for small investment banks to offer the market the same degree of safety because they generally cannot afford the cost of obtaining information about the true position of issuers (McCahery and Schwienbacher, 2010). According to Avendaño and Nieto-Parra, the 10 largest investment banks accounted for more than 80% of the market share of international debt issued in 1991-2009 by companies based in developing countries.

Banks with the best reputation tend to offer better terms to their customers in order to show the market a guarantee of quality (McCahery and Schwienbacher, 2010). Nonetheless, there is no empirical consensus on the effect of investment bank reputation on prices and underwriting fees (Fang, 2005). Logue and others (2002) showed that costs increase depending on the investment bank's reputation, in the sense that reputable banks charge higher fees, which can be interpreted as reputation-based economic rents. But Carter and Manaster (1990) and Livingston and Miller (2000) found an inverse relationship. One possible interpretation of this finding is that more prestigious brokers have greater bargaining power to get the members of the underwriting syndicate to accept lower underwriting fees. For international corporate issues by companies based in developing countries, the underwriting fee, too, is a decreasing function of investment bank reputation.

The relationship between firms and investment banks is also a factor that can affect the cost of financing, because the issuance benefits are higher for companies that have a closer relationship with the investment banks (Fang, 2005). This is because of less information asymmetry and more supervision by the bank (Boot, 2000). The option of using the investment bank that underwrote previous issues means establishing a closer relationship between the issuer and the investment bank, which becomes more familiar with the operations of the issuer. This helps to bring down the cost of underwriting securities. Therefore, loyalty tends to be associated with lower underwriting fees.

According to Avendaño and Nieto-Parra's analysis of the experience of developing countries, only 23% of corporate issues have a different underwriter than for previous issues; by contrast, the figure for sovereign issues is 80%. This suggests that firms in developing markets may follow a different strategy with respect to their underwriters, so there is not as much turnover as for their sovereign counterparts.

There are also noteworthy cost differences between international and domestic issuance. The currency in which the debt is issued is a crucial factor for underwriting costs. Issues denominated in major currencies (euro, Japanese yen and United States dollar) tend to have lower underwriting fees than issues denominated in currencies that are less traded in international markets (Nieto-Parra, 2012). This could be due to a greater capacity (therefore involving less effort) to place debt securities denominated in these currencies, thanks to greater demand on the part of institutional investors. In developing countries, about 95% of the total issued has been denominated in euros, Japanese yen or United States dollars.

After issuance, banks continue to examine issuer behaviour and even provide risk management services (Boot, 2000). As these institutions have more resources for analysing and monitoring the performance of debt security issues, relationships with reputable investment banks may send a positive signal for investors and for rating agency ratings.

3. Rating agencies

Surging securities issuance also highlights the role of rating agencies. These companies assess the creditworthiness of countries, banks and non-financial companies in order to gauge the capacity of issuers to meet their obligations. This rating therefore tends to influence third-party funding, because companies that offer greater safety for their creditors have higher ratings and, accordingly, find it easier to raise resources through debt securities. In other words, investors prefer to invest in higher-rated securities and demand higher interest rates on lower-rated securities.

According to Becker and Milbourn (2011), rating agencies play an essential role in the proper functioning of the financial system and strengthening of institutional investors. They are very important for the allocation of insurance company and pension fund resources. Fitch Ratings, Moody's and S&P are usually considered the leading companies with the highest credibility in assessing issuance risks.

Risk rating reduces information asymmetry and allows stakeholders to form opinions and make decisions (Gruic and Wooldridge, 2012). Risk ratings (which are usually based on an analysis of financial statements, internal controls and management functions) are relevant for disclosure of an organization's financial and operational strength. These ratings may influence third-party funding. The most reliable firms tend to receive higher ratings, so it is easier for them to sell their debt securities (Juárez, 2012).

Each company has its own methodology for gauging debt security default risk. In this setting, studies indicate that the rating agency's market reputation influences investor decision-making. For White (2001), the international credit rating agencies are likely to have more influence on rating decisions than domestic agencies because they have greater market credibility. Investors are therefore expected to rely more on risk ratings from companies with a good reputation index.

Country rating is also a factor in issuer rating: very seldom will a company be rated higher than its country. In other words, the best rating that the issuers tend to receive is equivalent to the country rating, regardless of their creditworthiness. According to the empirical evidence presented in chapter five by Avendaño and Nieto-Parra, the better the rating agencies' perception of country risk, the lower the issuance cost. It is important to recognize that changes in a country's rating often have a significant impact on attracting foreign investment, which can enhance the sovereign rating. These ratings can therefore accelerate trends, both positively and negatively.

In addition to providing information on the risk of the securities issued, rating agencies should track changes at the market and company level that could affect the rating later on. This is one way to help ensure the proper functioning of the capital market. However, there is no consensus in the literature as to the effectiveness of rating (Boot, Milbourn and Schmeits, 2006). Indeed, credibility was put to the test in 2008 when the global financial crisis revealed that ratings were unreliable. Market analysts felt that the agencies were unable to reflect the true position of companies because their ratings underestimated mortgage credit risk. This made the methodology followed by rating agencies the target of much criticism.

After the crisis of 2008, the regulations governing rating agency methodology changed. Despite improvements, some areas of corporate governance that affect company risk (such as ethics and corporate culture) are not yet part of the valuation methodologies. This bolsters the argument that the real contribution of the rating agencies to dissemination of international best corporate governance practices remains low. These areas are relevant even when the company in question is in a strong financial position at the time it issues securitized debt, because improper conduct by the directors could trigger many problems in the future that would increase the risk of default. Accordingly, assessing the

structure and operation of the corporate governance system is important in determining debt issuance risk, even if they are not assimilated by the rating agencies.

The discussion set out in the previous three subsections reaffirms that corporate governance yields benefits by lowering the cost of raising funds, improving risk ratings, decreasing security underwriting fees and attracting substantial financial resources administered by institutional investors.

Beyond corporate governance practices, actions by some external agents should also be considered in order to understand the debt securities market in Latin America. Several factors help to mitigate risk and, consequently, to bring down the cost of bond issues: (a) good corporate governance practices; (b) active engagement of institutional investors in issuers; (c) the relationship between investment banks and issuers of debt securities; and (d) a good credit rating from the rating agencies.

Against this backdrop, set out in an annex at the end of this chapter is a questionnaire on factors concerning the relationship between these agents and issuers of debt securities. The questions are organized into three categories: (a) the role of institutional investors; (b) the function of investment banks; and (c) the role of rating agencies. This questionnaire may contribute to further research in this area, whether or not it is on the Latin American experience.

Other agents that are not discussed herein can play an important role in improving corporate governance—especially the independent auditor. Lavados and Bakovic (2006) argue that independent auditors should define exactly what their role will be in reviewing a company's internal control system. They should strongly support the strengthening of audit committees in the companies they audit. Moreover, they should clearly define their function in relation to risk management at the audited company.

The following section provides a brief context for the bond market in the region, as well as statistical evidence on the scale of the corporate debt securities market worldwide and in Latin America.

C. The corporate debt market in Latin America

1. Brief context

Traditionally, banks have been seen as the main providers of short- and medium-term capital to businesses. However, as the structure of the financial sector changes, the option of issuing bonds, Eurobonds and other securities has become an attractive alternative for companies (OECD, 2013a). The average annual number of initial public offerings (IPOs) in OECD member countries has fallen from 1,170 in 1993-2000 to 650 in 2001-2012. Annual average values obtained have declined, too, from US\$ 134 billion to US\$ 70 billion (Isaksson and Çelik, 2013).

The surge in corporate bond issues (domestic and international) in recent years has opened an opportunity for funding business expansion and fuelled efforts to adopt good corporate governance practices to improve transparency and accountability and mitigate information asymmetry and debt issuance risks.

Developing regulatory frameworks that encourage good corporate governance practices is essential for lowering issuance costs, attracting capital and strengthening an alternative source of financing for companies, helping to mitigate problems arising from the traditional banking system's traditional short-term focus. This is relevant because a weak corporate governance structure tends to increase corporate bond risk and hamper international business expansion in the region (Núñez and Oneto, 2012).

After the debt crisis in Latin America in the 1980s, there was a move to change the economic policies of the countries of the region in order to facilitate access to the international debt securities

market. The increase in international debt issues is attributable to the growth potential and greater productivity shown by many Latin American countries (OECD, 2011b).

Good economic performance in the 2000s associated with greater liquidity in the global markets attracted more resources to the region, spurred a significant surge in the issuance of corporate debt and boosted creditworthiness. A number of countries made efforts in terms of their policy and institutional frameworks and to foster development of the secondary market. Although there have been positive results, overall the debt securities markets in Latin America remain underdeveloped (OECD, 2011b).

Despite market strengthening there are still weaknesses to be addressed. The family structure of enterprises, the high concentration of ownership and information asymmetry, for example, are hindering capital market strengthening because they do not encourage accountability or the adoption of good corporate governance practices (Núñez and Oneto, 2012).

In any event, emerging markets, which used to have low ratings, have become more creditworthy. This is particularly evident in Latin America. This trend, coupled with government policies, has contributed to capital market development in the region (OECD, 2011b), particularly in countries like Brazil, Mexico, Colombia, Chile and Peru.

In Brazil, capital market development has been driven primarily by banking system weakness in financing long-term, by the high demand for bonds and by the existence of an appropriate infrastructure for capital market operations (Saito, Sheng and Bandeira, 2007). In 2004, with a favourable international environment, companies began to step up fundraising by issuing securities. But the concentration of debt issues in a few sectors and low secondary market liquidity are still weaknesses that Brazil needs to resolve. The Brazilian Development Bank (BNDES) is working to stimulate market development by purchasing securities issued by companies.

In Mexico, bond market growth was driven by rising demand from investors. The use of debt issuance as an alternative source of financing has been an attractive option for Mexican companies, which see the potential for raising funds on competitive terms compared with traditional sources of financing. As in other countries of the region, institutional investors are the main buyers of debt securities (Núñez and Oneto, 2012).

In Colombia, the private bond market grew substantially over the past decade and peaked in 2009. At the same time, there were significant advances in regulation and in market instruments. Longer maturities and less volatile benchmark rates have helped promote market liquidity and reduce risk for issuers and investors. The real sector has become a major player in recent years, but lately the market seems to have lost a bit of steam, both on the supply side and on the demand side (Asobancaria, 2013).

Chile has seen capital market reforms such as the adoption of measures aimed at, among other goals, increased availability of issues, more flexible issuance requirements and conditions, market liquidity and expanded market access for small and medium-sized enterprises. Funding needs among companies in the infrastructure sector have helped to drive up the market value of Chilean debt because these securities have a good risk rating. On the demand side, Pension Fund Administrators (which are the largest institutional investors) have a high profile in the Chilean capital market, followed by foreign investors and investment funds. However, the Chilean market still faces some challenges related to the small number of issuers, low secondary-market liquidity and high transaction costs, among others (Mendoza and Reinoso, 2010).

In Peru, the capital market has brought development and enabled domestic firms to tap into financing at competitive rates. This can be explained by a number of factors, namely economic growth, improving regulatory frameworks, macroeconomic policies, national-currency stability and equal treatment of domestic and international investors. The capital market supervisory authority has implemented measures to encourage increased SME participation in the primary and secondary markets. One step was the adoption of regulations for alternative investment in 2012, which has given rise to a

segment for offering securities issued by smaller companies with the aim of bringing down issuance costs. Despite the growth of the stock market, financial institutions are still the main source of funds for companies, so the capital market has plenty of room for further development (Carbajal, 2012). The present administration has worked to reform the capital market along six main lines, including facilitating access for new mutual funds and investment funds, improving corporate governance and promoting MILA.

MILA is turning into a great opportunity for developing the securities market in its member countries. This international partnership will enable entrepreneurs from different countries to invest beyond their borders and make it possible for issuers to expand their opportunities to obtain resources at a low cost, capitalizing on the strength of the stock markets that are part of the integrated market.

MILA holds a number of potential benefits for investors, intermediaries, issuers and countries. Among them are (i) more financial instrument alternatives; (ii) more investment opportunities; (iii) access to more stock markets and improved risk assessment; (iv) creation of new portfolios diversified by sector, depending on the type of issuers in each stock exchange; (v) lower capital costs; (vi) increased demand for financing, attracting the interest of more investors; and (vii) integration of member-country economies, with the potential for being seen as a very attractive bloc for global investors.

According to Agudelo and others (2012), the countries with greater market capitalization (like Brazil, Mexico and Chile) have lower liquidity-associated transaction costs than do countries like Peru, Argentina and Colombia. In addition, there is a negative relationship between liquidity-associated transaction costs and stock market activity and volatility of returns on shares. What is even more important is the significant differences found between the stock markets of Chile, Colombia and Peru that justify their inclusion in MILA and that the potential saving in transaction costs is associated with a 10% increase in market activity.

Despite the differences across the countries of Latin America, it is reasonable to conclude that despite considerable efforts the capital market is still underdeveloped. It seems to be headed in the right direction, but it is probably necessary to accelerate the changes in order to move up to a new level. After this brief qualitative overview of the situation in some representative countries of the region, the following subsection is devoted to setting out quantitative evidence of international debt securities issues.

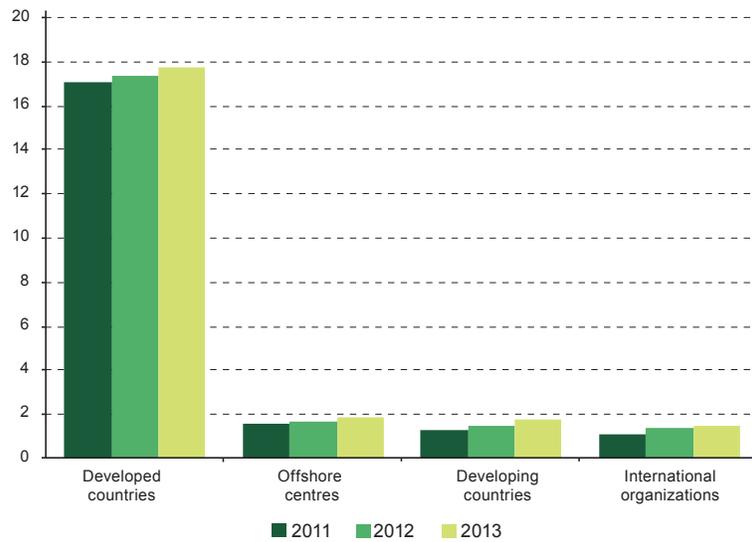
2. International debt issuance

Issuance of international debt is very common in a number of developed countries. Figure II.1 shows that the stock of international debt securities of developed countries, all types of issuers considered, totalled nearly US\$ 18 trillion in 2013. Meanwhile, the cumulative volume of such securities issued by developing countries was equivalent to US\$ 1.7 trillion in the same year. These countries' share of the world total increased from 6.0% in 2011 to 7.5% in 2013.

The data in figure II.1 aggregate all types of issuers, namely banks, other financial institutions, non-financial enterprises and the central government. Given the objectives of this book, figure II.2 shows the stock of international debt securities, excluding central government issues (sovereign debt). It can, therefore, be understood as the cumulative volume of corporate issues. The values shown presented are not limited to private companies because they also include State-owned enterprises and banks. Still, the stock of corporate issues in developed countries reached nearly US\$ 17 trillion in 2013. For developing countries, the value was US\$ 1 trillion. These countries' share of the global total has expanded from 3.4% in 2011 to 4.6% in 2013.

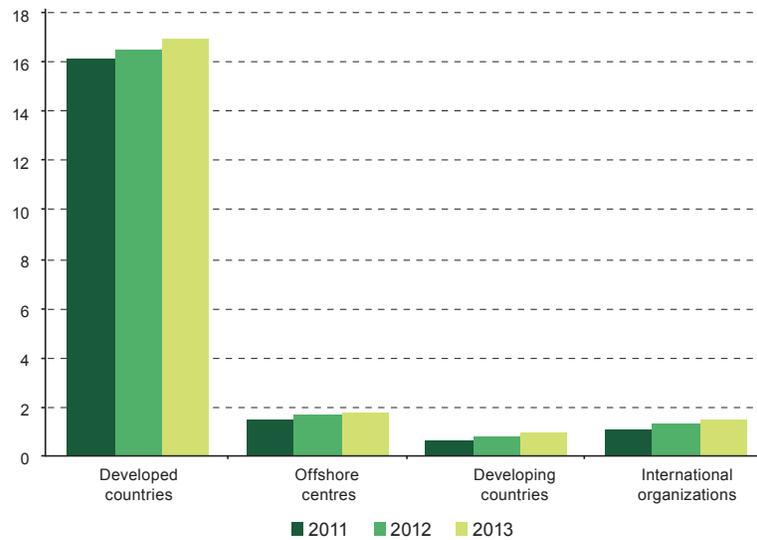
The stock of developing-country international corporate issues totalled as follows in 2013: Asia-Pacific (US\$ 346 billion); Latin America and the Caribbean (US\$ 334 billion); Europe (US\$ 158 billion, including Russia, Turkey, Poland, Hungary and Croatia); and Africa and the Middle East (US\$ 132 billion), as shown in figure II.3. Latin America's share has been stable at around 34%.

Figure II.1
Stock of international debt securities, 2011-2013
(Value as of December of each year, in trillions of dollars)



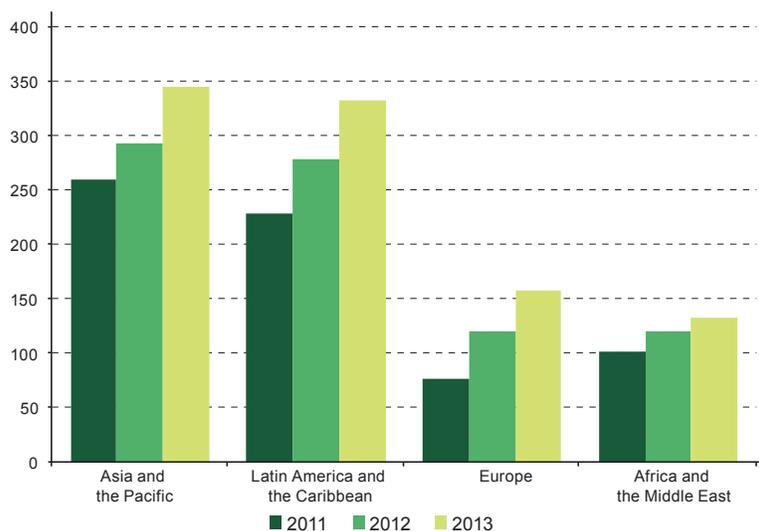
Source: Bank for International Settlements (BIS), 2014.

Figure II.2
Stock of international corporate debt securities, 2011-2013
(Value as of December of each year, in trillions of dollars)



Source: Bank for International Settlements (BIS), 2014.

Figure II.3
Stock of developing-country international corporate debt securities, 2011-2013
(Value as of December of each year, in billions of dollars)

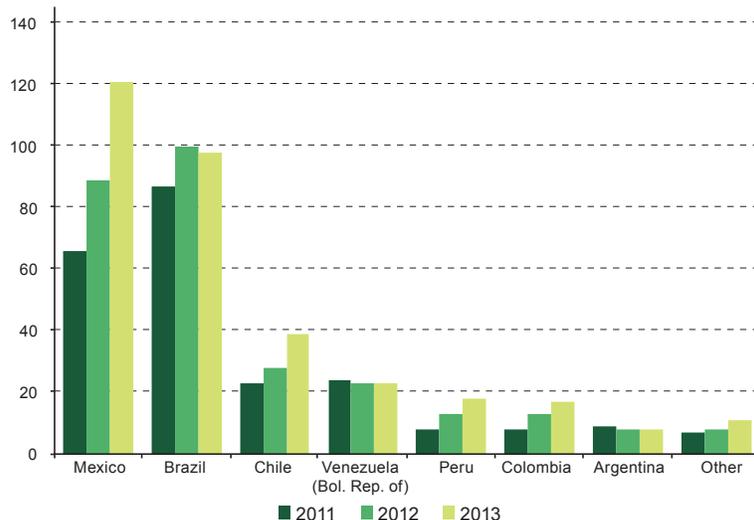


Source: Bank for International Settlements (BIS), 2014.

Based on information from the Bank for International Settlements (BIS) and the World Bank, it is possible to compare the stock of international bonds as a proportion of GDP. For countries that are part of the BIS database, the stock of international corporate debt in developing countries was equivalent to 3.6% of GDP in 2012. The figure was 9.6% in Africa and the Middle East, 5.4% in Latin America, 3.5% in Europe and only 2.2% in Asia-Pacific in 2012.

In Latin America, Mexico had the largest stock of international debt in 2013, followed by Brazil (see figure II.4). While issuance in Mexico is growing at a faster pace than in Brazil, these two countries together account for 66% of the regional total. In aggregate terms, the cumulative volume of corporate debt in the Bolivarian Republic of Venezuela, Peru, Colombia and Argentina is relatively small.

Figure II.4
Stock of international corporate debt securities in Latin America, 2011-2013
(Value as of December of each year, in billions of dollars)



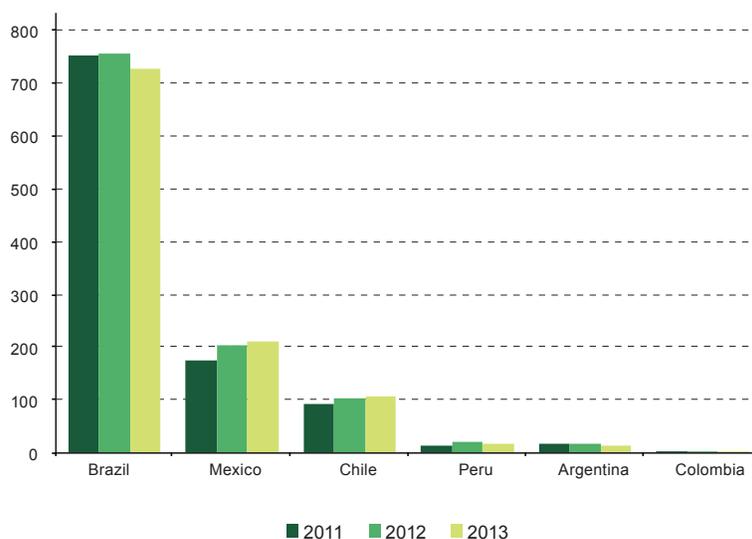
Source: Bank for International Settlements (BIS), 2014.

Adjusting for GDP size yields a very different outcome: Chile's stock of international corporate debt was equal to 10.3% of GDP in 2012. For the other countries, the ratio was: Mexico (7.5%), Bolivarian Republic of Venezuela and Peru (6.1%), Brazil (4.4%), Colombia (3.3%) and Argentina (1.6%).

As for domestic debt issuance, BIS statistics do not include figures for the United States, Germany or the United Kingdom, among others. Gathering this information poses many challenges despite adjustments to the methodology used by the BIS in 2012. Many issues of this kind are private and there is no record. Most data are obtained from private sources or by news agencies, which have their own limitations.

The stock of domestic corporate debt securities in Brazil totalled US\$ 727 billion in September 2013, compared with US\$ 210 billion in Mexico and US\$ 107 billion in Chile (see figure II.5). For the remaining countries, the figures are equal to or less than US\$ 15 billion. There are no data for the Bolivarian Republic of Venezuela.

Figure II.5
Stock of domestic corporate debt securities in Latin America, 2011-2013^a
(Billions of dollars)



Source: Bank for International Settlements (BIS), 2014.

^a Values as of December 2011 and 2012 and September 2013.

Chile is, once again, the country with the highest ratio when the values are adjusted for GDP. Chile's stock of domestic corporate debt was equal to 38.3% of GDP in 2012. For the other countries, the ratio was: Brazil (33.5%), Mexico (17.3%), Peru (9.3%), Argentina (3.4%) and Colombia (0.5%).

The decision to use the BIS database was not only for reasons of standardization, but also because in some countries the regulatory authority of the issuer's country does not make the record entry. In some of these cases, the record entry is made only by the authority of the country where the issue is placed.

Evidence from recent statistics shows that the absolute cumulative volume of Latin American corporate issues is relatively small in the international context, although they compare satisfactorily with developing countries. There is considerable concentration in Brazil and Mexico, both in international placements (with a combined share of 66% in 2011-2013) and in the respective domestic markets (88% for the same period). After a brief discussion of these statistics, the following section explains the corporate governance indicator for issuance of debt securities, which was prepared in the second phase of this project.

D. Corporate governance indicator and debt securities

1. The indicator

The indicator presented by Pérez Galindo in the previous chapter looks at corporate governance from the point of view of the debt issuance process, helping to identify, measure, mitigate and communicate the company's exposure. This section touches on matters related to the indicator.

The standards used for the corporate governance indicator related to the issuance of debt securities were grouped into the following categories:

- (a) Role of the board of directors;
- (b) Structure of the board of directors;
- (c) Role of the chair of the board of directors;
- (d) Selection of directors (inside and outside);
- (e) Board committees:
 - Audit committee;
 - Financial asset investment committee;
 - Corporate finance committee;
 - Risk committee.

The first category includes standards that serve as guidelines for the board of directors. The board sets goals and the business strategies for achieving them. It also monitors performance and evaluates compliance with established policies. To discharge these duties the directors need timely and reliable information; this will enable them to delegate responsibilities to board committees and establish mechanisms to improve investment and funding decisions. The committees should not be involved in the daily management of the organization, but rather in guiding and supervising business operations.

Regarding the structure of the board of directors, the best size is one that allows the directors to discharge their duties and make decisions quickly and efficiently. A board of directors is usually composed of inside (executive) and outside (independent or not) directors. Inside directors usually handle the management and operation of the company, while outside directors are responsible for supervising the organization. At least 50% of the directors should be outside directors; the duties of the chair and the chief executive officer should not be assigned to the same person.

The third category encompasses the responsibilities of the board chair, who works with independent outside directors to establish mechanisms for evaluating performance of the board (both as a whole and for each member separately) and the key executives of the company, as well as for monitoring the evaluation process. The functions of the board chairperson should be spelled out in the company by-laws. Inside and outside directors should be selected on the basis of experience and knowledge that can add value to the company. There are other selection criteria, as well: there should be more outside directors than inside directors; 50% or more of the total number of outside directors should be independents. Having independent directors is important for resolving potential conflicts of interest. In addition, evaluating the board and individual directors makes it possible to align the company's objectives and policies and improve the performance of the board itself.

The only board committees taken into consideration here are those that clearly are involved in debt issuance, such as the audit committee, the financial asset investment committee, the corporate finance committee and the risk committee. The audit committee is charged with selecting and engaging independent and internal auditors, who should report directly to the committee. Among other functions, the audit committee monitors the flow of information in various areas of the company, and it structures,

monitors and reports regularly on the internal control system. Financial asset investment committees are not commonly found in non-financial companies, but responsibility for mapping out an investment strategy and reporting on investment amounts and risks should be assigned to this committee. The corporate finance committee should be tasked with analysing and reporting on funding needs and alternatives for meeting them. Another key function of this committee is to follow up on engagement of financial intermediaries as needed for debt issuance. The risk committee is responsible for identifying and analysing the company's financial and non-financial exposure to financial asset investment and debt issuance risks.

A lack of such committees does not mean that their functions are not performed — just that they need to be done by the board of directors itself. Financial asset investment committees and corporate finance committees are the least frequently found, even in firms with parent companies with headquarters in developed countries. With these points in mind, corporate governance areas that impact debt issuance are set out in table II.1.

Table II.1
Corporate governance standards that impact debt issuance

Categories	Standards	
Role of the board of directors	1.1	Does it authorize the issuance of bonds, whether or not the regulator requires a placement memorandum?
	1.2	Does the bond prospectus comply with the regulator's requirements for public offerings?
	1.3	Is there information on resource use, both in the business strategy and per project and/or debt restructuring?
	1.4	Are the implications and actions relating to the company's issues and leverage levels known factors?
	2.1	Are the design and analysis of the issue delegated to the corporate finance committee?
	2.2	Is the analysis of the financial risks of the issue delegated to the risk committee?
	2.3	Is the responsibility of management reports on issuance information delegated to the audit committee?
Structure of the board of directors	3.1	Does the board have between 8 and 15 directors?
	3.2	Does the board have at least 50% outside directors?
	3.3	Are more than half of the outside directors independent?
Role of the chair of the board of directors	4.1	In the selection of some outside directors, is priority given to their expertise in finance, particularly in corporate financing?
	4.2	Is the chair of the board of directors an outside, independent director?
Role and selection of executive (inside) and non-executive (outside) directors	6.1	Do more than 50% of the directors have sound and updated knowledge of finance and corporate financing?
	6.2	Do more than 50% of the outside directors have sound and updated knowledge of finance and corporate financing?
	7.1	Is there a systematic training programme for directors?
	7.2	Do they have certifications in financial matters on which they make decisions?
	7.3	Is the performance of each outside director regularly reviewed?
	8.1	Do the outside directors flag conflicts of interest in the bond issuance process?
	9.1	Are there three or more outside directors for each inside one?
	9.2	Are the outside directors selected by a committee of independent directors?
	10.1	Do the inside directors sign off, as legally and criminally accountable, on disclosures concerning a bond issue and its implications for the financial position of the company?
	11.1	Is the internal audit director a member of the board?
	11.2	Does the internal audit director report directly to the board or the audit committee?

Table II.1 (concluded)

Categories		Standards
Audit committee	12.1	Is the audit committee chaired by an independent director?
	12.2	Is the independent auditor engaged by the audit committee, and does it report to the committee?
	12.3	Does the audit committee approve the internal and external audit programmes?
	12.4	Is there an effective reporting system on corporate finance?
	12.5	Does the committee prepare regular reports to the board and to general management on compliance with internal control policies on the use of financial resources for financing?
Financial asset investment committee	13.1	Is the investment committee chaired by an independent director?
	13.2	Does the chair of the investment committee have proven experience in investment strategies?
	13.3	Does the committee meet at least once a month?
Corporate finance committee	14.1	Is the committee chaired by an independent director?
	14.2	Does the committee chair have proven experience in corporate financing?
	14.3	Is this the committee that defines the funding requirements of the company and how to meet them?
	14.4	Is this the committee that selects the financial intermediaries to place bonds issued by the company?
Risk committee	15.1	Is the risk committee chaired by an independent director?
	15.2	Does the committee chair have proven experience and expertise in comprehensive risk management?
	15.3	Is it the risk committee that is responsible for ruling on reports on the financial risks faced by the company?
	15.4	Is it the risk committee that explains the company's bond issuance risks?

Source: Georgina Nuñez and Andrés Oneto (coords.), *Gobernanza corporativa en el Brasil, Colombia y México. La determinación del riesgo en la emisión de instrumentos de deuda corporativa*, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC)/CAF-development bank of Latin America/Inter-American Development Bank (IDB), 2012.

In short, all board of directors and board committee actions, along with director independence and the internal control system, are crucial for assessing a company's exposure and, therefore, its funding costs. After discussing corporate governance standards with an impact on the debt securities issuance process, the next phase of the methodological approach included weighting each category in order to lay out the matrix of benchmarks for the corporate governance index in table II.2.

Table II.2
Matrix of corporate governance index benchmarks in terms
of corporate debt securities issuance

Categories	Weight
Role of the board of directors	2.075
Structure of the board of directors	0.094
Role of the chair of the board of directors	0.566
Role and selection of directors	2.079
Audit committee	1.885
Financial asset investment committee	0.285
Corporate finance committee	1.508
Risk committee	1.508
Total	10.00

Source: Georgina Nuñez and Andrés Oneto (coords.), *Gobernanza corporativa en el Brasil, Colombia y México. La determinación del riesgo en la emisión de instrumentos de deuda corporativa*, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC)/CAF-development bank of Latin America/Inter-American Development Bank (IDB), 2012.

This weighting took into account the degree of importance assigned to each indicator category in the issuance process. Héctor Pérez Galindo provides a more detailed look at the indicator in chapter I of this publication. The matrix of benchmarks is set out in table I.3 of that same chapter.

Applying the indicator can yield an assessment of corporate governance practices and identify areas related to corporate bond issuance that could be improved, thereby enhancing risk transparency and decreasing transaction costs. However, as with most business indicators, other questions can arise within each category and the weighting is open to adjustment. In any event, this matrix of corporate governance standards is a tool for standardizing measurement of how companies behave in different markets.

Although the indicator provided is typically microeconomic (company level), it is indirectly influenced by legal and institutional factors. For example, it is reasonable to assume that the quality of enforcement is an important factor when companies in a given country decide whether (or not) to adopt good corporate governance practices.

E. The new evidence

Applying the indicator to 14 companies in Brazil, Colombia and Mexico drew attention to some areas of the corporate governance structure at the companies reviewed. Because it was difficult to get companies to participate by responding to the questionnaire, the findings from the index are based primarily on public information provided by companies to the regulator.

In the case of Colombia and Peru, representatives of the companies were interviewed in addition to drawing on public information. This positively influenced the index findings. Moreover, it led to the conclusion that companies do not publicly disclose all of their corporate governance requirements in a consolidated manner, even if they are in compliance and confidential documents are not involved. This means that any review limited to public information only (governance codes and by-laws, among other documents) would likely show a less complete degree of performance. Nonetheless, the index scores went up after the interviews, because it was found that the companies met standards that did not necessarily appear in their codes, by-laws or reports.

Chile and Peru scored the highest. The respective chapters examine specific corporate governance practices and describe in detail the regulatory and institutional framework in which these practices are followed, focusing on behaviours related to the process of securing funding through corporate debt issues.

For comparison purposes, table II.3 shows the average findings for Brazil, Chile, Colombia, Mexico and Peru. They are comparable despite differences in release year and the warnings that usually apply to multi-case studies. Despite the time lag in applying the indicator, the data are sufficiently robust to examine them together.

Because of the small sample size (22 companies), the findings for the subject companies do not reflect overall corporate governance performance in the five countries. They can, though, indicate potential weaknesses that should be addressed in order to improve the debt issuance process. Overall, the highest-scoring category was the role of the board of directors, with an average of 1.65. In other words, the companies came in at 80% of the benchmark value for that category (2.075). The companies scored 71% of the benchmark value for the category referring to the structure of the board of directors; the score for the audit committee was 60%, and the score for the role and selection of inside and outside directors was 49%.

The least satisfactory findings were for the risk committee (40%), the financial asset investment committee (36%), the corporate finance committee (32%) and the role of the chair of the board of directors (31%). These findings highlight four points that should become priorities for improving corporate governance performance in the issuance of corporate debt, even in countries that are in a relatively better position, as are Chile, Mexico and Peru.

Table II.3
Average values per country: Brazil, Chile, Colombia, Mexico and Peru

Categories	Benchmark	Brazil (2012)	Colombia (2012)	Mexico (2012)	Chile (2014)	Peru (2014)	Average
Role of the board of directors	2.075	1.19	1.60	1.73	1.79	1.93	1.65
Structure of the board of directors	0.094	0.06	0.08	0.06	0.06	0.06	0.07
Role of the chair of the board of directors	0.566	0.03	0.24	0.22	0.19	0.19	0.17
Role and selection of directors (inside and outside)	2.079	0.38	1.09	0.85	1.61	1.13	1.01
Audit committee	1.885	0.13	1.41	1.38	1.51	1.23	1.13
Financial asset investment committee	0.285	0.00	0.12	0.16	0.12	0.12	0.10
Corporate finance committee	1.508	0.00	0.00	1.07	0.75	0.57	0.48
Risk committee	1.508	0.00	0.28	0.75	1.13	0.85	0.60
Total	10.000	1.79	4.82	6.22	7.16	6.08	5.22

Source: Georgina Nuñez and Andrés Oneto (coords.), *Gobernanza corporativa en el Brasil, Colombia y México. La determinación del riesgo en la emisión de instrumentos de deuda corporativa*, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC)/CAF-development bank of Latin America/Inter-American Development Bank (IDB), 2012; see also chapters V and VIII, by Alvaro Clarke and Jorge Echandia, respectively, herein.

F. Conclusions

An analysis of the findings for the 22 companies in the five countries reviewed clearly shows that Chilean companies posted the best performance in the corporate governance indicator for issuance of private debt securities. This is not likely to be by chance: Chile has the highest ratio of corporate bonds outstanding to GDP, in both the international market and the domestic market. Actually, it would be a surprise if the index for Chile were not the highest in the region, in view of the continuous development of the institutional framework for the capital market. Chile has been out front of other Latin American countries in terms of major reforms.

Chile's good performance has radiated out to other countries of the region, particularly Peru and Colombia, which have emulated good standards and practices. Obviously, this is more likely to happen when there are institutional mechanisms and political will favouring convergence. MILA and, more recently, the Pacific Alliance are important initiatives for reaching those goals. In addition, the recent accession of Mexico to MILA could reinforce this trend.

If for Peru and Colombia increasing convergence with Chile (albeit at different rates) seems to be a way to compensate for the small size of the corporate bond market, this is definitely not the main challenge for Mexico or Brazil.

For Mexico, the corporate governance indicators for issuance of international debt securities (as a ratio of GDP) are relatively high and growing rapidly. Geographical proximity to the United States seems to favor the development of international securities issues; the domestic market is still relatively restricted. Access to the United States market would therefore seem to hinder promotion of the domestic market, especially since the latter has adapted (albeit partially) to the requisites for issuing debt in the United States market.

The low scores on the indicator for Brazil, combined with the small proportion of international issues and the large number of domestic ones (both as a percentage of GDP), seem to suggest that companies in Brazil are under less pressure to adopt some of the international good corporate governance practices for issuing debt because their buyers are Brazilian investors. Since the latter tend to know more about the real financial situation and corporate behaviour, Brazilian companies feel less pressure to spell out their corporate governance practices or set up specific financial committees even if they properly

adhere to specific functions but do not inform the market. This is one possible explanation, but it should be taken as an unvalidated hypothesis.

Adding two new countries (Chile and Peru) to the sample improved the overall corporate governance performance indicator for bond issuance. But it is reasonable to assume that including other countries in the region would tend to worsen the findings because of smaller market size and more fragile institutional frameworks. The cases of Chile and Peru, which have relatively high index scores and low dispersion among companies, point to the existence of national standards. If so, having regulations is even more important because companies seem more likely to come into line with recommendations (whether or not they have the force of law) to adopt practices much sooner than other local businesses.

Another important issue related to the role of external actors (institutional investors, investment banks and rating agencies) is their capacity to promote the adoption of good corporate governance practices in the countries of the region. The fact is that investment banks and rating agencies are predominantly global firms that tend to standardize procedures, favouring convergence towards good practices. Notwithstanding criticism stressing the lack of technical rigour of the ratings, it is unlikely that the role of the agencies could be replaced. They send signals to the market, as do investment banks.

Clearly, rating agencies and investment banks market services based on their reputation. Here, it is germane to note two key conclusions from chapter three hereof on the reality of developing countries worldwide, which in all likelihood applies to Latin America. First, the underwriting fee is a decreasing function of investment bank reputation and rating agency perception. Second, these agencies' perception of credit risk affects the fees for issues placed by reputable banks as well as by banks whose reputation is not so good. Furthermore, at present the rating agencies are not contributing much to the dissemination of international good corporate governance practices.

Regarding the role of institutional investors the situation is more complex because recent empirical evidence shows substantial differences in level of engagement among the different categories of institutional investors (pension funds, insurance companies and mutual funds) as well as wide variations in behaviour within each category. Engagement depends on a number of factors, such as economic incentives related to different business models, investment strategies and business practices. Also, when this level of commitment is not a cornerstone of the model, voluntary standards and public policies aimed at boosting the active participation of institutional investors in fostering advances in corporate governance tend to have a limited effect. Thus, investors have the potential to play a meaningful role in improving corporate governance to the extent that they are aligned with the economic benefits they expected.

It therefore emerges that in recent years —post-global economic crisis— the corporate bond market in Latin America has been performing well. These markets still tend to be small but have much potential for expansion. Nor is the corporate governance index score for the market unfavourable, particularly in Chile, Mexico and Peru. Chile stands out because of the volume of corporate bond issuance relative to GDP, a good regulatory framework and continuous improvement of corporate governance. Because national corporate governance standards seem to outweigh differences in business behaviour, and because institutional investor engagement is highly conditional on the economic benefits for those investors, standards must be geared to induce an improvement in the transparency of Latin American firms.

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Annex II.1

Impact of external agents on issuance of debt securities

The following table summarizes a set of guidelines aimed at identifying the impact of institutional investor, investment bank and rating agency operations on debt issuance.

Categories	Aspects of debt issuance
Role of institutional investors	<p>1. What are the main types of institutional investors that have acquired debt issued by the company?</p> <p>(a) International:</p> <p><input type="checkbox"/> Pension funds</p> <p><input type="checkbox"/> Investment funds</p> <p><input type="checkbox"/> Private equity firms</p> <p><input type="checkbox"/> Insurance companies</p> <p><input type="checkbox"/> Other _____</p> <p>(b) Domestic:</p> <p><input type="checkbox"/> Pension funds</p> <p><input type="checkbox"/> Investment funds</p> <p><input type="checkbox"/> Private equity firms</p> <p><input type="checkbox"/> Insurance companies</p> <p><input type="checkbox"/> Other _____</p> <p>2. What were the main criteria when deciding about investing in corporate debt securities?</p> <p><input type="checkbox"/> The company’s capital structure</p> <p><input type="checkbox"/> Debt ratio</p> <p><input type="checkbox"/> Leverage ratio</p> <p><input type="checkbox"/> Country risk rating</p> <p><input type="checkbox"/> Company risk rating</p> <p><input type="checkbox"/> Corporate governance performance</p> <p><input type="checkbox"/> Other _____</p> <p>3. Rank the selected criteria in order of importance (with 1 being the most important criterion).</p> <p><input type="checkbox"/> The company’s capital structure</p> <p><input type="checkbox"/> Debt ratio</p> <p><input type="checkbox"/> Leverage ratio</p> <p><input type="checkbox"/> Country risk rating</p> <p><input type="checkbox"/> Company risk rating</p> <p><input type="checkbox"/> Corporate governance performance</p> <p><input type="checkbox"/> Other _____</p> <p>4. Rank the selected aspects in order of importance for corporate governance (with 1 being the most important criterion).</p> <p><input type="checkbox"/> Board of directors practices</p> <p><input type="checkbox"/> Board composition (independent directors)</p> <p><input type="checkbox"/> Director experience</p> <p><input type="checkbox"/> Internal control and risk management</p> <p><input type="checkbox"/> Communication and transparency</p> <p><input type="checkbox"/> Shareholder rights</p> <p><input type="checkbox"/> Other _____</p>

Categories	Aspects of debt issuance
Role of investment banks	1. Who is/are the underwriter(s) selected to place debt securities? Year _____ : _____ Year _____ : _____ Year _____ : _____
	2. Has your company kept the same underwriter for its two most recent placements? () Yes () No
	3. What were the main criteria for keeping or changing the underwriter? () Fee () Relationship () Other _____
	4. How is the underwriter's fee for placing debt determined? _____
	5. What kind of issues have you conducted? () International (Eurobonds) () Domestic () Both
	6. What currency(ies) are your issues in? () U.S. dollar () Euro () Other _____
	7. Do the investment banks regularly monitor performance of your bond placements? () Yes () No
Role of rating agencies	1. What are the main criteria in the risk assessment model you use for debt issues? () Historical trend of financial ratios () Leverage () Market share and position () Quality of corporate governance () Internal control and risk management () Other _____
	2. Where does corporate governance quality rank among the main criteria? () _____
	3. Do international or domestic agencies rate your issue(s)? () International () National
	4. What rating was assigned to your debt issues? () _____
	5. Is the country risk rating very important for your risk assessment? () Yes () No
	6. How many agencies rate or have rated your debt issues? () _____
	7. What criteria are used for determining the underwriting fee you are charged? () _____
	8. Do you work well with the regulator when confirming a rating or authorizing issuance? () Yes () No

Source: Prepared by the author.

III. What factors impact the cost of corporate bond issuance? A study of emerging primary markets

Rolando Avendaño and Sebastián Nieto-Parra¹

A. Introduction

The purpose of this chapter is to analyse emerging corporate bond markets and the determinants of their issuance costs. The period analysed, 1991-2009, takes in the long cycle of corporate issuance in the global market before the international financial crisis of 2008. This analysis seeks to assess the importance of both firm-level factors and macroeconomic aspects in the final cost of issuance, which ultimately determines choices about whether to issue in international and domestic markets. Two dimensions of the cost of capital are analysed most thoroughly: the underwriting fee paid by the firm and the primary spread of the issue.

Accordingly, this chapter studies the role of reputation and rating agencies' perceptions in the context of a fixed-term primary corporate bond market. Preliminary findings indicate that the factors affecting each of these differ considerably depending on the type of cost. While the corporate spread is explained by macroeconomic variables (including sovereign ratings), firm variables are more relevant in explaining underwriting fees. These fees are a decreasing function of reputation and rating agencies'

¹ This chapter is based on Avendaño and Nieto-Parra (2014) and was prepared for the Economic Commission for Latin America and the Caribbean (ECLAC)/CAF-development bank of Latin America/Inter-American Development Bank (IDB)/Organisation for Economic Co-operation and Development (OECD) Development Centre project "Corporate Governance and Risk Assessment Corporate Debt Issuance". The authors wish to thank Christian Hernandez for his outstanding assistance with this research. They are also grateful to Nicolas Alvarez, Marc Flandreau, Pablo Garcia, Martin Grandes, Hector Lehuedé, Germano Mendes de Paula, Georgina Núñez, Andrés Oneto, Ugo Panizza, Richard Portes, Claudio Raddatz and Romain Rancière for their comments and input. The preliminary results of the research were presented at the Latin American and Caribbean Economic Association (LACEA) meeting of November 2010. The opinions and arguments in this document are the sole responsibility of the authors and do not necessarily reflect the views of OECD or its member countries.

perception of the issuer. The results suggest that investment banks (which set underwriting fees) are more interested in the issuer's financial sustainability than institutional investors (who determine primary spreads).

Signalling and advertising by investment banks in capital markets are of vital interest to potential investors. Investment banks acting as underwriters can solve information problems thanks to their reputation, with theoretical results suggesting that more reputable banks are associated with lower-risk issuers and charge higher underwriting fees in the primary market (Chemmanur and Fulghieri, 1994; Booth and Smith, 1986). Similarly, rating agencies can provide investors with useful information, solve principal-agent problems and deal with information shortcomings. In that context, banks' reputations and rating agencies' perceptions can affect the cost of capital for firms.

Are these patterns observed in emerging corporate markets? This chapter aims to answer that question by analysing the matching of issuers and investment banks and the perceptions of rating agencies in emerging corporate bond markets. While a considerable literature has been devoted to corporate markets in developed countries, there is no research on primary corporate bond markets in the emerging world, especially Latin America, where information is fairly scarce. In addition to the variables associated with the matching of issuers to underwriters and rating agencies' perceptions, we study the role of other determinants that could explain the behaviour of underwriting fees and primary spreads in bond issuance.

This chapter shows that the cost of capital for international bonds issued by emerging-market firms ultimately depends on a combination of macroeconomic factors, issuer and issue characteristics, rating agencies' perceptions of credit risk and variables associated with the matching of issuers and underwriters.

Focusing on the primary market provides the most thorough understanding of the structure of emerging corporate debt. There are at least two reasons for studying the primary market instead of the secondary market. First, by revealing the mechanisms of price formation in the primary market, this research yields a more accurate understanding of the sources of costs in international corporate debt issuance (see Ritter, 1987, for a discussion of the corporate market in developed countries). Second, the primary market is the place to analyse the behaviour and interactions of key players in the fixed-income market, such as issuers, underwriters, institutional investors and rating agencies.

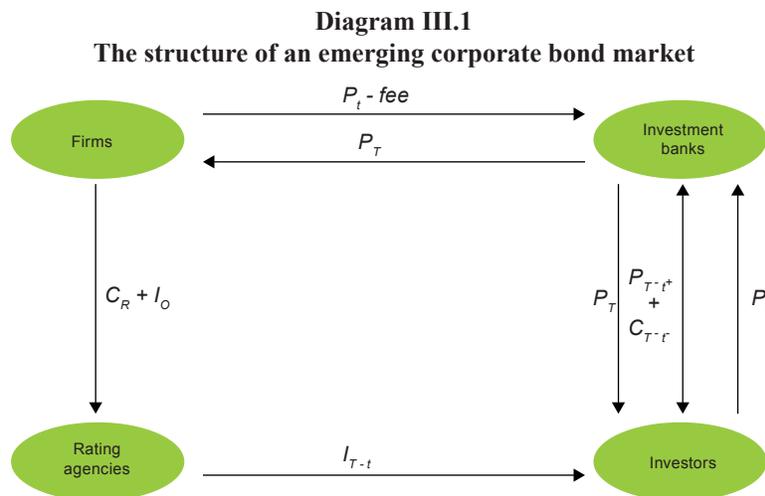
Important features of the microstructure of the corporate bond market underlie the determinants of underwriting fees and the primary bond spread. First, we study the determinants of investment banks' and institutional investors' perceptions of the quality of a bond issue by looking at the underwriting fee and the primary bond spread, respectively. Second, we estimate the impact that a better rating can have on fees and spreads, other things being equal. Lastly, we consider a set of variables associated with the strategy followed by firms and investment banks to tap institutional investors in the international market. Given the strategy, it is crucial to determine the key variables characterizing the issue, such as maturity, currency denominations, amount issued and bond regulations.

B. The operation of the global primary corporate bond market

In this section, we describe the structure of the global primary market for corporate bonds and the major risks faced by investment banks when acting as underwriters of debt securities in this market (see Flandreau and others, 2013, for further details of the structure of the primary market and critical steps in the issuance process).

A simple version of the structure of the corporate bond market is shown in diagram III.1, which illustrates the interactions between participants in that market when a financial transaction is executed. Investment banks are the underwriters in the emerging corporate bond market. Investors participate in the primary market or in the secondary market (by buying or selling securities) through investment

banks. The bulk of investment banks' income is derived from these transactions. In particular, the underwriting fee paid by the issuer to the investment bank underwriting the security will be deducted from the price offered to investors in the primary market, and is agreed between the investment bank and the firm before a bond is priced in the primary market.



Where:

- P: Price of the sovereign bond (financial transaction carried out against the transfer of the security)
- fee: Underwriter's fee paid by firms to investment banks
- C_R : Commission paid by the issuer to the rating agency
- I: Information flow
- T: Maturity date
- t: Issuing date
- C: Commission paid by investors to investment banks

Source: Sebastián Nieto-Parra, "Who saw sovereign debt crises coming?", *Journal of the Latin American and Caribbean Economic Association*, vol. 10, No. 1, Brookings Institution Press, 2009.

The rating agencies are the other key participants in this market. The issuer pays them a fee to obtain a rating which they calculate on the basis of relevant information provided by it and which is a key piece of information about issuer risk for institutional investors.

Besides its role as an intermediary between issuers and investors, one of the most important responsibilities of the underwriter is to promote the bonds. A preliminary prospectus (called a "red herring") is made available to investors and contains all the necessary information about the issue other than the offer price and the effective date of issue, which are not known at the time the "red herring" is prepared. With this preliminary prospectus, the underwriter and the issuer promote the bonds through presentations, telephone conferences, publications and sometimes "roadshows". The research departments of investment banks also circulate periodicals covering a number of issuers that contain advice to investors on the type of corporate bonds they should buy.²

These publicization and advocacy efforts are a source of risk for investment banks acting as underwriters, the main danger being the potential loss of reputation in the event an issuer defaults. In the developed-country corporate market, Hua Fang (2005) concluded that high-reputation banks charged higher fees, which can be interpreted as economic rents on reputation.

The roles and responsibilities of underwriters are not the same now as in the past, when investment banks provided their customers at both ends (lenders and borrowers) with a wide range of services. These banks acted as brokers, certifiers and lenders of last resort in the event of arrears or default. Today,

² See Nieto-Parra (2014) for an analysis of possible conflicts of interest between the recommendations issued by investment banks and their primary market sovereign debt underwriting activities.

underwriters are no longer guarantors and have outsourced certification to rating agencies, so modern investment banks primarily act as “market makers” for the issuer. As a result, analysis of emerging-market sovereign debt shows that defaults are now distributed randomly among the underwriters of such debt, something that has been called the “default puzzle” (Flandreau and others, 2009).

This process has beneficial aspects but has also brought new risks. Market discipline has weakened because underwriters do not assume the risk of default, so that more defaults on debt payments are transferred to the system. Moreover, the degree to which the increased risk remains manageable depends crucially on the ability of investors to diversify. However, large-scale diversification correlated against supply shocks is not necessarily feasible (Flandreau and others, 2009).

C. The literature on the primary corporate bond market

Empirical literature on the structure of primary emerging bond markets is fairly scarce. Research into issuance costs in emerging bond markets has focused on analysing the spread on bonds issued by sovereigns, while less effort has been devoted to analysing underwriting fees. Nieto-Parra (2009) finds that countries that will eventually undergo a debt crisis pay high underwriting fees. Conversely, sovereign bond spreads do not seem to be a good leading indicator of debt crises. Viewing the sovereign bond market historically, Flandreau and others (2009 and 2013) show the role of underwriters’ reputation as a signal of issuer risk guiding investors’ portfolio allocations. A large number of analyses concerning the structure of primary bond markets are limited to the access of emerging countries to the international bond market (Grigorian, 2003; Gelos, Sahay and Sandleris, 2004; Fostel and Kaminsky, 2007) or descriptive aspects related to issuance cost on the primary market (see Zervos, 2004, for the cases of Brazil, Chile and Mexico). Studies of emerging sovereign bond characteristics concentrate on regulatory topics, in particular the use of collective action clauses (Eichengreen and Mody, 2004; Gugliatti and Richards, 2003; Becker, Richards and Thaicharoen, 2003).

Research on the emerging corporate bond market has concentrated on the secondary market or on the scope for issuing debt or equity in international and domestic markets (Gozzi, Levine and Schmukler, 2008).

The scant literature on the determinants of issuance costs in emerging bond markets contrasts with the abundance of works on the determinants of underwriting fees and bond spreads in the primary corporate market in developed countries. These provide a useful basis for analysing emerging corporate bond markets.

Several factors are considered to determine corporate bond issuance costs in developed countries. Where the determinants of underwriting fees in particular are concerned, analyses cover the impact of certain issue characteristics, such as maturity (West, 1967; Higgins and others, 1980), the issue amount (Altinkihc and Hansen, 2000; Sorensen, 1979; Torstila, 2001), bond regulations (see Livingston and Zhou, 2002, for an analysis of securities issued under Rule 144A) and currency (see Santos and Tsatsaronis, 2006; Kollo and others, 2002; and Melnik and Nissim, 2006, for the impact of the introduction of the euro on fees).

Variables associated with the matching between the issuer and the underwriter are also considered to determine fees (Hua Fang, 2005; Livingston and others, 2000; Kollo and others, 2002; Burch and others, 2005). Research dealing with issuer characteristics has focused on the link between the quality of the issuer and the underwriting fee, finding an inverse relationship between them (West, 1967; Higgins and Moore, 1980; Rogowski and Sorensen, 1985; Lee and others, 1996; Kollo and Sharpe, 2002; Melnik and Nissim, 2006; Chitru and others, 2005; Hua Fang, 2005; Livingston and Miller, 2000).

This is interpreted as being a consequence of the greater effort required from intermediaries when they act as underwriters of lower-quality issues (see Altinkihc and Hansen, 2000). In the event of

default, investment banks risk a loss of reputation. By controlling for the endogenous matching between issuers and underwriters, Hua Fang (2005) finds that reputable banks charge higher fees, which can be interpreted as economic rents on reputation.

Research on issuance costs in developed-country corporate markets can be useful in determining factors that affect underwriting fees and primary bond spreads in the emerging corporate bond market. Here, it is vital to analyse the matching between issuers and underwriters, and the impact the perceptions of rating agencies have on the cost of capital, other things being equal.

In the same way, corporate governance can have a considerable impact on the capital cost of a corporate bond, since its mechanisms, if properly used, can reduce default risk via the mitigation of agency cost, monitoring of management performance and reduction of information asymmetries between firms and their investors. Thus, firms with a higher proportion of institutional owners and stronger external control over their boards should enjoy lower bond yields and higher credit ratings on their new bond issues (Bhojraj and Sengupta, 2001). Conversely, when institutional shareholders have less control over board decisions and at the same time there are disagreements over the distribution of resources allocated by controlling shareholders, the firm's credit rating will suffer and funding will be more expensive as a result. Institutional investors have a major responsibility for the governance of companies they invest in and can act as a restraint on boards, preventing malpractice.

D. The primary corporate debt market: stylized facts and information used

1. Main characteristics

Corporate debt markets represent an important segment in the array of fixed-income instruments available in emerging economies. In Latin America generally, many issuers of these debt instruments are prestigious and internationally active companies. However, the vast majority of issuances are not included in the portfolios of international investors and are not part of “benchmarks” (Ivanov, 2011). In recent years, the emerging corporate bond sector has had more attractive yields and higher returns on investment than other fixed-income sectors with similar ratings. In addition, default rates have been as good as or better than those of high-yield bonds in the United States.

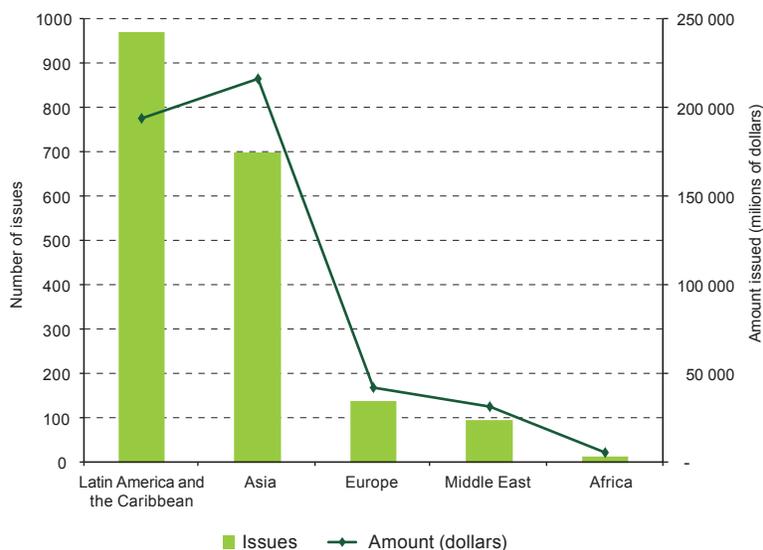
Improved emerging sovereign ratings during the first decade of the twenty-first century and reduced foreign-currency exposures in most emerging economies have allowed the corporate debt market to develop. This has been seen in a number of Latin American countries, and in general it has been perceived that some institutional investors have entered corporate markets where previously their investments were confined exclusively to public debt markets (Ivanov, 2011; Borensztein and others, 2009).

Corporate debt issuance has overtaken sovereign debt issuance in a number of emerging economies, especially larger or better-positioned ones such as Russia, Brazil and Chile. Given the growing surplus of new corporate emissions over sovereign ones, levels of emerging-market corporate debt are expected to exceed those of sovereign debt in a number of countries such as China and the Republic of Korea in the coming years, which will increase the depth and liquidity of the sector (Ivanov, 2011).

When the evolution of issues in the main emerging regions is analysed, a large proportion of them can be seen to have originated in Latin America during the 1990s and the first decade of the twenty-first century. In fact, there were over 950 issues in Latin America during that period, whereas none of the emerging regions of Asia, Europe, the Middle East or Africa exceeded 700. It is important to stress the corporate debt issuance performance of Argentina, Brazil and Mexico, since of 15 issuing countries in Latin America, these three alone accounted for some 89% of all issues, with 141, 389 and 334, respectively. In other emerging markets, issues are more evenly distributed between countries,

although Asia is an exception, with more than half of all issues by volume being accounted for by South Korea alone. When the value of issuance in each of these regions is analysed, Asia takes the lead, followed by Latin America and the Caribbean. Indeed, these two regions practically dominate the emerging corporate debt market, both by the number of issues and their value (see figure III.1).

Figure III.1
Corporate debt issuance in emerging markets, 1991-2009
(Number of issues and millions of dollars)



Source: Prepared by the author on the basis of calculations of Dealogic DCM Analytics.

Although the period subsequent to the 2008 global financial crisis is not part of this study, it might be noted that corporate bond growth has been substantial everywhere in the emerging world. In 2012, issues in Chile were put at over 3% of GDP, with figures of 2% for Mexico, 1.7% for Peru and 1% for Colombia. These levels were considerably higher than those before the crisis, as issues in 2006 were worth less than 1% of GDP in all these countries. The sectoral composition of issues has also been evolving over recent years in some Latin American countries, with the financial sector accounting for a larger share and the export sector a smaller one.

To analyse emerging markets, we used data on the market for corporate bonds issued by firms based in emerging countries over the 1991-2009 period. Debt securities conforming to the following parameters were considered for this analysis: (i) we analysed only corporate bonds issued in international capital markets (i.e. public and private issues in the global and euro markets); (ii) we included corporate bond issues for which the underwriting fee and the primary bond spread were known; (iii) we excluded issues with floating coupon rates.

The decision to study international issues was motivated mainly by the availability of comparable issuance data in Latin America. In local debt markets, this information is not easily comparable and does not have the same level of detail available as international issues for the analysis proposed. This could lead to some bias for the set of firms analysed, since international issues are mainly confined to a small group of large, export-oriented companies with relatively high borrowing capacity. In Chile, for example, just 15 firms have carried out international issues in the last four years. Likewise, there are some cost differences between local and international issues. Local issues, which are becoming more and more important in the region, are a matter for future research.

The final sample comprises 1,356 issues by 669 firms in 43 countries. Table III.1 presents the evolution of the corporate debt market over the 1991-2009 period. The total value of the corporate bonds

issued during this period was over US\$ 399 billion, with an average issue amount of some US\$ 430 million. The beginning of the international financial crisis meant a significant fall in issuance in 2008 and 2009 compared to previous years, which had been characterized by strong liquidity in global markets.

Table III.1
The primary emerging corporate bond market in Latin America, 1991-2009

Year	Number of countries	Number of bonds	Total amount issued (millions of dollars)	Average amount issued (millions of dollars)	Average maturity (years)	Total fee (millions of dollars)	Average fee (millions of dollars)	Average underwriting fee (percentage of amount issued)	Average primary bond spread (basis points)	Average share denominated in euros, yen or dollars (percentage of total)	Average number of lead managers
1991	4	12	1 602.2	133.5	4.1	25.90	2.16	1.59	383.8	100.00	1.00
1992	6	54	5 608.4	103.9	5.3	71.09	1.32	1.28	424.4	100.00	1.06
1993	13	176	23 629.0	134.3	10.2	286.72	1.63	1.19	386.4	90.91	1.16
1994	16	89	12 455.4	141.5	7.5	135.30	1.52	1.09	330.8	89.89	1.40
1995	16	73	12 272.3	168.1	8.2	126.33	1.73	1.06	287.8	84.93	2.04
1996	20	170	37 511.9	220.7	5.7	378.21	2.22	1.03	259.1	93.53	1.49
1997	28	199	60 000.8	301.5	5.8	601.94	3.02	1.01	222.8	92.46	1.06
1998	18	69	14 065.1	213.1	7.2	152.12	2.20	1.13	321.3	82.61	1.19
1999	22	70	29 139.9	422.3	7.5	264.34	3.78	0.98	370.7	100.00	1.11
2000	15	54	15 421.6	285.6	9.5	130.02	2.41	0.83	320.2	100.00	1.22
2001	17	53	28 923.1	545.7	8.5	175.55	3.31	0.64	302.4	98.11	1.19
2002	15	49	20 789.7	424.3	8.3	134.84	2.75	0.70	364.3	100.00	1.37
2003	12	53	26 057.9	491.7	6.4	123.32	2.33	0.57	332.4	96.23	1.47
2004	23	95	37 231.9	391.9	7.9	151.00	1.59	0.47	262.1	98.95	1.94
2005	14	58	28 110.5	484.7	7.5	154.20	2.66	0.56	258.2	100.00	2.00
2006	17	30	24 446.7	814.9	8.2	84.54	2.82	0.64	267.4	96.67	2.03
2007	8	15	8 344.5	556.3	9.6	73.71	4.91	0.97	273.4	100.00	2.67
2008	4	9	7 157.2	795.2	7.7	32.01	3.56	0.36	384.3	77.78	2.78
2009	2	4	6 442.3	1 610.6	7.6	30.74	7.68	0.48	606.9	100.00	1.50
	14.21	70.11	399 210.38	433.67	7.51	3 131.88	2.82	0.87	334.67	94.85	1.56

Source: Prepared by the author on the basis of calculations of Dealogic DCM Analytics and Thomson Reuters Datastream.

Bond maturities ranged from 4 to 10 years, with an average of 7.5. The total income received by underwriting banks for their services over the period was some US\$ 3.1 billion (an average of about US\$ 2.8 million per issue), with the underwriting fee averaging 0.87% of the total amount issued.

In emerging markets, the average primary bond spread was 334 basis points in the corporate bond market, compared with 312 basis points in the sovereign bond market for the same period. Lastly, 94% of issues were denominated in euros, yen or dollars, while the average number of lead managers was nearly 1.5 per issue. Table III.2 gives descriptive statistics for the variables used in this chapter (number of observations, mean, standard deviation and source) and highlights a substantial difference between the large number of variables available for issue characteristics (over 1,300 observations) and the number available for the characteristics of the issuing firm (less than 400 observations), while for some variables there were fewer than 300 observations, an example being the weighted average cost of capital (WACC), a key indicator of a firm's financial position.

Table III.2 reveals that there is a relative lack of standardized financial information on issuers based on data that include different emerging economies. Regarding the characteristics of issuers, we observe that these firms are not investment grade on average, and there is great variation in respect of share price volatility, the cost of capital and corporate rates of return. On average, these companies have an annual rate of return in excess of 3.5% and a WACC of over 8, which could include other control variables associated with the company that do not necessarily relate to its indebtedness and profitability. Given this, variables like liquidity and cash flow-generating capacity could be included,

but some of these indicators are not available for many of the firms in the sample. Other indicators such as working capital and earnings before interest, taxes, depreciation and amortization were included in some specifications but were not statistically significant in explaining underwriting fees or spreads.

Table III.2
Descriptive statistics for issuance and firm-level variables

Variable	Observations	Mean	Standard deviation	Low	High	Source
Issue characteristics						
Gross spread (percentage) (underwriting fee)	1 357	0.95	0.65	0	6.5	Dealogic
Spread over benchmark (basis points)	1 357	306.41	188.92	0	950	Dealogic
Amount issued (millions of dollars)	1 352	299	378	14.8	3 700	Dealogic
Number of issuing banks by bond	1 357	1.36	0.67	1	5	Dealogic
Investment grade dummy	1 357	0.42	0.49	0	1	Dealogic
Firm-level variables						
Total assets (billions of dollars)	368	7.26	20.9	3.57	161.00	Worldscope
Market value (billions of dollars)	399	4.3	14.8	1	132.00	Thomson Financial
Net income (thousands of dollars)	369	129 422	435 232	-622 553	3 048 105	Worldscope
Sales (billions of dollars)	368	1.79	5.06	1	44.4	Worldscope
Stock volatility	367	8.75	4.09	1	20.00	Thomson Datastream
Weighted average cost of capital (WACC)	224	8.70	10.83	-117.83	57.51	Thomson Financial
Profitability	367	0.04	0.05	-0.19	0.31	Worldscope

Source: Prepared by the author on the basis of calculations of Dealogic DCM Analytics.

Variables reflecting macroeconomic conditions in the country are available from widely used databases such as the World Bank Global Development Finance (GDF) and World Development Indicators (WDI) databases. Sovereign ratings are obtained from Standard & Poor's and external conditions (10-year United States Treasury Bond yields, the VIX index and United States industrial production) are available from Thomson Datastream. The main characteristics of bond issues, such as the amount issued, a no issue indicator, currency, maturity, bond regulations and special bond covenants, are obtained from Dealogic. The variables used to analyse the impact of regulations and special covenants are United States Security and Exchange Commission registration, Regulation S, Rule 144A and collective action clauses for issuance costs.

In addition to the reputation variable described below, we consider a set of issuer-related variables constructed from Dealogic data, such as the number of underwriters in the lead managers group, stability³ and interaction between Governments and underwriters. To measure the stability of issuer-underwriter relationships, we follow Kollo and Sharpe (2006) in estimating the proportion of issues (in value terms) underwritten by an underwriter with the same parent as the current underwriter. In the same way, we use a switch dummy taking the value 1 if the lead manager on the previous issue was different to the lead manager on the current issue. Overall, about 23% of all issues in the sample had a different underwriter from the previous one, which contrasts with the 80% observed in the case of sovereign issues. This suggests that emerging-market firms might follow a different strategy as regards underwriters and not switch as often as their sovereign counterparts.

Lastly, we integrate firm-level financial information obtained from Thomson Financial and Worldscope. The firm-level characteristics included in the specification are: firm size, capitalization in the year of issue and the firm's total assets, profitability (defined as net income divided by total assets in the year of issue), relative issue size (issue size over firm size), frequency (number of issues by the firm during the period), beta (the firm's beta), sigma (the issuer's stock return volatility during the 120 days prior to the bond issue date), total relative issues (the sum of all the firm's issue amounts relative to concurrent firm size during the sample period), total debt over total assets and the average cost of capital.

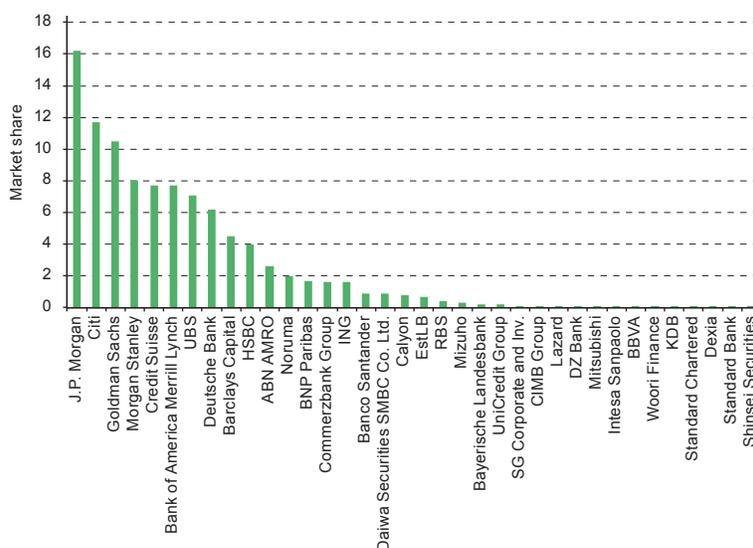
³ The stability variable is then the average for lead managers of issues.

2. Investment banks' market share and company ratings

The two key explanatory variables measuring the impact of investment banks and rating agencies on the cost of capital (i.e. underwriting fees and primary bond spreads) are obtained from the Analytics component of DCM Manager, the fixed-income product of Dealogic. These variables are underwriters' reputation and the credit risk perception of rating agencies. The standard methodology is to measure reputation by market share, a proxy often used in the corporate literature (McDonald and Fisher, 1972; Simon, 1989; De Long, 1991; Megginson and Weiss, 1991; Beatty and Welch, 1996; Livingston and Miller, 2000; Hua Fang, 2005).

Figure III.2 shows the emerging corporate debt market share of investment banks in the international capital market. The 10 largest investment banks (J.P. Morgan, Citibank, Goldman Sachs, Morgan Stanley, Credit Suisse, Bank of America Merrill Lynch, UBS, Deutsche Bank, Barclays Capital and HSBC) have a market share of over 80% between them. J.P. Morgan is the most reputable bank in the emerging corporate bond market, with a market share of over 15%. To measure the credit risk perception of rating agencies, we employ the residual of the corporate issue rating regression to reflect external factors and firm and issue characteristics. Following Eichengreen and Mody (2000), we prefer to use only the orthogonalized component of the corporate rating because it is correlated with other variables that are included separately as explanatory variables.

Figure III.2
Market share of investment banks in emerging corporate debt markets
(Percentages)



Source: Prepared by the author on the basis of calculations of Dealogic DCM Analytics.

Note: Reputation expressed as average percentage market share in 1991-2009.

Instead of using banks' market share and ratings as a continuous measure of reputation and of rating agencies' perceptions, we discretize both measures into a binary classification. In the case of investment banks' reputation, we use a dummy variable that takes a value of 1 when the issue is investment grade and 0 otherwise: in the investment banking industry, a bank is held to be either reputable or not (Hayes, 1971; Tinic, 1988; Carter, Dark and Singh, 1998; Hua Fang, 2005).

Regarding ratings (from Standard and Poor's rating agency), we use a variable that takes the value 1 if the issue is investment grade and 0 otherwise. Institutional investors and some regulations (like pension regulations in certain countries) differentiate strongly between issues depending on whether or not they are investment grade (Cantor and Packer, 1996; Dale and Thomas, 1991). Moreover, financing costs increase substantially for firms that are downgraded to below investment grade (Ferri, Liu and Stiglitz, 1999).

E. Determinants of issuance costs

1. Issuance cost estimation strategy

To calculate the determinants of cost of capital for corporate issues, we use a bond-level panel of firms from 43 emerging-market countries over the 1991-2009 period. This information is grouped using data from Thomson Financial, Worldscope and Datastream on firm-level characteristics. We also use macroeconomic and country-level data from the WDI and GDF databases. We estimate two separate models, one considering underwriting fees and another one for primary bond spreads. However, the estimation approach for issuance costs is the same in both cases and is specified below.

For the estimation, we start with a baseline model based on Eichengreen and Moody (2000). After that, we include year fixed effects in the OLS specifications, since high issuance costs could be explained by the re-emergence of this market in the 1990s and low costs in tranquil periods could be explained by the market maturing during the first decade of the twenty-first century. In a second step, we introduce external factors. In the third, we consider different characteristics associated with the issuer-underwriter relationship. Fourth, following Hua Fang (2005), we add a series of firm-level variables that depict the issuer's financial characteristics.

Lastly, we introduce the two key variables of this study: investment banks' reputation and the investment bank credit risk perception of rating agencies. At each stage, we check for the presence of multicollinearity of the explanatory variables for each at all stages of the estimation process by computing the variance inflation factors (VIFs).

With this set-up, we analyse the effects of the interaction between characteristics at the firm and issuer-underwriter level and the national and external level in determining the borrowing costs for our sample. As a robustness check for model selection, we carry out backward and forward stepwise selection, with very similar results to those yielded by the approach in the previous stage.

2. The determinants of underwriting fees

The results for the preliminary stages in the estimation of the underwriting fee using the benchmark model are summarized in table III.3. Initially, we considered a model following the specification of Eichengreen and Mody (2000) with additional macroeconomic variables. The results of this OLS-estimated specification include annual effects, external factors, issue characteristics, different configurations for the resulting firm-level characteristics and the results of the benchmark model for underwriting fees using the two key variables of this study: the underwriter's reputation (i.e. the investment bank's underwriting share in the corporate bond market) and rating agencies' credit risk perception (i.e. the residual of the regression with the investment grade dummy as the dependent variable). The best-performing of the underwriter reputation measures set out in table III.3 is the top three investment banks dummy (i.e. 1 if J.P. Morgan, Citibank or Goldman Sachs is the lead manager of the issue and 0 otherwise), determined from market share (figure III.3). It is important to note that only predictive high-level variables and/or those that did not affect the goodness of fit of the model were selected.

The results show that underwriting fees are driven by combinations of macroeconomic conditions, issue characteristics and firm-level variables. It is interesting to note that the number of significant macroeconomic variables is small when issue- and firm-level variables are included, by comparison with the large number of macroeconomic variables that help to explain fees. The results set out in table III.3 show that only two macroeconomic variables are significant in explaining fees. In particular, an increase in external debt relative to GNP and a decrease in the maturity of the total debt are associated significantly with a higher underwriting fee. An increase in the standard deviation of the external debt to GNP ratio will have a positive effect on the underwriting fee of 0.11%. These results can be explained by the positive impact that a country's solvency and capacity for long-term issuance have on investment banks' perception of the riskiness of corporate bond issues.

In the analysis of issue characteristics, table III.3 shows that the currency an issue is denominated in has a significant impact on underwriting fees. In particular, emerging corporate issues denominated in the most important market currencies (euros, yen and dollars) attract lower underwriting fees, and this can be explained by the greater opportunities for placing bonds denominated in these currencies (and thus the lesser effort involved in doing so) thanks to higher demand from institutional investors.

Table III.3
Determinants of underwriting fees (international issues): OLS time-fixed
and OLS time- and country-fixed effects regressions

	Benchmark
GDP growth (annual)	+
Ratio of external debt to GNP	+
Average maturity of new external debt	-
Ratio of reserves to GNP	
Dollar dummy	-
Euro dummy	-
Yen dummy	-
Profitability	-
Stock volatility	-
Frequency	-
Total debt as share of total assets	+
Residual investment grade	-
Reputation (top 1)	
Reputation (top 3)	-
Observations	
R-squared	186
Adjusted R-squared	0.536
Controls	Yes
Fixed effects (country)	Yes

Source: Prepared by the author on the basis of calculations of Dealogic DCM Analytics.

Note: The dependent variable in the OLS estimates is the underwriting fee paid by the firm to banks as a percentage of the issue value. A dark background indicates that variables are statistically significant at 1% and 5%. The sign of the coefficient for the variable is given on each line, with a plus sign indicating a positive effect on the underwriting fee and a minus sign a negative effect. Baseline control variables include annual GDP growth, external debt as a share of GNP, short-term debt as a share of total external debt, the average maturity of new external debt, the fiscal budget, external debt service as a share of reserves, debt service as a share of exports, reserves as a share of GNP, residual S&P country rating, current account as a share of GNP, inflation volatility, United States monthly industrial production growth, 10-year United States Treasury bond yield, the Chicago Board Options Exchange (CBOE) Volatility Index (VIX), a stability variable (Kollo), a switch dummy, years to maturity of the issue (log), number of bookrunners, issue size (log), total issues outstanding, no issues in the past 3 years dummy, Rule 144A dummy, Regulation S dummy, Securities and Exchange Commission (SEC) registration dummy, dollar, euro and yen dummies, reputation (top 3 banks), firm's market value, firm's profitability, firm's stock volatility, share frequency, firm's total debt as a share of total assets, firm's average cost of capital (Thomson) and a residual for the investment grade dummy, time dummies and country effects (when specified).

Firm-level variables, and credit risk measures in particular, are crucial in explaining underwriting fees. An increase in a firm's profitability has a negative impact on fees that is significant at 1%, with an increase in profitability of one standard deviation ($\sigma = 0.0514$) reducing underwriting fees by 0.12%. In contrast, there is a positive and statistically significant relationship between the ratio of total debt to total assets and underwriting fees. An increase of one standard deviation in the total debt to total assets ratio ($\sigma = 14.93$) means an increase in underwriting fees of 0.13%. These results are consistent with the corporate literature in developed countries showing that underwriting fees are positively associated with a higher risk of default. Investment banks' reputation and rating

agencies' credit perceptions have a significant impact on underwriting fees, as can be observed in table III.3. Similarly, there is a negative and statistically significant relationship between the fact of issues being placed by a reputable investment bank and fees. A possible interpretation of this result is that “the most prestigious underwriters have bargaining power in getting members of the underwriting syndicate to accept lower fees” (Livingston and Miller, 2000). However, this is not supported by the theoretical literature. Reputation should be positively correlated with compensation of the service provided (Chemmanur and Fulghieri, 1994).

To summarize these results, if all else is equal then an underwriter's reputation, a firm's solvency and rating agencies' perception of credit risk will significantly affect underwriting fees and consequently the cost of corporate capital in emerging markets. In particular, a positive perception on the part of rating agencies (i.e. the regression residual of the corporate issue rating) is negatively associated with underwriting fees.

3. Determinants of primary bond spreads

Table III.4 shows the results for the preliminary stages and the benchmark model for the estimation of primary bond spreads. For the sake of consistency and to make the findings comparable with the fee equation, we use the top three investment banks dummy as our underwriter reputation measure. The regression fit (R-squared) improves progressively from the initial model to the benchmark model, although this improvement is less marked than in the case of underwriting fees.

Table III.4
Determinants of primary bond spreads (international issues): OLS time-fixed effects regressions

	Benchmark
Average maturity of new external debt	-
Residual ratings (country)	-
Openness ratio	
Stability variable (Kollo)	+
Years to maturity	-
Log(issue)	-
Total issues outstanding	
Rule 144A dummy	+
Total debt as share of total assets	+
Residual investment grade	-
Reputation (top 1)	
Reputation (top 3)	-
Reputation (top 8)	
Observations	186
R-squared	0.536
Adjusted R-squared	0.431
Controls	Yes
Fixed effects (country)	Yes

Source: Prepared by the author on the basis of calculations of Dealogic DCM Analytics.

Note: The dependent variable is the primary corporate bond spread in basis points. A dark background indicates that variables are statistically significant at 1% and 5%. The sign of the coefficient for the variable is given on each line, with a plus sign indicating a positive effect on the spread and a minus sign a negative effect. Robust standard errors are clustered at the country level. Controls include annual GDP growth, the average maturity of external debt, a stability variable (Kollo), a switch dummy, years to maturity (log), number of bookrunners, Rule 144A dummy, Regulation S dummy, Securities and Exchange Commission (SEC) registration dummy, dollar, euro and yen dummies, firm profitability, firm stock volatility, frequency, firm's total debt as a share of total assets, residual investment grade dummy and time and country dummies (when specified).

A combination of macroeconomic variables and issuer and issue characteristics explain primary corporate bond spreads. In particular, the results show that variables for the macroeconomic conditions associated with an issuer's nationality are key explanatory factors for corporate spreads. An increase in external public debt as a share of GNP and a reduction in the maturity of the total debt have a positive impact on primary spreads. An increase of one standard deviation in maturity ($\sigma = 2.74$) is associated with an average spread reduction of 19 basis points. An increase in public debt default risk and a reduced ability to float long-term bonds are significantly associated with higher spreads. Moreover, other things being equal, an improved perception of sovereign risk by rating agencies (Standard & Poor's in this case) has a negative impact that is statistically significant at 1%. An improvement of one standard deviation in rating agencies' perception of sovereign risk ($\sigma = 1.72$) is associated with a spread reduction of about 43 basis points.

Where issuance characteristics are concerned, table III.4 shows that only the amount of the issue is significant, with an increase having a negative sign and being associated with lower emerging corporate bond spreads. A possible interpretation of this result is that only highly solvent firms are in a position to place large amounts of debt on capital markets. Finally, only one firm-level variable is significant: the ratio of total debt to total assets, which is associated with higher primary bond spreads. In contrast to the situation with underwriting fees, the impact of underwriters' reputation and corporate ratings on the corporate bond market are not significant. Table III.4 also shows that underwriters' reputation is a negative but not significant variable in explaining spreads. Similarly, rating agencies' perception of a firm's credit risk is negatively associated with primary corporate bond spreads but not significant. This last result contrasts with the situation for sovereign ratings, where a favourable perception of a country on the part of a rating agency is associated with lower costs of issuance for firms in international markets. It suggests that, all else being equal, institutional investors, unlike investment banks and underwriters, are more concerned about the perceptions of rating agencies when it comes to country risk than to corporate risk.

The fact that the sovereign rating affects the primary corporate spread can be put down to the "sovereign rating ceiling" concept. The Government usually makes the greatest calls on the country's wealth and has more tools than a private firm for repaying debt (tax rises or an inflation tax, for example), so that when investors lend to the private sector in a particular country, they usually do so on the same or less favourable terms than they would offer to the country's Government. This phenomenon, known in the literature as the "sovereign rating ceiling", plays an important role in emerging corporate debt markets and directly affects issuance costs in those markets. The finding presented thus confirms that the sovereign ceiling has a considerable impact on firms' issuance costs (mainly because of the primary spread), since even though credit rating agencies have progressively chosen to ease their policy of associating a private issuer's rating with sovereign ratings, the latter still play a vital role in the debt ratings granted to firms (Borensztein and others, 2007).

In emerging economies, it has been common for rating agencies to apply the sovereign ceiling. One of the first examples of this occurred in April 1997 when Standard & Poor's controversially announced that it would raise the debt of 14 Argentine firms, including three banks, to a rating higher than the one it gave Argentina's sovereign debt. Moody's argued that the measure was irresponsible, and many other market participants agreed (Durbin and Ng, 2005). When sovereign liabilities have an unfavourable credit rating, the ratings of that country's firms, however financially sound they may be, can be affected. This represents a negative externality for the private sector in emerging economies (Heinrichs and Stanoeva, 2013).

4. The impact of underwriter reputation on the cost of capital

Bank reputation is an important dimension for the pricing of corporate bonds in developed economies. The characteristics of issues placed by reputable banks were compared between themselves and also with those placed by less reputable banks (see table III.5). T-statistics for differences in means are

reported. When the top three banks (by market share) are taken as described above, there are significant differences between the two groups on a number of variables: top banks have lower underwriting fees, longer maturities and higher credit ratings, market capitalization and profitability.

Table III.5
T-tests for top three banks and other banks

Variable	Top 3						t-test (Ho: u1=u2, Ha: u1<>u2)
	Top 3		Non-Top 3		Total		
	Mean	Stand. Deviation	Mean	Stand. Deviation	Mean	Stand. Deviation	
Primary spread (basis points)	296.08	187.07	314.08	190.04	306.41	188.92	0.083
Underwriting fee	0.87	0.63	1.01	0.66	0.95	0.65	0.000
Ratio of reserves to imports	0.58	0.28	0.62	0.28	0.61	0.28	0.025
Debt service as share of exports	30.13	16.93	34.77	19.94	32.85	18.88	0.000
Ratio of reserves to total external debt	34.50	35.55	35.80	41.27	35.27	39.02	0.600
Ratio of external debt to GNP	37.68	14.85	36.74	15.51	37.13	15.24	0.335
Annual GDP growth	4.60	3.02	4.33	2.98	4.44	3.00	0.104
Total issues outstanding	2.71	3.00	2.62	3.01	2.66	3.01	0.602
Residual S&P rating	0.08	1.69	-0.21	1.74	-0.09	1.72	0.014
Fiscal budget	0.44	3.21	0.15	4.26	0.27	3.85	0.185
VIX volatility index	18.26	5.56	17.62	5.12	17.89	5.32	0.030
United States 10-year Treasury bond yield	5.65	1.05	5.84	1.01	5.76	1.03	0.001
United States annual industrial production	0.28	0.52	0.32	0.48	0.31	0.49	0.182
Years to maturity	7.85	5.73	7.09	7.87	7.41	7.05	0.050
Deal value proceeds	389 000 000	466 000 000	233 000 000	280 000 000	299 000 000	378 000 000	0
Rule 144A dummy	0.63	0.48	0.46	0.50	0.53	0.50	0
Investment grade dummy	0.44	0.50	0.40	0.49	0.42	0.49	0.146
Regulation S dummy	0.90	0.29	0.85	0.36	0.87	0.33	0.002
SEC registration dummy	0.12	0.32	0.07	0.26	0.09	0.29	0.005
Dollar, euro and yen dummy	0.98	0.14	0.91	0.29	0.94	0.24	0
Dollar dummy	0.91	0.28	0.82	0.39	0.86	0.35	0
Euro dummy	0.05	0.22	0.06	0.25	0.06	0.23	0.276
Yen dummy	0.02	0.12	0.03	0.17	0.02	0.15	0.123
Number of bookrunners	1.61	1.03	1.26	0.55	1.40	0.81	0
Average maturity of external debt	12.16	4.10	12.13	3.93	12.14	4.00	0.885
Stability index (Kollo)	0.50	0.37	0.55	0.39	0.53	0.38	0.011
Firm market value	1 761 623	4 479 027	1 788 202	4 399 955	1 774 578	4 433 678	0.958
Firm profitability	0.04	0.05	0.03	0.05	0.04	0.05	0.018
Firm stock volatility	8.67	3.65	8.83	4.54	8.75	4.09	0.705
Frequency	5.61	7.04	5.51	7.15	5.55	7.10	0.791
Total issue (relative)	14 500 000	78 500 000	12 900 000	58 800 000	13 700 000	69 500 000	0.839
Total issues outstanding	2.71	3.00	2.62	3.01	2.66	3.01	0.602
Ratio of firm's total debt to total assets	33.97	16.35	34.56	13.36	34.26	14.94	0.711
Firm's average cost of capital	8.09	12.75	9.38	8.19	8.70	10.83	0.376
Residual launch corporate rating	0.42	3.05	-1.10	2.86	-0.27	3.06	0.000
Residual investment grade dummy	0.02	0.47	-0.16	0.42	-0.06	0.46	0.000

Source: Prepared by the author on the basis of calculations of Dealogic DCM Analytics.

Note: Figures in bold indicate that the differences between means are significant at 5%.

The results presented so far (tables III.3 and III.4) assume that issuer-underwriter interaction is exogenous. However, differences observed in the t-test for top three and secondary (non-top three) banks in relation to issue and firm-level characteristics for each group suggest that the nature of this matching could be endogenous. Previous estimations to determine fees and spreads assumed that the top bank variable was exogenous. If the observed top bank is not randomly sampled, a bias might result, and the coefficient estimates in the linear regression in these equations are inconsistent (Maddala, 1983).

To measure the reputation effect correctly and deal with the selection bias problem, we implement Heckman's (1979) two-step methodology in the context of the corporate bond market. This approach has been used to study the entry of commercial banks into the corporate bond underwriting market, just as we are studying the interaction between underwriters and issuers.

A first step is to estimate a probit model for the "top bank" variable, with this taking a value of 1 if the issue is underwritten by a top bank and 0 otherwise. Because top and non-top banks do not possess the same technology for pricing fees and spreads, we estimate the second-step equations for the two types of banks separately, which means introducing the Mills ratio into the first step of the fee equations. The significance and sign of the inverse Mills ratio term reveal whether the information about the top underwriter-issuer matching significantly affects underwriting fees charged by top banks and other banks. A similar framework is implemented to analyse the relationship between issuer-underwriter matching and primary corporate bond spreads. We estimate a probit model for the determinants of the match between issuers and underwriters, including only those variables that can affect it. In this configuration, the probability of having a top bank as underwriter depends significantly on the investment grade dummy variable, suggesting this is considered an important dimension by the top banks.

Table III.6 summarizes the results for three reputation indicators as determinants of underwriting fees. For the reputable bank group, variables related to the characteristics of the issue, in particular its currency, have a negative and significant effect on underwriting fees. The non-reputable banks group is more affected by country-level characteristics, suggesting that less reputable banks take this dimension into account. Issue characteristics, in particular those related to the currency of the issue, have a similar (negative) effect on underwriting fees. Unlike top banks, less reputable banks may charge profitable firms lower underwriting fees, i.e. firms that work with them have to be more profitable.

Table III.6 shows the results of the second stage of the underwriting fee equation following correction of the original results by the Heckman approach. When correcting for possible selection bias in the interaction between issuers and underwriters, we can see that the proportion of non-selection risk for the top three banks is not significant. This suggests that the information about interaction between issuers and underwriters does not significantly affect underwriters' fees. Therefore, by contrast with developed economies, reputation has no direct effect on fees beyond what can be explained by observable characteristics. Country-level variables are more likely to affect issues handled by less reputable banks, while firms' investment grade residual affects underwriting fees in issues handled by both more and less reputable banks.

Table III.7 presents the results of the determinants of bond spreads for more and less reputable banks. Some differences were observed in the determinants for each group. For the three most prestigious banks it was observed that, with few exceptions, country characteristics did not play an important role in explaining the primary spread. Conversely, a significant negative effect was associated with the issuing currency. The profitability and credit rating agency perception variables reduced a firm's spread, while its liabilities tended to increase this. As in the previous case, the differences in determinants were mainly related to country characteristics (which were more important for less reputable banks) and profitability.

Following correction of the selection bias for the spread (table III.7), the results show that the risk of non-selection is not significant either. As in the case of issuance fees, reputation does not seem to affect spreads beyond the observable characteristics. These findings are at odds with the literature on corporate bonds in developed economies (Hua Fang, 2005), which shows a fee premium for the best banks, suggesting that bank reputation is a source of economic rents.

Table III.6
Determinants of underwriting fees (top three banks versus other banks):
regression models with Heckman correction

	Top 3	Non-Top 3
Annual GDP growth	+	+
Ratio of external debt to GNP	+	+
Average maturity of new external debt	-	-
Stability index (Kollo)	+	+
Number of bookrunners	+	+
Dollar dummy	-	-
Euro dummy	-	-
Yen dummy	-	-
Profitability	-	-
Firm stock volatility	+	-
Ratio of firm's total debt to total assets	-	-
Residual investment grade dummy	+	+
Lambda (top 8)	-	-
Lambda (top 3)		
Lambda (top 1)	-	-
Observations	99	97
R-squared	0.541	0.661
Adjusted R-squared	0.285	0.474
Controls	Yes	Yes
Country fixed effects	Yes	Yes

Source: Prepared by the author on the basis of calculations of Dealogic DCM Analytics.

Note: Heckman-corrected estimates based on the issuer-underwriter matching equation. The dependent variable is the underwriting fee paid by the firm to the banks as a percentage of the amount issued. A dark background indicates that variables are statistically significant at 1% and 5%. The sign of the coefficient for the variable is given on each line, with a plus sign indicating a positive effect on the underwriting fee and a minus sign a negative effect. Robust standard errors are clustered at the country level. Controls include annual GDP growth, external debt as a share of GNP, the average maturity of external debt, a stability variable (Kollo), a switch dummy, years to maturity (log), number of bookrunners, Rule 144A dummy, Regulation S dummy, Securities and Exchange Commission (SEC) registration dummy, dollar dummy, euro dummy, yen dummy, firm profitability, firm stock volatility, frequency, firm's total debt as a share of total assets, residual investment grade dummy and time and country dummies (when specified).

Table III.7
Determinants of primary bond spreads (top three banks versus other banks):
Heckman correction regression models

	Top 3	Non-top 3
Ratio of external public debt to GNP	+	+
Average maturity of new external debt	-	-
Residual S&P rating	-	-
VIX volatility index	+	-
United States monthly industrial production growth	-	-
Years to maturity (log)	-	-
Deal value proceeds (log)	-	-
No issue in last 3 years (dummy)	-	+
Firm profitability	-	-
Firm stock volatility	+	-
Ratio of firm's total debt to total assets	+	+
Residual investment grade dummy	-	-
Lambda top 8		
Lambda top 3	-	+
Lambda top 1		
Observations	92	94
R-squared	0.614	0.663
Adjusted R-squared	0.384	0.469
Controls	Yes	Yes
Fixed effects (country)	Yes	Yes

Source: Prepared by the author on the basis of calculations of Dealogic DCM Analytics.

Notes: The dependent variable is the primary sovereign bond spread in basis points. A dark background indicates that variables are statistically significant at 1% and 5%. The sign of the coefficient for the variable is given on each line, with a plus sign indicating a positive effect on the underwriting fee and a minus sign a negative effect. Robust standard errors are clustered at the country level. Controls include external public debt as a share of GNP, average maturity of new external debt, residual Standard and Poor's rating, the VIX volatility index, United States monthly industrial production growth, a stability variable (Kollo), a switch dummy, years to maturity (log), deal value proceeds (log), no issue in last three years dummy, Rule 144A dummy, dollar dummy, euro dummy, yen dummy, firm profitability, firm stock volatility, frequency, firm's total debt as a share of total assets, residual investment grade dummy and country and time effects (when specified).

F. Corporate governance implications of the determinants of the cost of capital

The results presented above show that less leveraged firms have lower issuance costs because fees are smaller (table III.3). This bears out the argument that effective corporate governance can reduce firms' financing costs directly or indirectly (Soh, 2011). Firms with better administrative standards and more efficient monitoring mechanisms are better equipped to allocate their resources efficiently and lower their financing costs, whether they finance themselves through equity or debt. From a financial perspective, corporate governance mechanisms can also reduce default risk by enabling management performance to be monitored. Ultimately, corporate governance can affect bond yields and credit ratings through its impact on the risk of corporate default.

Corporate governance practices are transmitted to financing quality through various channels. Corporate governance can mitigate agency risk by increasing the monitoring of board actions, constraining or overseeing their conduct and improving the quality of information flows within the firm. Furthermore, corporate governance can help to improve disclosure of information about the firm, its ownership structure and the role of institutional investors. The latter are a positive signal for financing, as firms with a larger proportion of institutional owners and strong external oversight of their board do not have to offer such high yields and receive better credit ratings for their new bond issues (Bhojraj and Sengupta, 2003).⁴ This last point is particularly relevant given that, according to the results shown in table III.3, a better credit rating for a firm means lower issuance fees.

In sum, corporate governance can play a key role in default risk, which ought to mean a lower cost of capital on capital markets, perceptions of greater macroeconomic risk aside. Although sovereign risk affects spreads by way of sovereign ratings first and foremost (table III.4), there is evidence that the credit rating agencies have been gradually applying the sovereign rating ceiling policy less, with some private-sector borrowers actually being given higher credit ratings than their countries' Governments. In the case of countries where default risk is perceived as lower, it can be seen that investors do not always think that default by the Government necessarily means default by firms too (Durbin and Ng, 2005).

An important factor to be considered with regard to corporate governance in the primary emerging bond market is the role of credit rating agencies in the cost of corporate bond issuance. They play a vital role in the stability of the financial system, assigning ratings to newly issued debt instruments that indicate the likelihood of default or arrears, thus correcting information asymmetries between issuers and investors (Covitz and Harrison, 2004). However, credit rating agencies are exposed to a conflict of interest between their financial growth and professional ethics, mainly because the rating process is paid for by the issuers themselves. Although agencies should in theory carry out an objective evaluation of their clients' debt payment capacity, they do not always do so, since the current model of payment for the rating service provides an incentive for both the firm rated and the agency to skew the ratings assigned (Harrington, 2011).

G. Conclusions

This chapter studies the factors driving the cost of capital in the primary corporate bond market in emerging economies by analysing interactions between major market players: issuers, investors, rating agencies and investment banks. In that context, it examines the signalling and advertising carried out by investment banks and rating agencies in emerging corporate markets, aspects whose theoretical and empirical study has largely been confined to mature markets (Hua Fang, 2005; Livingston and Miller,

⁴ Greater board independence at the company level would improve the operation of governance structures in emerging economies (Ararat and Dallas, 2011), where boards tend to have a more concentrated group of shareholders and creditors than those in developed countries.

2000; Kollo Esho and Sharpe, 2002; Burch, Nanda and Wartheret , 2005). To do this, it analyses a sample of international corporate bonds issued by 669 firms from 43 emerging economies over the 1991-2009 period. The analysis set out in this chapter provides a basis for further research to study local bond issues, which are increasingly important in the region.

This chapter also shows that the determinants of the cost of capital for emerging firms (as measured by underwriting fees and primary spreads) differ considerably. It notes that macroeconomic variables primarily affect spreads. In contrast, a larger number of firm-level variables affect fees, suggesting that investment banks pay more attention to issuers than do institutional investors. In particular, underwriting fees are a decreasing function of investment banks' reputations (as measured by the amount of business they transact in the primary emerging corporate bond market) and rating agencies' perceptions. The results suggest that primary bond spreads (unlike underwriting fees) are more influenced by rating agencies' perception of country risk (other things being equal) than of the firm's own risk.

How reputable underwriters are matched with issuers depends on a combination of issuer characteristics. When dealing with selection bias in issuer-underwriter matching (using the Heckman approach), we find no additional impact of reputable underwriters on fees and spreads beyond what is explained by observable characteristics. This finding contrasts with the theoretical insights provided in the literature and with the empirical results for corporate bond markets in developed countries, where bank reputation provides a pointer to issue quality. On the other hand, credit rating agencies' perception of credit risk affects underwriting fees for issues underwritten by both reputable and non-reputable banks.

The final part of this chapter explores a key channel for capital costs: corporate governance. This influences the cost of corporate financing by improving information flows, reducing the risk of default by the company or strengthening protection for minority partners and creditors, among other mechanisms. These aspects affect a firm's solvency, which in turn impacts underwriting fees in the primary market.

By revealing the mechanisms of price formation in primary markets, this research provides some clues to the strategies that companies can follow to reduce capital costs. Thus, optimizing the internal performance of firms, in part through an efficient corporate governance structure, influences the cost of issuance in international debt markets.

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IV. Bond issuance and corporate governance in Brazil: a multi-case analysis

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A. Introduction

A company's capital structure is a combination of its own and third-party resources. With their own resources, joint stock corporations (*sociedades anônimas* or SAs) can finance their activities by offering shares on the market, thereby attracting more shareholders. In contrast, the alternative of drawing on third-party sources mainly involves issuing bonds, using traditional bank loans, or obtaining credit lines from development banks.

To understand the current Brazilian context, it is instructive to consider the period between the 1970s and the mid-1990s. In those years, the prevailing form of enterprise was the family business, which meant new share issues were few and far between, because the owners were worried about losing control of the assets in question. Moreover the business climate in Brazil was characterized by economic instability, high inflation, high interest rates and low economic growth (Carvalho, 2002; Paula and others, 2009; de Paula, 2009).

In this situation, the volume of funds raised on the stock market in Brazil was small. Vieira and Corrêa (2002) point out that few firms had their shares listed on the stock market, and that businesses were concentrated in a small number of companies. This demonstrated the low liquidity levels then existing in the Brazilian stock market. Credit lines operated by the Brazilian Development Bank (BNDES) offered a number of advantages (such as attractive cost and timeframes), which discouraged the use of other financing sources. On the other hand, the bureaucratic requirements and inherent restrictions on how BNDES funds had to be used ended up encouraging greater use of other forms of

¹ The authors are grateful for comments by Mario Dehesa and the other participants in the expert workshop held in Mexico City in September 2011. Nonetheless, any errors and omissions are the authors' exclusive responsibility.

fundraising (Fraletti; Eid Junior, 2005; Sheng, 2005). Thus, issuing securities, such as promissory notes, real estate receivables certificates (CRIs), and receivables investment funds (FIDCs), and, in particular, unsecured debentures (*obrigações sem garantia hipotecária* – OSHGs), which prior to the 1990s had not been significant financing sources, have increased their presence in the range of options available to firms (Sheng, 2005; Paula and others, 2009).

Explanations for the development of the Brazilian debt market include the economic stability created after the Real Plan (as of 1994), corporate financing needs, the ineffectiveness of the banking system as a source of long-term funding, the demand for bonds, and a suitable infrastructure for the functioning of the market in question (Saito; Sheng; Bandera, 2007). Nonetheless, the issuance of OSHGs draws attention to the risk factors and management processes needed for the firm to be able to guarantee its capacity to meet the respective payments. Ultimately, firms that issue securities are sharing their risks with many investors, and this forces them to be more transparent and to provide detailed information on their management and earnings.

In addition, the unsecured debenture market in Brazil still small, because the secondary market is virtually nonexistent. This means that creditors have to hold their securities until maturity, which increases the potential for conflicts of interest between shareholders and bondholders (Saito; Sheng; Bandera, 2007).

In terms of identifying the risks of the business, the ratings assigned by specialized agencies provide information on the entity's situation and its potential ability to fulfil its obligations. Nonetheless, these are based on quantitative and qualitative factors, such as the reputation of the management and the application of formulas. In practice, the resultant ratings do not represent a cast-iron truth, but give an indication of company's ability to pay. Accordingly, once a debt issue has been authorized by the authorities, investors need to seek information that enables them to monitor the decisions of the companies' managers and judge whether the future expectations indicated by the rating agencies are correct (Sheng, 2005; Paiva; Savoia; Corrar, 2008).

Accordingly, the belief that information transparency, the conduct of business management, and the management of future risks can affect the quality of the bonds and the chances of the company defaulting on its obligations, seems appropriate. Following this line of reasoning, the use of corporate governance principles, based on aspects of agency theory discussed by Jensen and Meckling (1976), could be a tool that provides greater transparency and credibility to the financial information, reduces differences between shareholders and creditors, and optimizes internal controls and decision-making in firms. The result is that companies with the best corporate governance practices tend to be more transparent about their risks and their future expectations; and this could put them at an advantage other enterprises with lower governance practices levels when attracting external resources (Silveira, Perobelli and Barros, 2008).

The main objective of this chapter is to analyse the process of bond issuance in Brazil, which has grown in recent years as part of the range of financing alternatives, against a backdrop of corporate governance practices that can influence risk management in the organizations in question. Accordingly, following this introduction, the section B describes the concepts of corporate governance and the agency conflicts, and it reviews the standards inherent in debt markets and ratings in Brazil.

Section C analyses the relative importance of debt compared to other forms of fund raising, highlighting its characteristics and the most important changes that have occurred over the years. Section D presents a multiple case study that investigates how corporate governance helps in risk management and bond issuance in six Brazilian firms, namely *Petróleo Brasileiro* (Petrobras); Bradespar; *Diagnósticos de América* (DASA); Klabin; Lupatech; and Inepar. Lastly, section E sets forth a number of thoughts and recommendations for possible additional information that could help raise awareness of the risks the firm could incur and hence the quality of the debt that it issues.

B. Corporate governance, agency conflicts, regulation and rating

1. Corporate governance in Brazil

Carvalho (2002) defines corporate governance practices in general as mechanisms that assist enterprise decision-making and seek to minimize agency conflicts. Corporate governance comprises the values, principles and standards that underpin a firm's management, with objectives that include protecting investors (Andrade and Rossetti, 2004). La Porta and others (1999) make clear that the investors who finance a firm risk losing part of their return as a result of the objectives and actions of the firm's controlling entities; so corporate governance is a mechanism of protection against such factors.

Corporate governance-related issues gained notoriety in the 1990s, with the search for rules to restrain actions that aimed to maintain the privileges and interests of the firm's directors, rather than maximizing shareholder value.

In the ensuing years, an increasing number of countries recognized the importance of corporate governance practices, and new institutions were created to promote debate on the subject. The Brazilian Institute of Corporate Governance (IBGC) was founded in 1995; and this non-profit institution has helped to develop the institutional and business framework in the country, disseminating the Code of Best Corporate Governance Practices and highlighting the importance thereof (IBGC, 2011).

In 2000, the São Paulo Securities, Commodities and Futures Exchange (BM&FBOVESPA) established differentiated corporate governance segments with a view to stimulating investor interest in dealings with firms that have the best corporate governance practices, concerned for the corporate rights of the minority shareholders, and more transparent and better-quality information. This was considered one of the most important events for promoting corporate governance practices in Brazil (Rogers; Securato; Ribeiro, 2008; BOVESPA, 2011).

Admission to the Level 1, Level 2 or New Market (NM) segments requires the firm in question to commit to voluntarily adopt the corporate governance requirements of the specific segment to which it belongs. The difference between the levels corresponds to the company's degree of commitment. Level 1 is the segment with the least stringent demands, whereas level NM has the strictest requirements and encompasses firms that undertake to use the largest number of corporate governance practices in addition to those established by law. In 2009, the IBGC, whose basic principles are transparency, equity, accountability and corporate responsibility, unveiled the fourth version of the Code of Best Practices. That document addresses issues such as the responsibilities of the board of directors, the selection of its members, the remuneration of managers, the coordination of internal control, and risk management.

In addition to solving problems of transparency and conflicts between the firm's managers and its shareholders, and protecting minority interests, the use of good corporate governance practices can also provide other benefits. Their adoption enhances corporate image and gives investors more secure rights and access to better information, thus enabling them to reduce risk. The result in the stock market is increased issuance and greater liquidity (Andrade; Rossetti, 2004).

2. Agency conflicts

Agency conflicts occur, for example, in situations where the (principal) shareholder transfers responsibility for the firm's management and organizational decision-making to a manager (agent). The problem with this is that shareholders expect their share value to be maximized, but the managers may prefer to maximize their own personal interests, at the expense of the owner's objectives (Jensen, Meckling, 1976; Assaf Neto, 2003).

In addition to divergences of interest between shareholders and managers, conflicts also arise between majority and minority shareholders, or between shareholders and creditors (Borini; Lucchesi, 2004). Controlling shareholders can maximize their interests and ignore the objectives of minority shareholders; and owners with a small stake in the company may not have the same access to information or the same rights as the controlling shareholders (Silva and others, 2006).

Brazil's business climate fosters agency conflicts between majority and minority shareholders, since stock ownership is concentrated the hands of just one or a few shareholders (Silveira, 2002).

In the case bonds, lenders provide funds to enterprises in the expectation of receiving a remuneration to compensate for the risk of financing the entities in question, in addition to the repayment of principal. Those creditors expect the organization not to take greater risks than those envisaged when the funds were provided. Nonetheless, if the shareholders decide to make riskier investments, this could increase the likelihood of nonperformance of the loan contract, thereby causing agency conflicts between shareholders and creditors (Harris, Raviv, 1991, Weston, Brigham, 2004; Saito; Sheng; Bandeira, 2007).

Similarly, bond issuance may cause agency conflicts when shareholders are able to expropriate wealth from bondholders, by paying higher dividends or investing in highly risky projects (Harris; Raviv, 1991; Saito; Sheng; Bandeira, 2007). In the legal domain, Brazil is a country generally characterized by weak legal guarantees and low levels of creditor protection and enforcement.

In brief, corporate governance provides a useful means of optimizing the relation between shareholders and managers, ensuring fair treatment and better coexistence between majority and minority shareholders, and enhancing the availability of information to help creditors assess the real operating risks of the firms to which they lend.

3. The information factor and corporate governance

Secrecy and the withholding of information used to be considered vital for obtaining and maintaining power in organizations. Nonetheless, owing to stockmarket investment requirements, the availability of information for assessing the management and performance of the company has become fundamental for an organization's survival (Silva and others, 2006).

Braga Júnior and Almeida (2010) argue that the market value of a firm varies as a function of its transparency: specifically, the less information supplied the greater the risks. Thus, information disclosure is important for minimizing scepticism among investors and creditors, who might decide not to provide funds to certain companies, owing to uncertainty about the performance of the organization and lack of reliable data on the commercial risks involved (Rodrigues, 2003).

Custódio and others (2006) confirm that the disclosure of business data is fundamental for reducing the information asymmetry that exists between investors and creditors. These authors also argue that the quality of information disclosed to users has improved as result of corporate governance. Accordingly, information asymmetry should not exist (or at least should be mitigated) in companies with good corporate governance practices, since these institutions prioritize enhancing investor and creditor security, by increasing the quantity of information they provide and improving its quality (Moreiras, 2010).

According to IBGC (2009), firms need to provide their shareholders and creditors with information on matters such as the corporate situation, fluctuations in its economic-financial performance, its risks, the factors that guide business actions, and the decisions that help to create organizational value (Fernandes; Sousa; Faria, 2010; Júnio Braga Júnior and Almeida, 2010). Thus, IBGC (2009) recommends that a firm's management should identify and list the organization's main risks and their chances of occurrence, together with the prevention or mitigation measures adopted. The aim is to provide information for assessing the quality of the firm's management, and the risks that could affect its operations.

In 2009, Instruction 480/2009 of the Securities and Exchange Commission (CVM) raised the responsibility level of information provided by firms through the CVM. This instruction introduced the

Reference Form (RF) to replace the existing Annual Information Form, which had stricter information requirements. The RF is a document that provides a large amount of information, particularly on the history of a firm's bond issuance, its financial situation, data on independent auditors, its remuneration policy, risk factors that might affect its financial situation in the future, and the risk management policies adopted by it (CNB, 2009b).

One of the reasons for creating the RF was the CVM's desire for report that would serve as a standard prospectus. Accordingly, if a company wanted to make a public share offer or issue bonds, it would merely have to add specific information (Torres, 2011b). Investors and creditors would be able to make a better assessment of the performance of the organization, having access to the most complete and consistent information and knowledge of events that have really occurred in the firm, along with opinions, estimations and projections (PriceWaterHouseCooper, 2011). Consideration of this statement should raise the corporate governance level of listed companies in Brazil.

In terms of risks, the RF should provide investors with information on the issuer, its controlling entity, its shareholders, its subsidiaries and affiliated companies, and its suppliers and customers, in addition to regulating the sector, among other things. CVM Instruction 480 requires investors and creditors to be informed of the chances of favourable or unfavourable rulings in court cases, to enable them to take account of a potential loss when deciding to invest in a company. In addition, the organization must describe the main market risks, highlighting the firm's control structure and the risk management policies adopted by it, along with the strategies and tools used to manage those risks.

In short, companies that implement the relevant corporate governance recommendations tend to prioritize the supply of greater information to users, with regard to both ownership and economic and financial issues, and also to assist shareholder and creditor decision-making by providing information on risks that could have an impact on their performances.

4. The regulations and rating of debt issues in Brazil

Unsecured debentures (OSGHs) account for a large proportion of the bonds issued in Brazil. In definitional terms, they include both medium- and long-term bonds issued by joint stock corporations with a view to raising funds on the market. These companies give their bondholders claims on the amounts invested and the respective interest (BOVESPA, 2011).

Prior to the 1960s, the bond market was underdeveloped in Brazil. Law 4,728/1965 sought to change that situation, by defining new specifications for bonds and setting conditions that encouraged their issuance in the form of convertible debentures. Nonetheless, this law established procedures for public bond issuance and set the value of equity, rather than overall capital, as the new limit on total issuance (ANDIMA, 2008).

The effective use of bonds occurred after the passing of Law 6,385/1976, which created the CVM, and the passing of Law 6,404/1976. The regulations to the latter, submitted to the capital market, include a number of guidelines for the Brazilian bond market. Following the progress made by the passing of these two laws, the 1980s witnessed other events that were important for the development of the bond market: (a) the creation of the Securities Custody and Financial Settlement Centre (CETIP) in 1986, to serve as a clearinghouse and custody centre for private securities; (b) Central Bank Resolution 1,401 in 1987, putting private and public securities on an equal tax footing (ANDIMA, 2008); and (c) development of the National Bond System (SND) in 1988, by the National Association of Financial Market Institutions (ANDIMA) in association with CETIP, with a view to providing greater security, transparency and flexibility in trading.

In the early 1990s, and as a result of the economic plans (the Collor Plan and the Collor II Plan), Brazil endured years of high risk, high interest rates and inflation, compounded by low government credibility, economic stagnation and rising unemployment. After the Real Plan was adopted in the middle of the decade, the capital market began to strengthen and develop with a growing number of bond issues, which became a major fundraising instrument (ANDIMA, 2008).

To stimulate the bond market further, the CVM issued Instruction 404/2004, establishing standardized bonds, thereby allowing for simplified procedures for the record keeping, and for the terms and conditions of the bonds, which would be traded in a special segment of the stock market. Another simplifying factor behind the growth of the bond issuance, based on CVM Instruction 476/2009, involved “distributed offers with restricted efforts”. This instruction covers promissory notes, securities representing bank credits that are not the liability of a financial institution, bonds that are not convertible into shares, units of closed investment funds, and mortgage-backed securities or agribusiness product receivables.

Nonetheless, CVM Instruction 476/2009 limits the quantity of issues to determine which entities cannot “make another public offering of the same class of securities from the same issuer, within 4 (four) months from the closing date of the offer, unless the new offer is submitted for CVM registration.” Account also needs to be taken of the fact that statements are required from the purchasers or subscribers of those issues, to confirm that the amounts traded are not registered in the CVM, and are subject to trading restrictions. In general, bond issues offered in the framework of this instruction have increased considerably, such that, in 2010, the figure was over double the amount issued in 2009, and represented over 50% of total unsecured debentures issued in 2010 (ANBIMA, 2010; SND, 2011). Despite the development of bond issuance, the secondary market for these securities is still relatively small and illiquid, compared to the situation in other countries.

Another aspect to consider is that the bonds have different degrees of risk, which means that the investors require the largest possible amount of information to evaluate whether or not a firm is abiding by the provisions of the prospectus (ANDIMA, 2008). Credit ratings are instruments that highlight the risk of a given issue, through a set of procedures that award a score (i.e. the rating) which indicates a firm’s default risk (Brito; Corrar; Assaf Neto, 2009).

Crouhy, Galai and Mark (2001) draw attention to the fact that a quality rating goes beyond financial or quantitative issues, to encompass quality management, the reputation of the managers and the firms, changes in legislation and the technology area, in addition to specific issues. Accordingly, the opinions of the rating agencies may vary, and in no way reflect absolute truths.

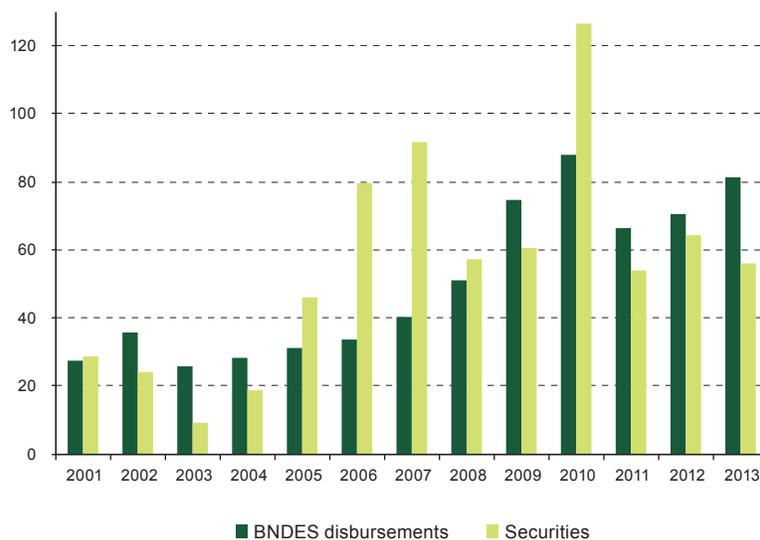
The performance of these rating agencies in Brazil started to become more representative as from the mid-1990s (Cardoso, 2000). For example, Brazilian financial institutions started to rate risk on a scale ranging from AA to H in 1999, as determined by National Monetary Council (CMN) Resolution 2682/1999 (Brito; Corrar; Assaf Neto, 2009). While this section of the chapter has been devoted to a discussion of corporate governance and the regulatory framework, the following section discusses the trend of the Brazilian debt issuance market itself.

C. Bond issuance compared to other forms of financing in Brazil

As mentioned above, macroeconomic policy fragility and high inflation increased the risks, and this scared investors in the 1980s and mid-1990s (Coutinho, 2004). After the Real Plan in 1994, the economy began to stabilize; but in 2004, rates of lending in Brazil remained low. According to the National Association of Finance, Management and Accountancy Executives (ANEFAC), credit operations in the country represented just 25% of GDP, compared to an international average of over 100%.

Since 2004, raising funds from other sources has gained in importance on the back of a more favourable international environment. This can be seen by comparing the disbursements of the BNDES system, a financing source in Brazil, with bond issues (see figure IV.1, which shows securities indexed to the General Price Index, IGP-M). It can be seen that the indexed value of securities disbursements grew from US\$ 18 billion in 2004 to US\$ 56 billion in 2013, with bond issues in excess of US\$ 126 billion in 2010. These amounts were updated for December 2013, when the average real-dollar exchange rate was R\$ 2.34 per US\$ 1.

Figure IV.1
BNDES securities disbursements and issuance, 2001-2013
(Billions of dollars, indexed values)



Source: Prepared by the authors on the basis of information from the Securities Commission (CVM) and Brazilian Financial and Capital Markets Association (ANBIMA), available on the website of the National Liabilities System (SDN) and Brazilian Development Bank (BNDES), 2014.

It is worth noting that the BNDES constantly influences the development of the corporate debt market, by purchasing securities in public offerings. In 2010, to encourage issuance biased more towards the long term, and to stimulate greater liquidity in the secondary market, the BNDES started to impose conditions on firms' securities issues. These included requiring firms not to express the remuneration of their bonds as a percentage of its interbank certificates of deposit (ICDs), and not to include prepayment provisions on securities with a maturity of less than seven years (BNDES, 2010).

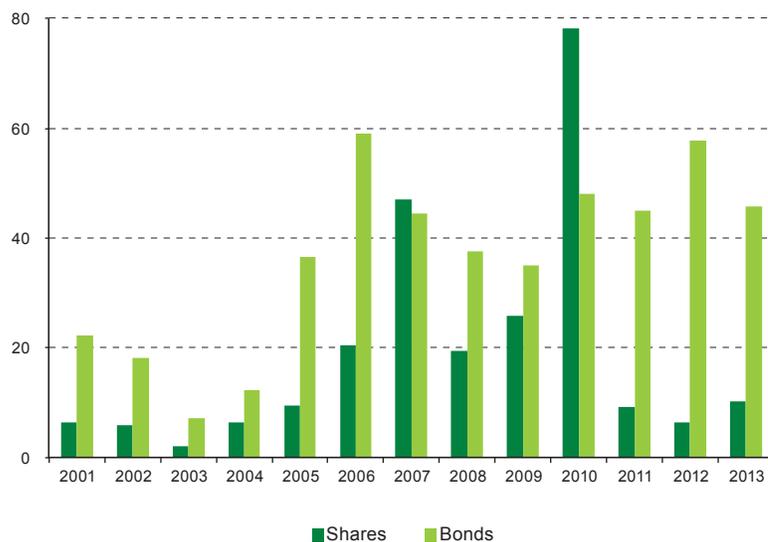
The BNDES also signed an agreement with BM&FBOVESPA, to develop the fixed-income and variable-income segments. The aim here was to stimulate the primary and secondary supply of fixed-income instruments, as well as debenture (OSGH) offerings. Even before these recent initiatives of the BNDES and BM&FBOVESPA, however, the securities markets had been growing in importance. Since 2005, securities issues (shares, bonds, promissory notes, CRIs and loan receivables or FDICs) have all grown considerably, as figure IV.1 shows.

Figure IV.2 compares the trend of the issuance of two types of securities: shares and bonds. Except for 2007 and 2010, debt issues outweighed shares. In fact, the volume of debt issues rose from US\$ 12 billion in 2004 (indexed values) to US\$ 46 billion in 2013. In the case of shares, the respective values were US\$ 6 billion (indexed values) to US\$ 10 billion. These values were updated to December 2013, when the average exchange rate was R\$ 2.34 per US \$1.

Bonds account for a large share of those issues in relation to total securities value. Unsecured debenture issues represented 40% of the securities traded in the period 2001-2013, and outweighed share issues (34%). The remainder was distributed between promissory notes (13%), FDICs (8%) and CRIs (5%).

As from 2009, following the publication of CMV Instruction 476, which authorized the issuance of securities with restricted efforts, the Brazilian scenario changed, as firms started to make issues that were not registered at the CMV. In 2009, bonds that were not registered (with a waiver or with restricted efforts) represented 60% of the total amount issued, and the figure rose to 70% in the following year. As in those years, the waived bonds were equivalent to just 4% and 1% of total unsecured debentures, which confirms that the larger volumes of bonds followed the guidelines of CVM Instruction 476.

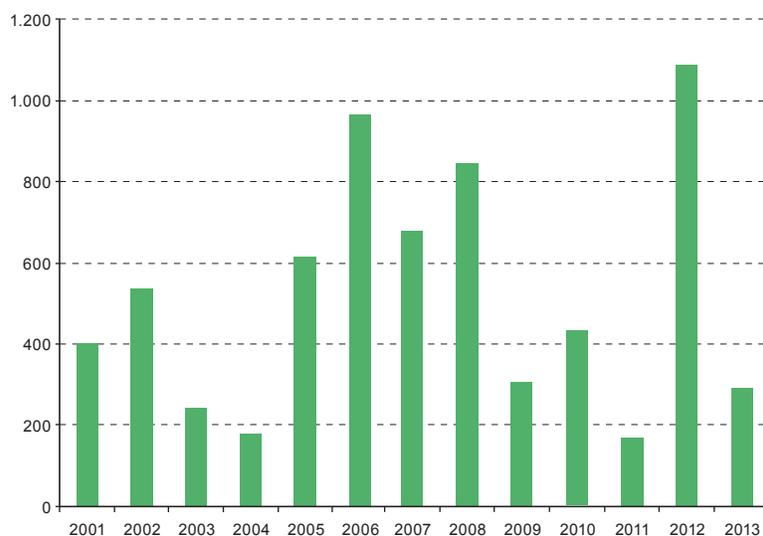
Figure IV.2
Issuance of shares and bonds, 2001-2013
(Billions of dollars, indexed values)



Source: Prepared by the author on the basis of information from the Securities Commission (CVM) and Brazilian Financial and Capital Markets Association (ANBIMA), available on the website of the National Liabilities System (SDN), 2014.

Figure IV.3 shows the average value of bonds for the period. There was a major difference between the annual figures, in indexed terms, which fluctuated between US\$ 179 million in 2004 and US\$ 1.08 billion in 2012. These amounts were updated for December 2013, when the average exchange rate was R\$ 2.34 per US\$ 1.

Figure IV.3
Average of bonds registered in the CVM, 2001-2013
(Millions of dollars, indexed values)



Source: Prepared by the authors on the basis of information from the Securities and Exchange Commission (CVM), 2014.

It is interesting to note that, during the 2000-2010 period, there was a significant change in the composition of borrowing by nonfinancial enterprises in Brazil, with the share of foreign loans plummeting from 42.2% to 8.2%. Similarly, the proportion of bank loans in Brazil grew from 29.4%

to 42.5%; the relative share of the BNDES increased from 14.9% to 26.1%; the share of bonds rose from 7.7% to 15.5%; and rural credit grew from 5.8% to 7.7% (Rocca, 2011).

It is also necessary to compare the financial costs of unsecured debentures and bank loans in Brazil. For example, in March 2007, the cost of bank credit averaged around 1,200 basis points above the interbank deposit (ID) rate. This spread narrowed drastically as from September 2007, to reach a level of 550 basis points in December 2008, after which the expansion seen in the first half of 2009 again raised it to a new level of around 800 basis points. In the case of bonds, the spread between 2004 and mid-2008, was very small, on the order of 80 basis points; but it grew considerably as from September 2008, to reach 250 basis points, showing the impact of the crisis on the risk premium paid by companies that issue bonds (CEMEC, 2010). Nonetheless, the difference between the financial costs of unsecured debentures and bank loans was very large in Brazil.

Oliveira (2011), one of the creators of the SND, argued that bonds still need to be popularized to achieve greater maturity and a larger transaction volume, in addition to reducing tax costs as suggested by the government. That author also stressed that it is important to consider indexing bond interest rates, because they involve risks, and the culture of (individual) investors does not cope well with losses. Paula and others (2009) discuss the advantages in terms of lower risk of government bonds compared to private sector bonds.

The international bond market is also an important tool of external financing for developing countries. The Brazilian market, for example, attracted a large amount of foreign capital based on the excess liquidity in the global economy (De Paula, 2009). This was evident following the 2008 financial crisis, when Brazil absorbed the largest amount of international capital flows of any Latin American country. Between January 2009 and April 2011, Brazil's external debt grew by 42.4%. This is largely explained by profit expectations among Brazilian commodity firms, the interest-rate spread, and the lack of domestic resources to finance investment as from 2009 (IEDI, 2011).

Nonetheless, the abundant flow of capital into emerging countries tends to be discontinuous. At times when this flow retreats, there are variations in the prices of foreign currencies and rapid acceleration of inflation, which culminated in rising interest rates in the countries in question (IEDI, 2011). Accordingly, to hedge against this high volatility of interest rates and exchange rates, Brazilian companies used derivative instruments to assist in risk management (Coutinho, 2010). Farhi and Borghi (2009) state that firms in emerging markets such as China, the Republic of Korea, India, Mexico and Brazil, suffered substantial losses as result of the 2008 financial crisis. This happened because many firms had operations in derivatives which, after the high volatility that has affected markets and the consequent losses recorded, failed in their hedging function.

In short, despite the instability experienced in the past, the Brazilian economy has allowed bond issuance to grow as a financing alternative for its firms. Good governance practices, increasingly applied in Brazilian firms, also became allies in the search for greater transparency and respect from creditors, investors and shareholders in the development of Brazil's debt markets (ANDIMA, 2008).

In Brazil, the predominance of debt issuance concentrated in just a few sectors, and the lack of liquidity on the secondary market, are issues that warrant attention. Nonetheless, the figures for bonds and other capital market securities showed good prospects (ANDIMA, 2008; ANBIMA, 2010). This section has shown the importance of bonds in the Brazilian scenario, the characteristics of the corresponding issues and the reasons why firms look to bond issues to finance their activities. The next section analyses six experiences of Brazilian companies that have issued debt.

D. An analysis of various Brazilian cases

In the context of corporate governance practices and debt issuance on the Brazilian market, the aim of this section is to more closely define the quality of securities issued by firms in Brazil. For that purpose, six cases were selected which highlight some of the situations encountered nationally.²

² This section was written in 2012 and its figures have not been updated.

1. PETROBRAS

Petrobras, created in 1953, is a company controlled by the Brazilian government that operates in the following sectors: the exploration and production, refining, marketing and transportation of oil and natural gas, petrochemical products, and the distribution of petroleum, electricity, biofuels and other renewable energy sources. In the decades following its creation, Petrobras created Petroquisa (1967), with operations in the petrochemical sector, and Petrobras Distribuidora (1971), which markets and distributes petroleum products in Brazil (Petrobras, 2011a).

In February 1998, the company issued 43,000 bonds in a private offering, which were exclusively subscribed by BNDES. The amount raised was US\$ 384 million. These bonds, with a remuneration that rose to 2.5 percentage points per year above the long-term interest rate (TJLP), are scheduled to mature in February 2015 (Petrobras, 2011a).

In May 2002, Petrobras convened an assembly to promote a reform of its statutes which, among other things, sought to establish “corporate governance guidelines” aimed at guaranteeing the good functioning of the board of directors in the strategic leadership of the enterprise, in the supervision of the directors’ work, and in the defence of the interests of all shareholders (Petrobras, 2002b; Petrobras, 2011a). Also in 2002 apart from the legal amendment, the board of directors approved the code of best corporate governance practices and the internal regulation of the board of directors and its committees, and it updated the ethical code created in 1998 (Petrobras, 2011b). Nonetheless, this was not sufficient to protect the state-owned enterprise from interference by the government in its role as owner.

Yokoi (2010) comments that in 2010 Petrobras made one of the most successful share offerings of all time, when it raised nearly US\$ 70 million for the maintenance of petroleum reserves in the pre-salt layer. Although this operation was described by the international press as the cornerstone of Brazil’s global financial presence, the federal government nonetheless attracted several criticisms of its role as majority shareholder. In general, the strongest opposition is the fact that the government has set a bad precedent for the capital market by engaging in manoeuvres directed specifically at increasing its share in the company.

In August 2002, the firm made its second issue of non-convertible bonds, selling 750,000 bonds at a nominal value of R\$ 1,000 each with a 10-year maturity and raising a total of US\$ 242 million. These funds strengthened the firm’s working capital and were destined for modernization and technological development projects, and for paying off its financial debt (Petrobras, 2002a; Petrobras, 2011b). Atlantic Rating considered the bonds to be of excellent quality and low risk, which showed Petrobras was capable of meeting the total payment of interest and principal on the maturity date. Moody’s considered that the firm had greater capacity and presented a lower probability of loss than other local issuers.

In the third issue, which took place in October 2002, Petrobras introduced a clause that reserved up to 6.5% of the offering for individual investors or companies (provided they were not considered institutional investors). This was a novelty compared to the second issue (Estadão, 2002a), and it created a way to make this financial instrument more widely popular. The chief characteristics of this third issue are: (a) Class: non-convertible; (b) Number of bonds: 775,000; (c) Nominal value: R\$ 1,000; (d) Maturity: eight years. As occurred with the funds raised in the previous issue, the company used the US\$ 204 million for debt payments, investments in internal projects, and cash flow (Petrobras, 2002b).

Petrobras did not indicate the existence of a formal and specific risk management committee in its prospectus, but insisted that these risks would be managed under the guidance of its directors. It also emphasized that it was using contracts such as swaps to hedge against fluctuations in the firm’s import and export prices. It was also considering hedging operations against changes in interest rates, the exchange rate, and commodity prices, using value-at-risk (VAR) measures (Petrobras, 2002b).

The bonds in the third issue were rated AAA, by Atlantic Rating, which meant that, like the second issue, the rating agency considered the securities to be of excellent quality and low risk. In addition, the bonds were deemed very unlikely to suffer impacts from unexpected events. SR Rating, in turn, reported that Petrobras offered maximum guarantees. The following year, the third bond issue was given the highest

rating assigned by Fitch in its national rating scale for Brazil. This rating was valid for the company's operations in late 2010, when the maturity and payment of the securities occurred (SND, 2011).

In 2004, Petrobras implemented the Program of Integrated Control Systems and Methods (Prisma), which increased its corporate governance actions and improved compliance with the Sarbanes-Oxley Act (SOX). One of the results of this project was the creation of the Risk Management Committee, on which employees and executives from all corporate and business areas served. In 2010, in response to the new corporate governance model developed by the firm, the Financial Integration Committee was set up to replace the Risk Management Committee. The new committee is sponsored by the Finance Board, consisting of all finance management executives. In addition, the managers of the business areas also participate in discussions on specific topics. The responsibilities of this committee are to evaluate financial risk exposure and issue guidelines for measuring, monitoring, and managing the risks associated with Petrobras activities (Petrobras, 2011a).

There was greater concern for internal controls and the creation of committees to optimize risk management, together with financial controls to evaluate the performance of the company's executives, and attendance at board meetings. For that purpose, it was considered that Petrobras has steadily improved its corporate governance practices since 2002, when it made its second bond issue, even though it remains listed on the traditional BM&FBOVESPA market. It is also emphasized that the organization still has no arrears on its securities, which are perceived by Fitch as of the best quality to be found in the Brazilian market. The firm is not expected to have problems of arrears or default with its unsecured debenture holders.

In the Petrobras experience, a comparison of the three bond issues shows that the first was traded exclusively with the BNDES, whereas the later ones have been public offerings. More important still, the latter now include a concern for the greater dissemination of the offering. Nonetheless, given that the bond flotation was a success, it is frustrating that the firm has not used this source of financing again since 2002.

2. Bradespar

Bradespar, formed in 2000 as a spin-off from Banco Bradesco, aims to invest in leading industrial firms, which are differentiated by their long-term returns, such as Vale (mining) and CPFL Energia (electric power generation and distribution). Accordingly, Bradespar can be viewed as a financial holding company.

In 2001, the company demonstrated its firm intent to abide by best corporate governance practices and formally affiliated to BM&FBOVESPA corporate governance level 1, thereby committing to abide by the directives of this segment. During the course of its operations, the company has made two capital increases by using reserves and making a public share offering to investors (Bradespar, 2011a). In 2004, for example, the firm issued preferential shares and raised US\$ 380 million, representing the second-largest offer on Brazil's stockmarket in that year (Bradespar, 2009).

In 2005, Bradespar granted tag-along rights (the right of minority shareholders to sell their shares when control of the company is sold) above the level specified by the law. Since then, shareholders holding preferential shares have been entitled to receive 80% of the amount paid for each share of the controlling block, whereas the shareholders owning ordinary shares have a tag-along right equivalent to 100% of the amount paid by the controlling interest if the control of the firm changes hands (Bradespar, 2009). Bradespar is thus a firm that can be considered to use more advanced corporate governance practices than the average of Brazilian firms.

In January 2009, the company made its first debt issue, consisting of 610,000 non-convertible bonds for a nominal value of R\$ 1,000, making a total offering of US\$ 265 million. The maturity of these bonds is three years.

Fitch ratings classified Bradespar securities as of good quality, indicating that the firm has a very low credit risk compared that of other Brazilian issuers (SND, 2011). Market sources calculated that the Bradespar bonds were 10 times oversubscribed (Valor Econômico, 2009).

Although the Bradespar bonds had a three-year maturity, in May 2009, the company sold shares with voting rights in CPFL Energia and partially redeemed the bonds it had issued (Bradespar, 2009). In June 2009, aware of the opportunity to obtain more attractive interest rates on the market, the company prepaid all of that issue, which had cost 125% of Interbank Certificate of Deposits (CDI) rate. The following month, it issued two series of unsecured debentures, which committed to pay interest at 105% of the CDI rate for securities with a maturity of 12 months and at 108% of the CDI rate for those of 24 months, thereby reducing its borrowing costs substantially (Bellotto, 2009). This represents more active financial management, which is understandable in the case of a financial holding company.

The first series of the second issue (with one-year maturity) made it possible to raise US\$ 72 million, while the second series of the second issue (with a two-year maturity) raised a further US\$ 342 million. The funds raised were used to redeem the promissory notes issued in January 2009 and to strengthen the firm's working capital (Bradespar, 2011b). The rating of these two series were slightly better than the original issue.

For a better understanding of the Bradespar risk rating scenario, the Fitch Ratings report drew attention to risks inherent in the firm's activities. These stem from the fact that Bradespar's earnings vary according to profitability and other aspects intrinsic to the operations of the firms in which it invests. Nonetheless, the rating agency highlighted the potential of the Bradesco financial conglomerate and the investment in Vale and CPFL Energia, which afforded a certain financial stability and a substantial dividend flow, as reflected in the low risk level of the firm's securities (Valor Econômico, 2010). Accordingly, the chances that Bradespar would default on its second unsecured debenture issue were practically zero. In fact, in July 2010, Bradespar redeemed the first series of the second bond issue without any difficulty (Bradespar, 2011b); and the second bond series was repaid in July 2011.

To control the risks on outstanding bonds, apart from the rating, investors had access to an important instrument, the RF. In short, the RF contains information that provides greater transparency, thereby making it easier to identify the risks that could affect the firm's activity, and the protection procedures adopted. The greater transparency offered by this report is one of the foundations of corporate governance.

In July 2011, Bradespar made its third bond issue, again divided into two series. The first series, maturing in one year, corresponded to a value of US\$ 186 million, while the second, with a two-year maturity, raised US\$ 327 million. This has a commitment to pay interest rates at 104% of the CDI rate in the case of the 12-month bonds and at 105.5% of the CDI rate on the 24-month bonds, again obtaining a reduction in funding costs. No information was available on the rating of this issue.

In short, Bradespar has been adopting the best corporate governance practices specified for BM&FBOVESPA level 1 since 2001. Moreover, the introduction of CVM Instruction 480 enabled investors to learn more about the real risk of the firm through the RF. In the specific case of these two bond issues, the RF could not be used before the issues, but only when it was first published in May 2010.

Even without the use of the RF, investors who chose to invest in Bradespar bonds did not have any problems with the payments. The creditors of the first issue were repaid early, a few months after the issue, because the company found ways to reduce its borrowing costs. The creditors of the second issue received the principal and interest in the two ensuing years.

It should be noted that Bradespar currently holds two assets: 5.7% of Vale and 9.0% of CPFL Energia. Like Petrobras, Vale is a firm with a high level of capitalization, which is tracked by several capital market analysts. Accordingly, the monitoring of the prospects of these firms makes it possible to reduce information asymmetry and thus decrease the risk assumed by the creditors.

Although there were no problems with the bonds issued by Bradespar, in future issues the RF will be an important tool which, in conjunction with the issue prospectuses and the opinions of rating agencies, will provide greater transparency, thereby helping investors to form an opinion on the likelihood of default on a given issue. In the Bradespar experience, the most relevant aspect was the issue of new bonds under more favourable conditions, and the repayment of bonds paying higher interest rates. The downside is that the bonds have a relatively short maturity period.

3. Diagnóstico América (DASA)

Founded in 1961, Diagnóstico América (DASA) adopted its current name in 2000, after receiving investments from investment funds managed by Banco Pátria. In 2004, the company, which operates in the outpatient, hospital, and laboratory market, was the first in the sector to have its shares listed on the stock market, entering BM&FBOVESPA's NM segment. The share issue aimed to raise funds to take over competitors and maintain investments. In 2006, it became a firm of dispersed control in BM&FBOVESPA (DASA, 2011). The company was among the first in the country to not have defined control (majority shareholder), like Lojas Renner, which fragmented its shareholder base in 2005.

In April 2006, DASA made its first bond issue together with a supplement, with a view to redefining its debt profile and consolidating its working capital (DASA, 2011). The amount issued was US\$ 95 million, in the form of 20,250 non-convertible bonds, of a nominal value of R\$ 10,000 and five-year maturity.

The first bond issue was rated by Standard and Poor's as "brA", the second level below the best credit rating (AAA) on that rating agency's scale. In its opinion, DASA securities were vulnerable to impacts from changing economic conditions. Nonetheless, the company's capacity to fulfil its obligations was seen as very strong compared to that of other borrowers in Brazil (SND, 2011). Four years later, in July 2010, based on good expectations for generating increasingly large cash flows for the firm, the better structure of costs and favourable demand for diagnostic services, Fitch awarded a positive outlook to this company's corporate ratings. Nonetheless, the agency said that DASA could have difficulties in dealing with fierce competition (Laguna, 2011).

It is notable that, despite the health sector not making much use of debt issuance as a source of financing, DASA succeeded in placing US\$ 435 million worth of additional bonds on the market in May 2011, by selling 70,000 non-convertible securities with a nominal value of R\$ 10,000 (Mandl; Adachi, 2011; SND, 2011). The term of these securities was again five years. The difference in relation to the first issue is the use of CVM Instruction 476 to offer unsecured debentures with restricted efforts (SND, 2011). At that time, DASA had already repaid the bonds issued in 2006. The uses to be made of the funds raised in the second issue include refinancing the debt and strengthening of the firm's working capital (Westphalen, 2011).

In the experience of DASA, however, the rhetoric of good corporate governance practices (affiliation to the NM) was not always borne out in practice, because transactions with related parties were perceived by the market as a mechanism of expropriation from shareholders and creditors. According to Correa and Fogaça (2009):

When Diagnósticos da América, better known as DASA, opened up its capital in November 2004, there was a party atmosphere. Controlled by a private equity fund owned by Banco Pátria and the physician, Caio Auriemo, one of the founders of the Delboni Auriemo laboratory (the embryo of DASA), the company rapidly became one of the stars on the stock exchange. On the first day of trading its shares closed up by nearly 20%, the highest rise of all initial public offerings (IPOs) in that period. The market expectation is that DASA's directors will turn it into the great consolidator of the clinical testing market, a sector that is still highly fragmented in Brazil. This expectation has largely been fulfilled. In the course of a decade and 21 takeovers, DASA sales grew from R\$ 70 million to a forecast R\$ 1.6 billion in 2009. Today it is the largest firm in the sector in Latin America. All of this growth was steered by Auriemo and Banco Pátria. In the last few months, however, the old owners have started to distance themselves from the firm. Auriemo resigned as board chairman in late April and sold his 10% stake in the company's capital in July. During this period, Banco Pátria also quietly sold nearly all of its holdings, and currently its stake is less than 2%. When the founder leaves the company he created, this is usually cause for concern among investors. "The market may see this result as indicating that the share has reached its peak price", says Santander analyst Daniel Gewehr. In this regard, DASA threw a surprise. Following the departure of Banco Pátria and Auriemo, the shares actually rose. From late April to 31 July, the company's shares rose by 43%, outpacing the Bovespa index by more than twice. In other words, investors applauded the departure of the old leaders. Why?

The explanation for this reaction is that, with the departure of the old controlling owners, the DASA executive board could now put an end to a practice that is both common and questionable in publicly traded companies: business with related parties, in which different firms with the same shareholder (or family) cut deals and do business amongst each other. In DASA this type of contract was quite common. The firm responsible for managing the car park of the networks service units belonged to José Auriemo Neto, one of Caio's nephews. The construction firm responsible for putting up the new laboratories and remodelling the old ones was RMA (Renato Magnanini Auriemo, son of the DASA founder). Touch Tecnologia, the company that develops the main software used by the network, was owned by another of Caio's sons, Ricardo. All the mergers and acquisitions throughout DASA's history were done through Banco Pátria. "Our strategy of investing in the firm is always to consolidate the market", claimed Olímpio Neto Matarazzo, a Banco Pátria shareholder. He said that in 10 years, the bank had advised 95 takeovers in the 11 firms in which it has invested. Overall, the services provided by the Auriemo family and Banco Pátria cost the laboratories network around R\$ 30 million in 2008. In favour of Auriemo and Banco Pátria, however, it has to be said that transactions with related parties had been disclosed in the prospectus of the IPO and in all income statements. Nonetheless, in recent times, with the atomization of the company's capital, investors have felt increasingly uncomfortable with the situation.

It needs to be borne in mind that the most recent DASA issue took place in 2011, in other words after the old controlling shareholders had departed. This year the firms have already published RFs providing greater detail on the firm, on its risks, and on its internal controls. Accordingly, investors in the second issue had better information than the creditors of the bonds issued in 2006. Owing to the ending of certain relations with related parties, which the market considered polemical, the risk of expropriation from shareholders and creditors also decreased.

4. Klabin

Created in 1899, Klabin operates in the markets for paper and paperboard, corrugated cardboard packaging and industrial bags, and in the production and marketing of timber logs for use in the furniture and construction industries (Klabin, 2011). During its long business history, the company has acquired stakes in other enterprises, for which, in addition to traditional financing, it has raised funds by issuing bonds. The company made its first bond issue in 1989. Nonetheless, this is not recorded in the SND or CVM, and information on this issue has not been obtained. In the case of the second issue, in 1990, the company offered two series, totalling 135,000 bonds. The securities in question were not convertible into shares, as they had a 10-year maturity, and have now been redeemed.

In 1999, the firm issued over 15,000 non-convertible bonds maturing in five years, which generated US\$ 83 million for the company. The following year, Klabin took over Igaras, a packaging manufacturer, for which it raised US\$ 98 million with the Bradesco and Chase banks. Later, to repay part of that loan, it increased its capital in 2001 by issuing 154.4 million shares without voting rights. The firm granted a period in which existing shareholders had priority in purchasing the shares. Nonetheless, owing to lack of interest, BNDESPar (a BNDES subsidiary which holds shares in various companies) ended up with a 20.7% stake in the total capital of the organization. The controlling interests in Klabin, meanwhile, had to dilute their share from 41.8% to 34.7% (Durão, 2000; Moreira, 2001).

As a result of electricity rationing and the devaluation of the real against the dollar in 2001, the price of Klabin shares fell sharply. With regard to the foreign currency debt, the company had a good cash flow, and a large proportion of its earnings were in United States dollars, so it believed it would not face solvency problems (Valor Econômico, 2001a). Nonetheless, in June 2002, the firm approved a bond issue, because it was worried about market instability and the imminent expiry of the short-term debt. In this year, Klabin experienced difficulties in terms of a lack of export credit (unprecedented for the company), and was forced to delay some of its payments (Valor Econômico, 2002). Thus, its financial difficulties stemmed from macroeconomic problems.

Klabin's financial situation led to the expectation of a potential default (Moreira, 2003). Given this situation, the firm raised funds through a US\$ 200 million loan to redeem its bonds, and it structured

an offer to obtain over US\$ 340 million in non-convertible unsecured debentures (Moreira, 2002a). The company reported that, still with difficulty in refinancing its debt, it had already paid most of the amount falling due by December 2002, including the expired portion of Eurobonds. It also stated that the funds raised through bonds would help it to make payments falling due in 2002, together with the amount needed for the following year (Moreira, 2002b).

The fourth Klabin bond issue was divided into two series, each of US\$ 130 million (maturing in 1.8 years and three years, respectively). Through the aforementioned public offer, Klabin sold 10,360 convertible securities on the market, for a nominal value of R\$ 100,000. The loan obtained at the end of the year and the issue of these bonds helped to reduce its dollar-denominated debt from 70% in 2001 to 34% in 2002 (Valor Econômico, 2003).

Nonetheless, the net debt in late 2002 amounted to roughly US\$ 771 million, which was more than in 2001 (Moreira, 2003); and the firm was forced to sell a number of assets to reduce this. In mid-2003, it sold Riocell to Aracruz (Valor Econômico, 2003); and also in 2003, using part of the funds obtained from the sale of Riocell, Klabin prepaid the bonds in its fourth issue, retiring the securities in question from circulation (Klabin, 2003). For the payment and refinancing of the debt, and to increase its working capital, Klabin then made a US\$ 107 million non-convertible bond offering in 2004. This was its fifth bond issue, with a three-year maturity. These bonds have now been redeemed.

After receiving the proceeds of the fourth bond issue and from the sale of assets, the firm decided to invest in producing cards for packaging, corrugated cardboard, and industrial bags. Having recovered from the crisis, Klabin said that 40% of that investment would come from its own capital, while the remainder would be financed with funds from BNDES and other export credit agencies (Vieira, 2006).

In 2008, with the world immersed in financial and economic crisis, the company decided to postpone the investments it had planned for the year but stated it was financially very strong, and had sufficient funds to cover its debts for the next three years (Camarotto, 2008). In late 2009, the Board of Directors approved the code of conduct in an attempt to improve its corporate governance practices and steer the company's actions in that direction.

Despite the strength shown over more than 100 years of existence, Klabin experienced an unprecedented crisis in the 2001-2002 biennium. Accordingly, given problems in fulfilling obligations owing to a lack of credit caused by macroeconomic problems and, in addition to using the funds raised through debt issues, it was forced to sell some of its assets. It is notable that it was precisely when it joined the differentiated corporate governance level of BM&FBOVESPA in 2002 that it delayed its payments. Nonetheless, it succeeded in overcoming the situation without damaging the bond holders of its first four issues; and the last issue was important in the financial restructuring process. Like Bradespar, the bond issue was associated with longer-term bonds over time.

5. Lupatech

Lupatech is an equipment manufacturer and service provider mainly serving the oil and gas sector. It began activities in 1980, with the establishment of Microinox; four years later it created Valmicro; and in 1993, following a corporate restructuring process, Microinox and Valmicro merged to form the current Lupatech.

In 2000 Lupatech purchased shares in Metalúrica Nova Americana (NAM), and the following year it bought the remaining shares (Lupatech, 2011a). In 2002, the company created Lupatech North America, through a joint venture between the subsidiary Lupatech Investments, and the United States enterprise Ideal Controls. Nonetheless, the strategic partnership ended three years later.

According to Nestor Perini, then president of Lupatech, “corporate governance is fundamental when attracting investors”. The firm claims that, although was not included in the BM&FBOVESPA differentiated levels, it used corporate governance concepts and sought, through transparency and accountability, to show investors that the resources used in the firm were not being diverted or falsified in

the financial statements. As a result, in 2003, the company gained two large shareholders: the emerging-company investment funds BNDESPar and GPTecnologia (UFRGS, 2005).

In 2006, Lupatech was listed on the stockmarket, under the rules of the NM and BM&FBOVESPA. For that purpose, its publicly offered shares generated a total of US\$ 71 million in new resources for the firm, and a movement of roughly US\$ 138 million through the sale of shares owned by the shareholders. This operation has had a number of consequences for the firm, such as: (a) greater atomization of its shareholder control; (b) a strengthening of its commitment to best corporate governance practices; and (c) progress in an expansion programme that includes a resumption of the internationalization process, the acquisition of new firms, and an increase in its exports (Bueno, 2006; Lupatech, 2011a).

In October 2006, for example, with the aim of expanding its operations in South America, Lupatech announced the acquisition of two Argentine enterprises: Válvulas Worcester and Esferomatic. These firms were considered leaders in the ball valves segment, and holders of roughly 60% of the market targeting the industrial sector, mainly oil and gas (Borges, 2006). In that same month, the company made its first debt issue, consisting of 22,700 bonds with a nominal value of R\$ 10,000 each, generating funds equivalent to US\$ 106 million, with five-year maturity.

In the opinion of S&P, the organization was susceptible to the effects of economic changes, but had capacity to reasonably fulfil its financial obligations. The unsecured debentures of that first issue were bought back in November 2007 and cancelled in the same month (Pentágono Debt Research, 2007; SND, 2011).

In 2007, Lupatech continued to acquire a variety of firms, such as Kaestner & Salerno (K& S), Ocean Coating, and Jefferson Sudamericana. In the following year, the companies Gavea Sensores, Sinergás GNV do Brasil, Fiberware, Norpatagonica and Tecval were also incorporated into the group, as the firm pursued an audacious expansion policy through acquisitions. In May 2009, it embarked on a restructuring of its debt profile and obtained US\$ 59 million in credit lines from the BNDES; and, in August 2009, it completed the subscription of US\$ 174 million nine-year bonds. The proceeds of these two loans entered in the second half of 2009 and were used to pay short and medium-term debt and finance the firm's takeovers, the formation of working capital, the strengthening of capital structure, and expansion and modernization of its productive capacity (Lupatech, 2009; Rosas, 2009; Lupatech, 2010a; Lupatech, 2011a; Lupatech, 2011b).

Despite its efforts to restructure its debt profile, in November 2009 the reduction of revenues and cash flow, stemming from the global financial crisis, led the company to default on certain aspects of its obligations, known as debt covenants. As a result, Moody's lowered its corporate rating, indicating that the company's results were worse than expected (Fregoni, 2009).

In late December 2009, the creditors approved the payment of commissions at 0.975% of the nominal value of the bonds, to compensate for the default on the covenants (Mandl, 2010). This meant that Lupatech paid US\$ 2.1 million to its investors to rescue it from a default situation (Mandl, 2011; Lupatech, 2011a, 2011b).

The company was hit by the global crisis and in 2010 announced losses of US\$ 42 million. Its sales revenue also fell away sharply, since gross earnings in 2010 was 18% less than in 2008. In justification, the company stated that, according to the review of tenders between 2009 and 2010, Petrobras had postponed its orders to Lupatech. In the words of Nestor Perini, the firm invested had heavily in the expectation of receiving Petrobras orders, but these failed to materialize. Thus, the company recorded performance below expectations (Lima, 2011).

At the close of fiscal 2010, the company's short-term debts were 62.9% higher than in 2009, mainly due to the contracting of new credit lines and higher interest payments on the convertible bonds. Similarly, the value of the consolidated net debt was 6.6% above that reported in the 2009 financial statements (Lupatech, 2010b, 2010c). As a result of the firm's situation, S&P lowered its risk rating again (Mandl, 2011).

In early 2011, Lupatech again had to renegotiate its borrowing limits with its creditors (Mandl, 2011). In the same period, to cover its financial obligations, it obtained US\$ 42 million from Banco Bradesco, with a six-month grace period, through the Progredir program, which is designed specifically

for Petrobras suppliers (Juliboni, 2011). Maybe it would be timely for Petrobras also to take to steps to improve its suppliers' corporate governance practices, in addition to putting pressure on its suppliers to improve production processes as it currently does.

Bearing these difficulties in mind, in June 2011 Lupatech tried to renegotiate its bonds for the third time in two years. In that same month, the company's Net debt/EBITDA ratio was roughly 27 times, higher than that considered acceptable in the bond prospectus. The main creditor in this negotiation was the BNDES, which held 90% of the second Lupatech bond issue. Consequently, to avoid prepayment of these amounts, the firm had to pay premiums to its creditors (Torres, 2011c).

In addition to the financial problems, in late 2009 the Lupatech family holding company was involved in a legal dispute with the company Livro Companhia Securitizadora de Crédito Financeiro (Kroehn, 2010). A polemical report issued by Kroehn (2010) published in the magazine "Isto É Dinheiro" explained that the case concerned allegations of the use of corporate funds to pay personal debts, and the concealment of assets to escape creditors.

In response, the president insisted that "Lupatech is a company listed on the NM of BM&FBOVESPA, the segment of the Brazilian capital market that requires special corporate governance commitments; and this, in itself, would prevent the practices that I am accused of, and denotes the claimant's total ignorance of the subject" (Gazeta de Caxias, 2010). Lupatech also issued a statement to the market in March 2010 alleging, among other things, that it abides by the corporate governance practices established in the NM of BM&FBOVESPA, and therefore has a healthy image in the market (Lupatech, 2010d).

Kroehn (2010) also argued that, in view of its good corporate governance practices, it is inappropriate for one person to simultaneously to chair both the board of directors and the executive board, as Perini did until September 2011.

The firm does not have committees set up, and its structure includes the board of directors, the executive board, and the fiscal board. In the prospectus for its first bond issue, Lupatech said that it was aware that one of its operational risks is its reliance on sales to Petrobras and successful takeovers. In fact, the company significantly increased its borrowing to expand its operations but did not obtain the expected return on those new investments.

As regards its structural composition, the existence of a finance committee, responsible for investment analysis and bond issuance, could support Lupatech's bond issuance processes. The presence of a formal risk management committee could also help the firms identify operational risks and, above all, reduce them, with the aim of averting potential conflict between the firm and its creditors, including the bondholders.

6. Inepar

Inepar, a systems, equipment, and services supplier in the electricity, oil, gas, mining and metallurgy infrastructure sectors, began operations in 1953 under the name of ENCO—Engenharia e Comércio. Years later, in 1976 following the merger between ENCO and Inepar—Industrias Eletromecânicas do Paraná, the firm adopted the name of Inepar Indústrias e Construções, which it still uses to this day (Inepar, 2011).

In the 1990s, Inepar made investments in other firms and forged several partnerships that were important for its operations, such as alliances with General Electric and Motorola. During this period, it decided to issue bonds on the market as a source of financing. It is important to note that in three of the five series, the bonds were convertible into shares, which is unique in the cases analysed here. In general, Brazilian firms prefer non-convertible bonds, to avoid the probable dilution of the share of majority shareholders.

In December 1994, Inepar made its first issue, consisting of 2,667 bonds convertible into voting shares totalling US\$ 28 million. In March 1996, it made a second unsecured debenture issue, this time in a single series, and raised US\$ 36 million through 35 million convertible bonds, with a plan to increase the capital of the subsidiary Inepar Telecomunicações. In that year, the company sold over 25,000 bonds on the market, divided into 20,000 non-convertible bonds and 5,000 bonds that were convertible into non-voting shares (Inepar, 2001).

Nonetheless, unlike what happened with the first issue, in which all the bonds have been paid or converted, the firm had problems fulfilling the obligations with the creditors of the last two issues, owing to financial difficulties (Inepar, 2001; Estadão, 2002b). In the second issue, for example, of the 35,000 bonds issued, 19,784 were exchanged for shares in Inepar Telecomunicações, and the remainder were re-scheduled in early 2001. Their payments were extended and divided up, with the settlement date of the final amount set for February 2002 (Inepar, 2001).

Facing difficulties meeting its third-party obligations, the firm issued an additional US\$ 123 million in bonds in April 2001. This fourth issue was divided into two series, both with five-year maturities. In its prospectus for the public offering of convertible bonds, the company acknowledged the existing risk factors that could influence fulfilment of the unsecured debentures. These included economic instability, governmental intervention in the economy, inflation, and the possibility of requiring additional funds to complete its investment plans (Inepar, 2001).

In addition, the company admitted that it had renegotiated some of the conditions on its second issue. In the case of court proceedings, apart from describing them, it indicated the probability of loss or gain as remote or possible. It generated information to enable investors to evaluate the probability of a potential liabilities impacting on the firm's financial situation (Inepar, 2001).

Atlantic Rating rated the firm's securities as of reasonable quality, indicating that Inepar would be in a position to meet the interest and principal payments, but might be affected by economic changes. SR rating has indicated that the company provided adequate protection to creditors, although the rating did not encourage demand for the securities. Nonetheless, Inepar needed to bring the negotiations to a good conclusion, because apart from its plans to invest in equipment, capital goods and electric systems, the firm issued bonds with the aim of using most of the proceeds to alleviate its lack of financial resources resulting from the group's weak performance in 2000 (Inepar, 2001; SND, 2011).

In addition to this difficult situation, the chair of the Inepar board of directors and controlling shareholder, with roughly 60% stake, was put under pressure by the minority shareholders (BNDESpar and the pension funds Previ and Aerus) to cede control of the group, change the command structure of the organization, and provide management based on corporate governance precepts. It is notable that the minority shareholders were unwilling to provide additional resources to the firm, mainly because it was controlled by a single individual. Accordingly, restructuring and the inclusion of good corporate governance practices, at that time would have reduced conflict between the shareholders and, consequently, would have eased the firm's financial problems, with a capital injection from the shareholders (Exame, 2001).

The crux of the problem originated in the 1990s, not from sector and/or macroeconomic problems but from the acquisition of several firms during the period of privatizations, assuming that the BNDES, partner and supplier capital for financing and credit, would extend funds to the firm. The company, however, did not receive the resources it was expecting and lost the financial support it had obtained. As a result, Inepar filled up with debt.

In 1999, the sale of its stake in Telemar to Banco Opportunity without previously consulting the Previ shareholders (the country's largest pension fund), which had the first option on purchase, further increased minority shareholders' aversion to injecting additional resources into Inepar. While conflicts between Inepar shareholders were constant, and financial difficulties growing, the share price fell and in July 2001 reached its lowest in three years. To further complicate the crisis in the company, the attempt to launch a fourth bond issue to obtain working capital, failed. This occurred because of the CVM's requirement in the filing of Inepar accounts, which, in addition to the presentation of 11 reservations by the auditors, also contained unclear explanatory notes. In an interview with the magazine "Exame", Marcel Trindade, then CVM director, was forthright in claiming that the "group definitely does not earn a score of 10 in terms of corporate governance" (Exame, 2001).

To overcome this situation, Inepar sold several of its assets, such as investments in hydroelectric power and telecom companies. Nonetheless, the proceeds were not sufficient to resolve its financial

problems (Exame, 2001; Balarin, 2003). In 2001, following lengthy discussions, the partners signed a memorandum in which they undertook to restructure the firm in terms of financial resources and participation in capital, with dilutions of the capital structure and the inclusion of corporate governance practices in the company's statutes, with a view to firm's admission to the NM of BM&FBOVESPA (Valor Econômico, 2001b; Félix, 2001; Casado, 2001).

In late 2001, the repercussions of the crisis continued to affect the firm's relations with its creditors. As a result, Inepar obtained a 60-day period to repay certain securities, renegotiating the payment of the final amortization of the third issue (first series) in five installments (Inepar, 2001; Estadão, 2002b; Coimbra, 2004). In April 2002, when the final part of that negotiation expired, the firm's securities were given a "junk" rating by Atlantic Rating. In October 2002, following further defaults with creditors on the second and third issues, the firm justified itself by arguing that it had not received a financial contribution from its shareholders, because its financial restructuring process had not been completed. Accordingly, it could not make the payments on the renegotiated portion, which fell due in that month (Estadão, 2002c).

In 2003, the securities of the second series of the fourth bond issue were classified by Fitch Atlantic Ratings as belonging to a company that was in arrears with its obligations. Moreover, in September 2003, Inepar filed an action of nullification and request for review of duties against the fiduciary agent and bondholders. Since October 2003, it has been unable to make principal repayments, so the matter has been referred to the courts (Pentágono Debt Research, 2010; SND, 2011).

As the firm was in arrears on its obligations with the bond issue, early expiry of the bonds was declared in November 2003, along with the recovery of all amounts owed by the firm. Nonetheless, even so, Inepar did not make payments, which triggered an enforcement suit on the second bond issue in 2004 (Pentágono, 2010).

In general, there were no problems with the bonds in the first issue. In relation to the second issue of 35,000 bonds, 19,784 were swapped for shares in Inepar Telecomunicações, 9,362 were redeemed, and 1,838 were repaid as a capital increase. In the first series of the third issue, 4,750 unsecured debentures were redeemed, and 15,250 were disbursed as capital increases. In the case of the second series, 87 were redeemed, 3,168 were converted into non-voting shares in Inepar, and 1,245 were disbursed. In December 2010, a total of 500 bonds were still in circulation (Inepar, 2010a; Camargo, 2011). In the case of the fourth issue, in January 2003 the company cancelled 119,190 bonds from the first series, along with 135,000 from the second series; and as 15,156 securities were converted into shares, in December 2010, a total of 654 unsecured debentures remained in circulation. The payments on the fourth issue were also rescheduled in May 2010 (Inepar, 2010a; C&D, 2011).

Accordingly, the firm always used bonds as a source of financing; and, in 1995, the amount owed represented 20% of the third-party capital used in that year. In 1996, when the company made two bond issues, the proportion was equivalent to 22%.

In 2008, Inepar announced its intention to align with BM&FBOVESPA level 2 (Valor Online, 2008). Nonetheless, only in March 2011 did the company gain admission to level 1, which is less demanding. It thus joined a group of firms listed in BM&FBOVESPA which undertake to disseminate best corporate governance practices.

Indicating its intention to settle its overdue obligations, in April 2011, Inepar signed a contract for the first stage of negotiations with BNDES, to refinance its debt of approximately US\$ 105 million in 120 monthly installments, at the long-term interest rate (TJLP) plus 2.5% per year (Seabra, 2011). Following the problems experienced by Inepar, which impacted both on its financial situation and on the conflict between shareholders and its wide-ranging participation in other companies, in 2011, unlike the previous scenario, Inepar had interests in a smaller range of firms, such as IESA, Inepar Equipamentos e Montagens and Inepar Energia. Currently, Inepar is controlled by Inepar Administração e Participação, and it had a different management structure than in 2001.

Inepar seems to have a lower quality of debt than the other five firms studied. Although it declared its effort to set up a corporate governance structure and, therefore, apply good practices since mid-2001, when its restructuring process began, the rapid growth strategy and the financial crisis, together with many takeovers, weakened its financial position. In addition, conflicts of interest between the controller and the other shareholders helped to worsen the situation. These included, for example, the unwillingness of BNDES, along with the other shareholders, to inject capital into the firm, given the difficult relation with the controlling shareholder. This fact complicated the company's financial situation still further and contributed to its default with its creditors. In this scenario, good corporate governance practices could be an effective tool for resolving these conflicts and avoiding their impact on the firm's situation.

7. Comparative analysis of the cases studied

The corporate governance approach of the firms analysed is compared using information available in RFs, corporate governance yearbooks, the firms' websites, and their statutes, to survey the corporate governance structure in each case. The issues investigated and their respective weighting was suggested by the coordination of the study. When the replies were affirmative, the firm was awarded one point, multiplied by the respective weight; and, when the replies were negative, the firms were awarded zero. As a limitation, it should be noted that in all cases in which the company's actions were not explicitly identified, it was decided to consider the question as null and void, to minimize errors. Accordingly, the calculation of corporate governance levels is a conservative estimate of the real situation of the companies analysed (table IV.1).

In general, the indices of the Brazilian firms investigated are very distant from the benchmark. In fact, for a maximum possible value of 10, the highest score obtained in the Brazilian sample was 2.52, with average and minimum scores of 1.79 and 1.35, respectively. It is important to bear in mind that this index does not aim to rate corporate governance performance in general, but only to evaluate the strength and weaknesses that corporate governance may have in a single aspect, namely that related to debt issuance.

Moreover, a low score on the index does not mean corporate governance as a whole is functioning badly. It only reflects aspects that need to be improved to reduce the risk in debt issues. The main conclusion from table 1 concerns the limited dissemination of certain specific committees. Most firms reported that they did not have audit committees, although some reported the use of a fiscal (or oversight) board. Only one company mentioned the existence of a finance committee, which, in addition to looking after finances, was responsible for calculating, disseminating, and managing the potential risks associated with the firm's activities. More importantly still, none of the six companies had committees on investments in financial assets, corporate financing, and risks.

KPMG (2008) also showed that little use is made of board committees in Brazil. At that time, only 12% of all firms listed on the BM&FBOVESPA used committees, although the figure was higher for companies listed in the NM (25%), especially among firms that have certificates of deposit (American Depositary Receipt, ADR levels 2 and 3) traded in the United States (82%). Even for this latter group, despite the firms having audit committees, only 24% had adopted a finance and/or investment committee. To some extent this evidence is consistent with the results shown in table IV.1. Although the authors have not discussed the factors behind the low rate of committee use in Brazilian firms, their greater dissemination among firms that have ADRs suggests that their use is more highly valued in denser financial markets. Accordingly, it is reasonable to expect the use of committees in Brazilian companies to grow over the next few years, including as a result of the improvement in corporate governance practices observed in the country.

The very low score displayed in table 1, for all firms, makes it impossible to identify a positive correlation between best corporate governance practices and better debt issuance behaviour. It is also important to note that this could be partly due to the fact that this represents corporate governance practices at the present time, whereas problems of noncompliance occurred in earlier years. Accordingly, a firm that faces solvency problems could have been pressured to improve its corporate governance practices. Moreover, it would be impractical to try to calculate results at the time of financial distress, not only because of the difficulty of obtaining data, but mainly because corporate governance is an ongoing process of improvement.

Table IV.1
Corporate governance index of selected Brazilian firms

Categories	Standards	Standards for bonds	Weight
The role of the board of directors	1. The board of directors shall establish mechanisms to ensure the collection of timely and reliable information on all the investment (in financial and non-financial assets) and funding activities conducted by the company.	1.1 Does it authorize the issuance of bonds, whether or not the regulator requires a placement memorandum?	0.377
		1.2 Does the bond prospectus comply with the regulator's requirements for public offerings?	0.377
		1.3 Is there information on resource use, both in the business strategy and per project and/or debt restructuring?	0.377
		1.4 Are the implications and actions relating to the company's issues and leverage levels known factors?	0.377
2. The board of directors may delegate responsibilities and functions in board committees chaired by an independent outside director.		2.1 Are the design and analysis of the issue delegated to the corporate finance committee?	0.189
		2.2 Is the analysis of the financial risks of the issue delegated to the risk committee?	0.189
		2.3 Is the responsibility of management reports on issuance information delegated to the audit committee?	0.189
The structure of the board of directors	3. The size of the board of directors shall be appropriate for prompt decision-making.	3.1 Does the board have between 8 and 15 directors?	0.031
		3.2 Does the board have at least 50% outside directors?	0.031
		3.3 Are more than half of the outside directors independent?	0.032
The role of the chair of the board of directors	4. The chair of the board of directors shall establish the mechanisms for selection of outside directors on the basis of the value they can contribute.	4.1 In the selection of some outside directors, is priority given to their expertise in finance, particularly in corporate financing?	0.189
		5. The chair of the board of directors shall be an independent outside director.	0.377
The role and selection of executive (inside) and non-executive (outside) directors	6. The directors (inside and outside) shall be selected on the basis of the value they can bring to the board of directors.	6.1 Do more than 50% of the directors have sound and updated knowledge of finance and corporate financing?	0.095
		6.2 Do more than 50% of the outside directors have sound and updated knowledge of finance and corporate financing?	0.095
		7.1 Is there a systematic training programme for directors?	0.189
		7.2 Do they have certifications in financial matters on which they make decisions?	0.189
		7.3 Is the performance of each outside director regularly reviewed?	0.189
		8.1 Do the outside directors flag conflicts of interest in the bond issuance process?	0.189
		9.1 Are there three or more outside directors for each inside one?	0.189
		9.2 Are the outside directors selected by a committee of independent directors?	0.189
		10.1 Do the inside directors sign off, as legally and criminally accountable, on disclosures concerning a bond issue and its implications for the financial position of the company?	0.377
		11.1 Is the internal audit director a member of the board?	0.189
11.2 Does the internal audit director report directly to the board or the audit committee?	0.189		

Table IV.1 (concluded)

Categories	Standards	Standards for bonds	Weight
Audit committee	12. The committee shall be chaired by an independent outside director with experience in internal control.	12.1 Is the audit committee chaired by an independent director?	0.377
	(i) The independent auditor shall be engaged by the committee and report directly to it.	12.2 Is the independent auditor engaged by the audit committee, and does it report to the committee?	0.377
	(ii) The committee shall approve the internal and external audit programmes.	12.3 Does the audit committee approve the internal and external audit programmes?	0.377
	(iii) The committee shall follow up on the internal and external audit recommendations.	12.4 Is there an effective reporting system on corporate financing?	0.377
	(iv) The committee shall approve the design and operation of the internal control system, whose main function is the production of reports. The committee shall be responsible for maintaining a system of timely generation of reports, especially on financial matters, risk management and performance of the company and its managers.	12.5 Does the committee prepare regular reports to the board and to general management on compliance with internal control policies on the use of financial resources for financing?	0.377
Financial asset investment committee	(v) The committee shall submit regular reports to the CEO and the board of directors on compliance with or violation of internal control policies.		
	13. The committee shall be chaired by an independent outside director with experience in financial markets.	13.1 Is the investment committee chaired by an independent director?	0.095
	(i) The committee shall structure the strategy for investing the company's cash surpluses.	13.2 Does the chair of the investment committee have proven experience in investment strategies?	0.095
	(ii) The committee shall review the company's investment strategy with appropriate frequency.	13.3 Does the committee meet at least once a month?	0.095
Corporate financing committee	14. The committee shall be chaired by an independent outside director with experience in corporate financing.	14.1 Is the committee chaired by an independent director?	0.377
	The committee shall decide on funding needs and mechanisms proposed by general management.	14.2 Does the committee chair have proven experience in corporate financing?	0.377
	(i) The committee shall approve the selection and engagement of financial intermediaries required by the company for placing the financial securities it issues.	14.3 Is this the committee that defines the funding requirements of the company and how to meet them?	0.377
		14.4 Is this the committee that selects the financial intermediaries to place bonds issued by the company?	0.377
Risk committee	15. The committee shall be chaired by an independent outside director who has experience in comprehensive risk management.	15.1 Is the risk committee chaired by an independent director?	0.377
	(i) The committee shall engage rating agencies and receive from them regular reports on the company's portfolio of financial instruments.	15.2 Does the committee chair have proven experience and expertise in comprehensive risk management?	0.377
	(ii) The committee shall rule on reports of financial and credit risks related to the company's portfolio investments in financial securities, carried out by its risk unit.	15.3 Is it the risk committee that is responsible for ruling on reports on the financial risks faced by the company?	0.377
	(iii) The committee shall report regularly on compliance with or deviation from the investment strategy on the part of the company's treasury unit.	15.4 Is it the risk committee that explains the company's bond issuance risks?	0.377
	(iv) The committee shall submit regular reports to general management and the board of directors on the effectiveness of the investment strategy.		
(v) The committee shall prepare an inventory of the relevant non-financial risks for the company and specify which are quantifiable and which not.			

Source: Prepared by the authors.

Table IV.2 offers a second, more simplified, attempt to systemize the six cases reviewed. Only four factors were considered: (a) the type of market in which the firm appears in the BM&FBOVESPA (traditional, level 1, level 2 and NM), which is considered a proxy for the formal level of corporate governance; (b) serious corporate governance problems, seen as an indicator of the real level of corporate governance; (c) adoption of the finance committee, which is taken as a parameter for risk management; and (d) default or renegotiation of the debt.

Table IV.2
Corporate governance and problems with debts in selected firms

	Type of market in the BM&FBOVESPA	Serious corporate governance problems	Finance committee	Default or renegotiation of the debt
PETROBRAS	Traditional	No	Yes	No
Bradespar	Level 1 (2001)	No	No	No
DASA	NM (2004)	Yes	No	No
Klabin	Level 1 (2002)	No	No	2002
Lupatech	NM (2006)	Yes	No	2009, 2011
Inepar	Level 1 (2011)	Yes	No	2002-2003

Source: Prepared by the authors.

The review of six Brazilian companies reached the conclusion that the relation between corporate governance and debt issuance is complex, as described below:

- Adherence to the highest levels of corporate governance (NM of BM&FBOVESPA) is not necessarily the best guarantee of effective corporate governance practices, as shown in the controversial operations with related parties in the DASA experience;
- An improvement in corporate governance (migration to the differentiated levels of BM&FBOVESPA) is not necessarily sufficient to avoid financial problems caused by unexpected events, as shown in the case of Klabin;
- In some cases, a combination of high risk (high growth rate, increasing productive diversification, and heavy reliance on a single consumer) ends up being subordinated to the need to exploit market opportunities, as shown in the case of Lupatech;
- In some cases, an improvement in corporate governance (migration to the differentiated levels of BM&FBOVESPA) occurs some time after the problems with the debt issued.

E. Conclusions and recommendations

The foregoing analysis of the Brazilian capital market scenario revealed the scant priority given to bonds in the country prior to the mid-1990s. This occurred mainly because of a lack of regulation, high inflation rates, high interest rates, and other factors relevant to the economic instability experienced in Brazil. Nonetheless, there was significant development of this form of financing particularly after the Real Plan in 1994.

Bonds in Brazil are mostly public. Paula and others (2009) consider that profitability, together with the low incidence of risks stemming from sovereign issues, have a negative influence on the Brazilian corporate bond market. In conjunction with this, the relative lack of liquidity in the secondary bond sector makes them less attractive to investors. To remedy this situation, the BNDES has invested heavily in developing the debt market, both as a purchaser of the securities, and by participating in projects in conjunction with other entities, such as the BM&FBOVESPA.

The bond market has grown considerably since 2004. Private-sector securities as a proportion of GDP grew from 2.4% in December 2004 to 5.6% in December 2008, and to 9.5% in December 2010. The growth in bonds issued with restricted efforts, based on CVM Instruction 476, has contributed to this. This increase was due to a more streamlined and simple debt issuance process in Brazil as from 2009. In addition, the reference form, a requirement established by CVM Instruction 480, provides additional information on the Brazilian firms.

Another decisive factor in the debt market relates to the risk of default on the issues or renegotiations with the creditors. This was brought to the fore in the case of Inepar, which went through a crisis and was unable to meet its obligations to investors. In addition to Inepar, two other firms also had to renegotiate some clauses with their bondholders — Lupatech (based on an aggressive growth strategy, combined with heavy reliance on a single customer, which generated greater risk) and Klabin (owing to the abrupt reversal of external financing conditions, affecting traditional credit lines in anticipation of export contracts).

To protect investors in bond purchases, additional information on the risks related to the firm in question is essential. The use of good corporate governance practices is an alternative which, in addition to providing various benefits for the companies and their shareholders, helps investors and creditors to take consistent decisions. Moreover, with respect to corporate governance, Law 10,303/2001, which amended Law 6,404/1976, has brought a number of significant benefits, such as the reduction in the proportion of non-voting shares and the possibility of using arbitration to settle disputes. In addition to the benefits provided by the legislation, the CVM and IBGC issued codes of good corporate governance practices in order to mitigate information asymmetry.

BM&FBOVESPA, in turn, established differentiated corporate governance segments in 2001, and its listed firms undertake voluntarily to follow the directives of their respective segment. The objective was to give the market signals that the firms were committed to transparency, equity and accountability. Nonetheless, there are some firms that have a good corporate governance structure and good practices, despite being listed on the traditional market.

Petrobras, for example, is listed on the traditional segment of the BM&FBOVESPA, but has a code of good corporate governance practices. Moreover, the firm has not had any problems in meeting its obligations; its ratings are always excellent and consistent with events subsequent to the issues; and its corporate governance structure is more robust than those of other companies, because it is the only one that has a finance committee, as well as other committees that were encountered in the other five cases. This result cannot be dissociated from the larger scale of its business, which ends up stimulating the improvement of corporate governance and risk management practices.

Bradespar, a financial holding company, belonging to BM&FBOVESPA corporate governance level 1 has also issued bonds with very low credit risk. The company bought its bonds back in advance and no problems were identified with the bondholders. It has not set up committees, and so does not have a specific and formal committee for dealing with risk, its finances, and audit related issues, which would help to improve its operations.

DASA, the company that operates in the health market and is listed on the NM of BM&FBOVESPA, was one of the first to have atomized its capital in Brazil. With a view to expanding its businesses, the company offered shares and bonds, which are rated as pertaining to an organization that was susceptible to economic changes. The firm only has one bond issue in circulation, and no evidence has been found of any problems with the bondholders, although the company has faced corporate governance problems, in particular in terms of transactions with related parties. Its structure does not include investment, finance, or risk committees. Nonetheless, the company has an audit committee that helps to evaluate its internal processes and supervise the internal and external audit work.

Lupatech, which supplies equipment and services mainly for the oil and gas sector, was quoted in the stock market in 2006 (attached to the NM of BM&FBOVESPA) and, in that same month, issued bonds.

Although its rating was not good, the rating agency considered that the firm could pay its debts. Two years later, the company made a private bond placement and used the BNDES to attempt to restructure its debt profile. In the following months, the company made three renegotiations with its bondholders and paid the costs related to the covenants. To extract itself from the situation, the organization put forward a strategy based on the asset disposal and cost cutting. In addition to having defaulted on a payment, doubts were raised over the effectiveness of the company's corporate governance models. Accordingly, the establishment of auxiliary committees on finance and risk management, as well as the promotion of best corporate governance practices, could support better decision-making in the entity and provide more consistent information to investors.

Klabin, a firm that operates in the cellulose and paper market, also adopted an expansion policy; and the firm's rapid growth forced it to have recourse to the debt market to finance its activities. At the peak of the crisis resulting from the withdrawal of traditional financing sources (export credit), it defaulted on obligations to its creditors. In addition, the firm was forced to sell a number of assets and seek other ways to improve its financial performance. Paradoxically, this happened in the year in which it was registered in BM&FBOVESPA corporate governance level 1. The company also does not have committees related to risk, finance, and audit unit structure, and like the others, its problems could be mitigated by using such resources.

Inepar, a systems and equipment supplier, had clear problems in fulfilling its obligations. Its lengthy restructuring process and the crisis it faced, led the company into debt renegotiation and default. Its corporate governance structure is improvable, and it would benefit from the creation of committees that currently do not exist in the firm. In addition, the conflict of interest between the shareholders (which even prevented a financial restructuring and generated losses for bondholders) is another matter that could be alleviated or eliminated by effective application of good corporate governance practices.

In general, one of the main conclusions of this chapter is that, when calculating an index to evaluate corporate governance strengths and weaknesses in debt issuance, more committees need to be adopted by Brazilian firms, particularly committees on financial asset investment, corporate financing and risks. This would tend to reduce the bond-issuance risk.

The difficulty of correlating best corporate governance practices with lower risk in a given debt issue reflects the fact that the two phenomena are not necessarily synchronous, but evolutionary processes. Today, of course, Brazilian firms have adopted better corporate governance practices than a decade ago, both in general and for bond issuance in particular. Moreover, the country's stronger macroeconomic fundamentals are creating new business opportunities and greater financial leverage for the firms. Consequently, the potential for issuing debt has also increased.

In this context, the debt market in Brazil has grown significantly, with the stimulus including the BNDES, whose credit lines have been one of the main sources of corporate funding. ANBIMA (2010) expects bond issuance to increase still further in the coming years. The new fixed-income market (NMRF) is set to be launched late this year, aiming to reduce transaction costs and obtain greater transparency, liquidity and volume, thus deepening the secondary bond market. This initiative, of a self-regulatory and voluntary nature, is inspired in the similar experience of the NM of the BM&FBOVESPA and is supported by the BNDES. The NMRF will be based on the following pillars:

- Standardized securities, to make it easier for investors to perform analyses and comparison with other assets.
- Atomization: no investor may hold more than 20% of the issue, to stimulate the secondary market in the securities.
- Low unit value of the bond, to attract more investors; in this scenario, the NMRF would have a unit value of R\$ 1,000.

- Creation of two liquidity funds. The initial task of the first fund would be to promote the liquidity on the secondary market, in a transition phase, thereby promoting price transparency. The idea is that private and voluntary funds, but in association with the BNDES, are an actor of weight in terms of the bids. The second is a private fund to ensure liquidity in the face of a weakening of one or other intermediary.

Considering that the NMRF is a joint initiative promoted by private banks, the government, firms, and investors to promote the debt issuance market in Brazil, it is inadvisable to propose other public policy measures at this time, but better to wait for this project to unfold before making new suggestions. On the other hand, corporate governance offers vital tools for the firms, because transparency and accountability help to mitigate risk for minority shareholders and creditors. That obviously is essential for the development of the debt market. In short, the bond market in Brazil is still in the initial stages of its growth. There is a long road to travel, including the need to increase the liquidity of the secondary market, in which good corporate governance practices are important to overcome the obstacles. In particular, greater use of committees on financial asset investment, corporate financing and risks is highly recommended.

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V. Corporate governance and corporate debt issuance in Chile

*Alvaro Clarke*¹

A. Introduction

The development of debt markets requires highly developed corporate governance in the firms involved so that investors have the assurance of recovering their funds and obtaining the expected return.

In Chile, there is now an extensive institutional system created to provide an appropriate supervision structure, encompassing regulatory bodies, valid and accredited counterparties that intermediate between issuers and investors to protect their respective interests, and agents specializing in the management of economic and financial information, all of which provides an incentive for issuing firms to improve their corporate governance standards.

Key features of this system are the effort to involve shareholders so that they play a responsible part in major company decisions by participating in shareholders' meetings and the establishment of boards of directors possessing explicit regulatory rights and responsibilities with a view to ensuring proper corporate management. The system also provides for organized representation of investors vis-à-vis debt issuers at bondholders' meetings.

Lastly, there are the activities of the Superintendency of Securities and Insurance (SVS), which is responsible for enforcing regulations, and the operations of specialized agents such as risk rating agencies, which evaluate and rate debt issues, and auditors, which certify companies' financial statements. All this takes place within a legal framework that devolves the responsibility for acting upon the agents concerned.

To study the issue more thoroughly, the corporate governance practices of four Chilean firms were analysed, one apiece in the service, industrial and financial sectors and one State enterprise. The

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findings of this study provide preliminary confirmation that the system works much as it is supposed to. However, it should be pointed out, as a methodological comment, that the evaluation instrument was extremely hard to apply, which inevitably reduces the accuracy of the conclusions. For example, the indicator includes legal structures in corporate governance arrangements that are exclusive to one jurisdiction; it specifies a number of committees that are found in one particular situation but cannot be assumed to be present everywhere, since the number and type of committees is a management decision for the board, so that by construction they will differ by firm, business sector, the main risks in the organization, etc. Furthermore, what is important is whether particular functions are carried out, not whether particular committees exist or not, and these variables are difficult to observe. In summary, the conclusions need to be viewed with a measure of detachment.

B. Objectives

The objective of this study is to extend the analysis of corporate governance and the issuance of corporate debt instruments in Chile, considering the role of risk rating agencies, institutional investors (pension funds, development banks and insurance companies) and investment banks in improving corporate governance practices in the debt instrument issuance process.

This involves the following:

- (a) Analysing the importance of risk rating agencies, institutional investors and investment banks in Chile, while considering the impact of corporate governance and debt issuance performance indicators.
- (b) Investigating why, when, how and to what extent institutional investors, investment banks and risk rating agencies in Chile are instrumental in improving corporate governance and the issuance of debt instruments.
- (c) Identifying which elements in the regulation and oversight system need to be strengthened.
- (d) Applying the questionnaire and analysing four major cases of firms issuing debt instruments in the following areas: manufacturing, services, finance and government.
- (e) Identifying the weakest points in the application of corporate governance law.

C. The structure of the capital market in Chile

The capital market in Chile operates within a fairly stable legal and regulatory framework where the regulator is constantly seeking to improve transaction efficiency and ensure proper price formation, as well as increasing levels of market information and transparency so that investors can make properly informed decisions.

The main actors in this debt market are:

1. Debt issuers
2. Investment banks
3. Institutional investors
4. Risk rating agencies
5. Regulators

Debt issuers are firms whose legal status is usually that of a limited liability company (*sociedad anónima*), with an ownership structure similar to that found in continental Europe, characterized by

fairly high shareholder concentration and a strong presence of business groups or conglomerates. In fact, the existence of these business groups is recognized by the regulations, which define and list them.²

Table V.1 gives the percentages of voting rights held by the controlling shareholder in non-financial firms registered with the SVS. It shows that over the last decade, about 70% of these firms have had a controlling shareholder, with rights to about 60% of cash flows.

Table V.1
Ownership structure of non-financial firms registered with the Superintendency of Securities and Insurance (SVS)

Year	Rights held by the controlling shareholder	
	Voting (percentages)	Cash flow (percentages)
1995	65	57
2000	70	61
2005	70	61
2009	68	59

Source: Larrain, B., M. Donelli and F. Urzúa, “Ownership dynamics with large shareholders: an empirical analysis”, *Journal of Financial and Quantitative Analysis (JFQA)*, vol. 48, No. 2, 2013.

Investment banks play an important intermediation role, acting in the first instance as lead managers and structuring a primary debt market in which their reputation, professionalism and assets enable them to establish a relationship of trust with investors. At this early stage in an issue, they also usually act as representatives of debt bondholders to safeguard the interests of investors vis-à-vis issuers.

Interactions between issuing firms and the capital market take place within a fairly consistent and complementary legal and regulatory framework, with few instances of conflict in legal competence. The most important laws include the Securities Act, the Companies Act, the Pension Funds Decree Law, the Banks Act, the Insurance Act and the Uniform Funds Act, along with other legal provisions. The four main regulators overseeing different aspects of financial markets in Chile are:

- The Superintendency of Securities and Insurance (SVS), which protects the fiduciary aspect of the securities market. Among many other things, it supervises publicly traded companies and issuers of publicly traded investment, capital or debt instruments. It monitors insurance companies for solvency, and it regulates risk rating agencies and audit firms.
- The Superintendency of Banks and Financial Institutions (SBIF), which monitors the solvency of the banking system.
- The Superintendency of Pensions (SP), which oversees investments by pension fund administrators (AFPs), including such things as eligible instruments and investment policies and limits, as well as the election of directors, the development of regulations and so on.
- The Central Bank also participates actively in regulatory issues through its board, setting some of the structural limits in the pension system. These limits are on the maximum percentage of investment in State instruments, overall foreign investment, which may be by fund type, and investment in higher-risk instruments and those requiring foreign exchange cover. It also influences a number of important aspects within the purview of bank regulation.

² Circular 1664, which sets maximum concentration limits for institutional funds. Thus, fund allocations in these portfolios are subject to limits that apply collectively to all issuers in the same business group.

Where corporate governance is concerned, there are a number of aspects of market structure worth highlighting.

First, Chile is a “legalistic” country, and as a result regulation is fairly extensive and self-regulation limited. This explains why, unlike most of the region’s countries, Chile has not instituted the country concept of a code of best practices for corporate governance as a requirement for listed firms to inform the market of their standard.

Second, in view of company ownership structures, the regulatory framework has been designed in such a way that those providing firms with financing have fairly effective oversight instruments. Thus, listed firms are legally required to create a directors’ committee with a majority of independent members, whose functions include reviewing all related party transactions and notifying them to the board of directors, dealing with auditors and risk rating agencies and proposing them to the board and/or the shareholders’ meeting, and considering executive compensation contracts and presenting them to the board. The aim of the regulations is for independent directors to have a decisive influence in these areas and be able to act independently of company management.

Third, in order for takeovers to be economically efficient and also equitable, transfers of share ownership leading to a change in the controlling shareholder must be at “market prices” via a public takeover bid providing similar terms to all shareholders.

Lastly, the private pension system has made possible the involvement of major accredited investors such as pension funds and insurance companies, which handle large volumes of funding and are subject to strong social influence and oversight, something that encourages and enables them to play an active role opposite management.

Table V.2 shows the relative importance of the main institutional investors. In 2013, these managed assets worth about US\$ 261 billion, or some 91% of GDP, with investment funds and insurance companies accounting for particularly large shares of 57% and 17% of GDP, respectively. The diminished share of pension funds and insurance companies in the last five years is due to a decline in the value of investments because of the global debt crisis.

Table V.2
Assets administered by institutional investors

Investor type	2002		2009		2013	
	Billions of dollars	Percentages of GDP	Billions of dollars	Percentages of GDP	Billions of dollars	Percentages of GDP
Mutual funds	5	7	18	10	39	14
Investment funds	1	1	3	2	9	3
Insurance companies	13	19	36	20	49	17
Pension funds	36	54	118	65	163	57
Total	54	81	172	97	261	91
GDP	67.2		180.6		285^a	

Source: Prepared by the author on the basis of information from Superintendency of Securities and Insurance (SVS), “Estadísticas mercado de seguros” [online] http://www.svs.cl/sitio/estadisticas/seg_mercado.php; “Estadísticas mercado de valores” [online] <http://www.svs.cl/sitio/estadisticas/valores.php>; Marco Mendoza and Gustavo Reinoso, “Lecciones del desarrollo del mercado de capitales en Chile”, *Moneda* [online] <http://www.bcrp.gob.pe/docs/Publicaciones/Revista-Moneda/Moneda-146/Moneda-146-04.pdf> and International Monetary Fund (IMF).

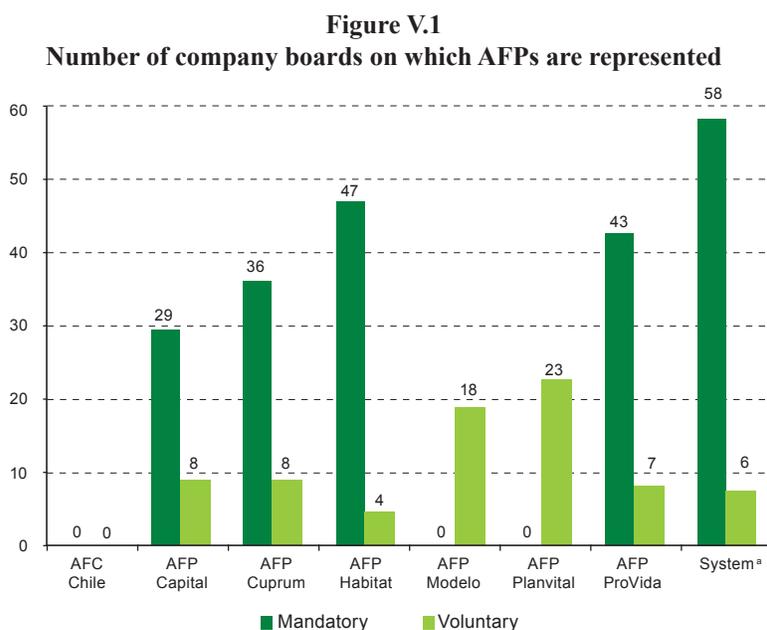
^a Value projected by the International Monetary Fund (IMF) for 2013.

Consequently, not only are a majority of directors on the boards of publicly traded companies usually elected by the votes of the controlling group, but the shareholders’ meeting appoints a number of

independent directors who have the backing of these institutional investors, including pension funds and others. This creates a more effective climate of oversight within the board and also at the shareholders' meeting, which has the power to influence the firm's borrowing policies, among other things.

This is borne out by the corporate governance report prepared by OECD (2011), which emphasizes this role of Chilean institutional investors, and particularly pension fund administrators (AFPs), in improving the corporate governance of firms they invest in. It points out, however, that because the Chilean market is shallow, the authority has gradually raised the limit on how much pension funds can invest abroad from between 6% and 12% in 1999 to an overall maximum of 80%. The reform process has further expanded the options for workers' savings, as each AFP has five risk-differentiated funds, with different proportions being invested in fixed-income instruments and in variable-income instruments such as shares, for which the range is from 5% in the lowest-risk fund to 80% in the riskiest. This has had implications for corporate management, as more concentrated equity investments provide greater voting power. However, AFPs are limited to a maximum of 7% of the equity of any individual issuer, and this significantly reduces the potential impact that individual pension funds can have on corporate governance, making it impossible for them to become controlling shareholders. Nonetheless, the collective impact of AFP actions is very far-reaching, as the law expressly permits them to coordinate their votes and use cumulative voting in order to attain the 12.5% of votes necessary to secure the election of a director on a seven-member board.

Figure V.1 shows the number of boards on which each AFP is represented. The regulatory framework places restrictions on them, one example being that in elections to the board they cannot vote for candidates backed by the controlling shareholder.³ It does however allow them to coordinate with one another and combine blocks of shares to elect directors or resolve board issues.



Source: Superintendency of Pensions (SP).

^a The number of companies in the "System" column is not the sum of the figures for the individual AFPs and the Unemployment Fund Administrator (AFC), as there are overlaps in compulsory and voluntary attendance at the shareholders' meetings of different issuers.

The debt market for both corporate bonds and commercial paper has grown in recent years, as can be seen in table V.3, which shows the stock of financial instruments.

³ The law recognizes the controlling shareholder and control concepts.

Table V.3
Stock of financial instruments
(Millions of dollars)

	2005	2006	2007	2008	2009	2010	2011	2012
Share issues	124 794	175 211	202 833	161 732	209 154	313 384	290 470	308 208
Corporate bonds	12 634	15 181	17 724	22 219	24 937	28 396	33 518	34 343
Securitized bonds	1 937	2 125	2 365	2 281	2 018	2 057	1 935	1 669
Commercial paper	621	679	700	960	899	602	553	428
Mortgages	2 056	2 447	3 007	3 644	3 387	3 118	3 100	3 361
Total	142 042	195 643	226 628	190 836	240 396	347 557	329 576	348 009
Percentages of GDP	110	134	132	138	133	147	142	128
GDP	129 156	146 191	172 314	139 108	180 618	235 831	231 573	271 954

Source: Superintendency of Securities and Insurance (SVS), with securities values estimated at the average dollar exchange rate for the year.

For 2012, the share component was 88.6%, followed by corporate bonds with 9.9%. Shares represent 113% of GDP and bonds and commercial paper 13%.

As regards AFP investments in 2013, analysis of the main components reveals that about 21.5% was in State instruments, 10.2% in bank bonds, 9.4% in shares and 7.7% in corporate bonds and commercial paper, as shown in table V.4. AFP share investments represented 5.4% of GDP and bonds and commercial paper 4.4%.

Table V.4
Pension funds' investment portfolio as of December 2013

Investment type	Amount <i>(millions of dollars)</i>	Fund <i>(percentages)</i>
Domestic investment	93 774	57.7
Variable income	18 702	11.5
Shares	15 357	9.4
Investment funds, foreign capital investment funds (FICE) and others	3 345	2.1
Fixed income	75 072	46.1
State instruments	34 939	21.5
Corporate bonds and commercial paper	12 610	7.7
Bank bonds	16 529	10.2
Mortgage notes	1 475	0.9
Term deposits	9 161	5.6
Mutual and investment funds	137	0.1
Other	221	0.1
Investment abroad	68 939	42.4
Total	162 591	100

Source: Superintendency of Pensions (SP).

In the case of insurance companies (see table V.5), 31.9% of all investment was in corporate bonds and just 2% in shares. They had no investments in commercial paper, probably because of the investment horizon entailed by the term matching rules applying to these firms. In addition, much investment (66% of the total) was in fixed-income securities. Their bond and share investments represented 5.3% and 0.3% of GDP, respectively.

Table V.5
Life insurance companies' investment portfolio as of December 2013

Investment type	Amount (millions of dollars)	Fund (percentages)
Domestic	42 034	88.7
Fixed income	31 277	66.0
State instruments	2 091	4.4
Bank bonds	6 683	14.1
Bank deposits and syndicated loans	1 399	3.0
Unsecuritized corporate bonds	15 113	31.9
Commercial paper	0	0
Securitized bonds	362	0.8
Mortgage notes and bonds	1 289	2.7
Mortgage loans (banks)	568	1.2
Mortgage loans (administrators)	3 772	8.0
Variable income	3 001	6.3
Equity in publicly traded companies	969	2.0
Mutual funds	1 164	2.5
Investment funds	869	1.8
Other investments	7 756	16.4
Property investments	6 362	13.4
Loans	442	0.93
Other investments	952	2.0
Investments abroad	5 345	11.3
Total	47 379	100

Source: Superintendency of Securities and Insurance (SVS).

This shows that, from a corporate governance perspective, AFPs play a unique and substantial oversight role as shareholders, while this role is divided between AFPs and insurance companies where issues of bonds and commercial paper are concerned. This is an important source of discipline for management, helping to ensure that financial obligations are met.

D. Debt discipline in corporate governance

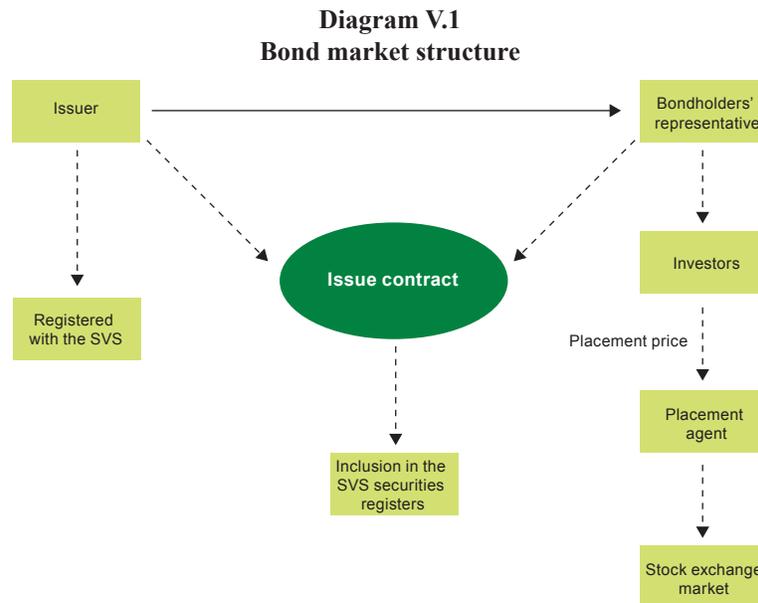
Proper execution and fulfilment of debt issues are a matter for investors themselves, and especially institutional ones, which play a predominant role by laying down certain parameters in advance to ensure that the issue conditions are reasonable enough for them to become involved and generate purchase authorities, as well as participating in the bondholders' meeting. Logically, they are accredited investors with the resources to properly analyse the quality of the financial instruments being offered. This is reinforced in practice by investment banks, which are responsible for issue placement and initially act as bondholders' representatives, so that they set out to ensure appropriate levels of protection and contractual compliance by issuers vis-à-vis investors for each issue, enabling debt securities to be traded safely and reliably in the market.

The regulations applied by the SVS are also important because they legally mandate a statement of liability from the general manager and directors to the effect that information is true and provided responsibility, while issuers are required to provide regular economic and financial reports for as long as the issuance contract applies and until the debt is fully repaid, this information being in the public domain. The requirement for debt issuers to appoint two risk rating agencies and have them periodically evaluate the quality of the bonds (only one rating is required for commercial paper) is important in ensuring that investors are kept informed and can monitor their investment in case it is at risk of deterioration or downgrade.

The structure of the bond market is shown in diagram V.1. Besides investors themselves, a vital role is played by the bondholders' representative, who is required to protect bondholders' interests and oversee compliance with issue contracts. This set-up helps ensure there is an appropriate system of payment supervision and financial protection for investors, with actors able to coordinate their interests using the arrangements provided for by the regulations. In addition, the placement agent represented by the investment bank plays an active role in the bond market, has incentives to monitor the soundness of the operation, and brings financial expertise to the system.

To prevent the value of the debt from depreciating and make default less likely, debt issues tend to include covenants that typically provide for:

- Compliance with liquidity, solvency and leverage (debt/capital) parameters.
- Conditions and arrangements for new debt issues.
- Constraints on major corporate decisions.
- Bans on assets sales, takeovers and divestments, and mergers.
- A requirement to maintain a given risk rating.
- Other conditions.



Source: Prepared by the author.

Failure to comply with these contractual conditions leads to the application of penalties and to negotiations in which institutional investors play a critical role because of the large share of the issue they hold and the highly skilled staff available to them.

These issue contracts, which are designed to safeguard the interests of the different parties involved, particularly the issuer and the bondholders, with a view to the instrument being placed in the market, undoubtedly impose discipline on upper managers and encourage them to act within a responsible and concrete financial framework, and this improves corporate governance from a number of perspectives.

First, management needs to adhere to a debt contract that lays down specific compliance parameters. These are calculated from information prepared by the company, applying the International Financial Reporting Standards (IFRS), and audited by specialist firms that are overseen by the SVS, with the knowledge and on the responsibility of the board, which must seek approval from the shareholders' meeting and report to it regularly.

Second, risk rating clauses in bond contracts involve ratings prepared exogenously and independently by firms that are also within the regulatory purview of the SVS. The analysis involved in the process includes corporate governance variables, signalling to issuers that this factor is of value and creating an environment of appropriate incentives.

Third, public bond issues are monitored by the investment market, which analyses company information and makes recommendations to buy, hold or sell, generating market follow-up that influences bond prices in the secondary market.

Fourth, the history of market debt issuance has entailed the build-up of a large stock of knowledge and relationships that have grown deeper and denser over time. Increasingly skilled and professional management teams have evolved as a result, improving the management standards of firms and investors. This has been particularly marked in firms that have carried out issuance in developed markets or raised debt in the international banking system.

Fifth, and closely related to this, there is the placement of debt in international jurisdictions, particularly the United States, which has required compliance with regulations of a high standard, forcing firms to reorganize and adopt policies commensurate with these requirements.

Lastly, board make-up and organization has become a key variable when it comes to attracting resources to firms. The two main types of organizations analysing and reporting on this are risk rating agencies and investment banks, the former by analysing the risk of the instrument and issuer and the latter by leading the placement process, which tends to suggest there is a board in place which the market can rely on.

Similarly, the SVS issued General Regulation No. 30 of 1989 for the same purpose, requiring companies to produce periodic reports on firms and companies that issue public debt, so that issuance can be monitored and public information of relevance to the market generated. Thus, investors, stockbrokers, market analysts and other local or global agents are continually analysing firms and making price recommendations.

E. Risk rating agencies

For the market to be kept properly informed, the regulatory framework has assigned a quasi-public role to risk rating agencies, as the law requires any debt issue to be publicly evaluated. Thus, firms are obliged to engage two rating agencies at their own expense for bonds and one for commercial paper. In the case of securities representing capital such as shares, mutual fund units and investment fund units, this is voluntary.

The commitments made by the issuer under the relevant debt contracts are evaluated by the rating agencies, which calculate default risks impacting the value of the debt. The rating scale is set by law, and the general guidelines for rating methodologies are laid down by the General Regulation. As a way of guaranteeing the independence of their judgements, a number of requirements must be met to ensure that rating decisions are free of conflicts of interest.

These ratings also have an impact on the eligibility of instruments for institutional investors. In the pension fund industry, for example, there are restrictions on what securities can be invested in and how much can be invested, depending on how risky they are; in fact, an instrument must be at least investment grade for resources to be allocated to it. Ratings are also proxies for jurisdictional quality where investments abroad are concerned, so that only certain financial centres qualify as recipients of AFP resources⁴. This is particularly important because of the predominant role it gives to the rating function.

⁴ The rating of Ireland, traditionally a destination for investment funds, dropped greatly as a result of the last financial crisis, making instruments traded or sold in that jurisdiction ineligible.

There are currently four risk rating agencies:

- ICR Chile Clasificadora de Riesgo Limitada
- Clasificadora de Riesgo Humphreys Limitada
- Feller-Rate Clasificadora de Riesgo Limitada
- Fitch Chile Clasificadora de Riesgo Limitada

The level of competition in the rating industry and the limits on the potential for capture by one or more clients are determined by the fact that the regulator has set a revenue limit on rating services involving securities sold to the public, whether compulsory or voluntary, so that no more than 15% of total revenues in any year can come from the same issuer or business group.

1. Risk rating methodologies and corporate governance

A number of corporate governance aspects are included in rating methodologies, among them:

- Management characteristics
- Executive skills and turnover
- Administration and planning structures and systems
- Decision-making centres within the firm
- Any business group the issuer is part of
- The strategic importance of the firm within the group
- Support within the business group
- The interests of the main owners in relation to the behaviour of the firm
- Shareholder concentration
- Owners' financial record
- The degree of oversight and the existence of agreements on concerted action by shareholders
- Related party operations
- Information transparency

Consequently, rating processes need to involve the procurement and analysis of information that casts light on the aspects mentioned so that corporate governance practices can be deduced to some extent and weighted as part of the rating process. Nonetheless, there are no studies to show the impact of these considerations on ratings or on corporate governance.

F. Corporate governance indicators

In the context of the overall functioning of the securities market, there are as yet no well-developed or investor-recognized corporate governance performance indicators, just as there is no corporate governance ranking. Rather, as will be seen further on, the regulator has opted to have firms and companies themselves declare and disclose their corporate governance practices, leaving it up to investors and the market to properly weigh the risks involved. This is done under SVS General Regulation 341 of 2013 for the firms analysed.

1. Review, research and results

The first step in the research was to review the questionnaire on corporate governance, risk, finances, investments and auditing that had been provided and analyse its compatibility with Chilean laws and regulations, supplemented by corporate governance practices, as shown in table V.6. This yielded the following results:

1. The recommendation to issue debt is made by the board to the shareholders' meeting, which then rejects or approves it. If it gives its approval, it delegates implementation to the board.
2. Any public securities offering is authorized by the regulator, in this case the SVS.
3. Issue prospectuses must be submitted to the SVS so that it can check that they reflect the issue approved and that regulations are being complied with.
4. The purpose of any public securities issue and the intended use of the funds raised must be declared. When an issue is worth over 40% of the company's pre-issue assets, additional safeguards will be put in place, such as an extraordinary administrator and a custodian, so that the funds are delivered gradually under appropriate supervision.
5. Debt issuance supervision and implementation reporting standards are higher for bonds than for commercial paper, mainly because of the larger amounts involved and the longer repayment terms, as well as the different levels of risk affecting them. Consequently, two risk ratings are required for the former and only one for the latter.
6. The regulator considers that a new debt issue affects the value of securities already issued, so the regulations ask issuers to report on the current and historical financial situation and draw up new economic and financial projections, especially for major variables. Constant evaluation is also required of the risks to the issuer and the efforts being made to mitigate them.
7. The law requires companies with equity of over US\$ 50 million that make a public share offering to set up a directors' committee charged, among other things, with monitoring related party transactions and proposing levels of compensation for executives, risk rating agencies and audit firms. Neither the law nor the regulations provide for the creation of investment, financing and risk committees to support the board. Likewise, there is nothing to prevent these functions being performed by ad hoc committees, this being considered a matter for the board.
8. The law and regulations do not provide for the creation of an issuance oversight committee, whether in the form of an audit committee or a directors' committee.
9. In Chile, it is unusual for a board to have more than eight directors, with five being the norm. In the case of companies making a public share offering, the law requires a minimum of seven directors if they are required to form a directors' committee.
10. Outside directors are the norm in Chilean firms. The law and regulations explicitly ban inside directors in publicly traded companies.
11. An independent director is a requirement in companies that carry out public share offerings. This provision is complemented by the election capacity of institutional investors, which must vote for independent directors.
12. The role of chair of the board is rarely held by an independent director, basically because companies and firms belong to business groups and/or large conglomerates. In the few cases where this does happen, it is usually in companies that are under heavy technical or political pressure.

13. In general, there is a strong tendency for Chilean companies to bring in chairs and/or directors with strong economic and financial skills, training and experience. This would partly explain the lack of training and certification plans in these areas. It is common for directors to include professionals with postgraduate qualifications such as master's and doctoral degrees in related subjects, and professionals with vast experience in regulatory agencies.
14. It is unusual for there to be performance evaluations for directors, since these, including independents, are usually recruited and selected by seeking out candidates who have a distinguished record in public- or private-sector enterprises or in regulatory or government bodies and merit a place on the board by virtue of their responsibilities and performance. It is usually the chair of the board who carries out searches for executives and directors.
15. Any conflicts of interest that directors may have in relation to debt issues must be declared, this being considered a good corporate governance practice in most firms and prescribed in their codes of conduct and ethics for all staff, including board members. Other safeguards are the monitoring carried out by investors through bondholders' representatives, the work of investment banks, the good name and independence of risk rating agencies and the technical capabilities of institutional investors.
16. In the case of debt issuance, the regulations require societies wishing to join the register to carry out a debt issuance registration, this being carried out by the general manager and the directors appointed by the board for this purpose. All of them must declare that the information being reported is reliable, complete and sufficient to provide a clear picture of the economic and financial situation of the company, as well as a realistic idea of the risks involved.
17. On the whole, the tendency in Chilean companies is for the internal audit director to report to the board. In companies that are majority foreign-owned, the internal auditor reports to the board and to the audit committee of the parent company.
18. In the case of publicly traded companies with a high level of equity and shareholder concentration, the independent director chairs the directors' committee, which carries out a number of functions such as reviewing financial statements (certified by the independent auditors) and related party transactions and proposing independent auditors and risk rating agencies, executive compensation, etc.
19. Outside directors are elected by the shareholders' meeting. Independent directors are normally supported by institutional investors. To be elected by the AFPs, a candidate must be on the register of independent directors kept by the SP.
20. Neither the law nor regulations require companies to have the internal audit director report to the board, but it is common practice. In the case of companies under foreign control, it is common for the audit committee to come under the board and report to an audit committee at the parent company.
21. In Chilean companies, by law, the only body chaired by an independent director is the directors' committee.
22. In public companies, the independent auditor is usually proposed by the board and elected by the shareholders' meeting. In cases where companies elect an independent director, the auditor will be proposed by the directors' committee, chaired by the independent director, which will approve the external audit plan and sometimes the internal audit plan.
23. In Chilean business culture, a great deal of board time is usually spent on economic and financial issues, particularly budgetary oversight, investment, financing and risk. Recently, more concern with auditing and compliance issues has been in evidence.

Table V.6
Laws and regulations concerning corporate governance and debt

Category	Standards for bonds	Legislation
The role of the board of directors	1.1 Does it authorize the issuance of bonds, whether or not the regulator requires a placement memorandum?	The board has no power to authorize bond issues, this being a matter for the shareholders' meeting, which will hold a special session to authorize the issue of bonds or debentures convertible into shares . ^a The SVS requires the placement memorandum to be submitted to it before issuance so that it can check whether the approved issuance terms and current regulations are being met.
	1.2 Does the bond prospectus comply with the regulator's requirements for public offerings?	The bond prospectus must meet the regulator's requirements for public offerings in accordance with Act 18045 on the issuance of long-term debt securities and Section XVII on the issuance of short-term debt securities. The Superintendency, furthermore, has made it compulsory under General Regulation No. 30 to produce a bond issuance prospectus and submit it in advance to the Superintendency for it to check whether the approved issuance terms and current regulations are being met.
	1.3 Is there information on resource use, both in the business strategy and per project and/or debt restructuring?	Under Act 18045 on the issuance of long-term debt securities, when an issue is registered the issuer must state its purpose and the intended use of the funds raised. If the purpose is to finance new projects worth over 40% of the total value of its pre-issue assets and requiring the funds raised to be applied in successive stages over a period of more than a year, a special administrator for these resources and a custodian will be appointed. For an issue of commercial paper, the intended use of the funds must also be declared, but a lower level of supervision is required. Under General Regulation No. 30, the SVS also establishes what information must be submitted by the issuer to explain the investment and financing policy which the issuer's managers must adhere to in accordance with the articles of association and their principals' instructions.
	1.4 Are the implications and actions relating to the company's issues and leverage levels known factors?	Act 18045 on the issuance of long-term debt securities states that when registration of an issue is required, the issuer will state the borrowing limits. Under General Regulation No. 30, the SVS establishes the issuer registration process and the information required from organizations on the securities register, and requests a rationale for the financial statement, which must contain an evaluation of the financial situation and the business risks affecting it. The current financial situation of the firm must be set out, showing changes over the same period as the financial statements submitted. <ul style="list-style-type: none"> • The definition or formula used for ratios or indicators must be shown. • A proper analysis of the financial situation must include at least the following: <ul style="list-style-type: none"> - Summary of the results obtained by the company. - Summary of the company's cash flows, identifying the main sources of financing. - Financial amounts and indices showing the level of liquidity and solvency. - Financial amounts and indices showing how the management is using the company's funds. - Financial amounts and indices showing the firm's ability to generate returns from the resources available. - Description of how the organization's activities and businesses have developed. The main risks involved in the organization's activity and any mitigation measures must be disclosed.
	2.1 Are the design and analysis of the issue delegated to the corporate finance committee?	No law or regulation provides for there to be a corporate finance committee as part of the board. Nonetheless, it is common for boards to appoint a directors' committee that analyses, evaluates, designs and proposes the characteristics and aims of the issue.
	2.2 Is the analysis of the financial risks of the issue delegated to the risk committee?	No law or regulation provides for there to be a risk committee. Nonetheless, it is common for boards to appoint a directors' committee that analyses, evaluates and explains the financial risks involved in an issue.

Table V.6 (continued)

Category	Standards for bonds	Legislation
	2.3 Is the responsibility of management reports on issuance information delegated to the audit committee?	The law only refers to a directors' committee in the case of publicly traded companies with an equity value of 1.5 million development units (UF) or more where at least 12.5% of voting shares are held by shareholders who control or own less than 10% of these shares apiece. The main functions of the directors' committee ^b are reviewing and analysing external audits and proposing the auditor(s) to execute them. Nonetheless, the board can delegate the task of preparing management reports on issuance information to the internal audit committee. However, the SVS has established in General Regulation No. 30 that the issuer must submit regular management reports on issuance, prepared by itself.
The structure of the board of directors	3.1 Does the board have between 8 and 15 directors?	Act 18046 on public companies states that the number of directors must be specified in the articles of association and that this number is to be invariable. It also establishes that the boards of publicly traded companies may have no fewer than five directors. If a publicly traded company is required to appoint ^c at least one independent director ^d and set up a directors' committee, the minimum number of directors will be seven.
	3.2 Does the board have at least 50% outside directors?	The law provides that the board is to consist only of outside directors voted in at the shareholders' meeting.
	3.3 Are more than half of the outside directors independent?	The law only provides for the election of independent outside directors in the case of certain publicly traded companies ^e whose assets and shareholder concentration make it advisable for them to appoint at least one independent director ^f and set up a directors' committee, to be headed by the independent director. Anyone in any of the situations set out in note 14 will not be deemed independent.
The role of the chair of the board of directors	4.1 In the selection of some outside directors, is priority given to their expertise in finance, particularly in corporate financing?	No law or regulation prescribes or provides that outside directors must have any particular professional capabilities (knowledge, skills and experience). However, shareholders commonly propose professionals with these capabilities at the shareholders' meeting.
	4.2 Is the chair of the board of directors an outside, independent director?	No law or body of regulations prescribes or provides that the chair of the board must be an independent outside director. Nonetheless, this can happen for political or technical reasons.
The role and selection of executive (inside) and non-executive (outside) directors	6.1 Do more than 50% of the directors have sound and updated knowledge of finance and corporate financing?	No law or body of regulations prescribes or provides that directors must have any particular professional capabilities. Nonetheless, groups of shareholders commonly propose professionals with the requisite capabilities to the board.
	6.2 Do more than 50% of the outside directors have sound and updated knowledge of finance and corporate financing?	All directors are outside directors and no law or regulation prescribes or provides that directors must have any particular professional capabilities. Nonetheless, groups of shareholders commonly propose professionals with the requisite capabilities to the board.
	7.1 Is there a systematic training programme for directors?	No law or regulation prescribes or provides for a systematic training programme. However, SVS General Regulation 341 consulted on the induction procedures for new board members and received varied but positive answers, albeit not formally. The same regulation states that this practice is voluntary.
	7.2 Do they have certifications in financial matters on which they make decisions?	Outside directors often have postgraduate qualifications in financial subjects, although no law or regulation prescribes or provides that directors must have financial qualifications to take part in the financial decision-making required of them.
	7.3 Is the performance of each outside director regularly reviewed?	No law or regulation prescribes or provides for a regular review of outside directors. Nonetheless, SVS General Regulation No. 341 consulted on the processes used to rate directors and found that a minority of firms had an evaluation mechanism. The regulation states that the practice is voluntary.

Table V.6 (continued)

Category	Standards for bonds	Legislation
8.1	Do the outside directors flag conflicts of interest in the bond issuance process?	<p>The body that decides on bond issuance is the shareholders' meeting. The board proposes the bond issue, the shareholders' meeting authorizes it and the board implements and executes it on the latter's authority. In addition, Act 18046 on public companies states that stockbrokers and securities agents may not be board members, and nor may their directors, managers, high-level executives or administrators. This restriction does not apply in stock markets. The conflicts recognized by the law and submitted to arbitrage are those arising between bondholders or their representatives and the issuer or special administrator.</p> <p>The persons identified may not have a relationship with the issuer. If any disqualification should arise for this reason during the performance of their duties, they will refrain from further action, resigning from the position, and must report these circumstances as an essential fact to the superintendent overseeing them and the bondholders' representative, where applicable, and a bondholders' meeting will be called as soon as possible if the disqualification affects it or the special administrator. They must also report when the rating company or any of its main partners is deemed to have an interest in a particular issuer, whose securities it may not rate. Nor may the conduct of a rating process be entrusted to persons with an interest in the issuer of the securities concerned.</p>
9.1	Are there three or more outside directors for each inside one?	The law provides that the board is to consist only of outside members voted in at the shareholders' meeting.
9.2	Are the outside directors selected by a committee of independent directors?	Outside directors are elected by the shareholders' meeting. The law only provides for the election of independent outside directors in certain publicly traded companies ⁶ that are required to appoint at least one independent director ⁶ and set up a directors' committee, to be headed by the independent director. The independent director is elected from the roster of independent outside directors submitted in the election at the shareholders' meeting.
10.1	Do the inside directors sign off, as legally and criminally accountable, on disclosures concerning a bond issue and its implications for the financial position of the company?	The law provides that the board is to consist only of outside directors voted in at the shareholders' meeting. In any event, SVS General Regulation No. 30 provides that an affidavit must be sworn to the veracity of all the information provided for registration purposes, signed in the case of public companies by the general manager or whoever is acting in his or her stead and by the same majority of directors as is required in the articles of association for the adoption of board resolutions, which must be duly approved by the board or shareholders' meeting. Additionally, a special affidavit to the effect that the issuer is not in default must be signed by the persons indicated above, as appropriate.
11.1	Is the internal audit director a member of the board?	No law or regulation prescribes or provides that the internal audit director must be a board member. In some cases, it can happen that a directors' committee with responsibility for internal auditing is formed, although this is not a widespread practice.
11.2	Does the internal audit director report directly to the board or the audit committee?	No law or regulation prescribes or provides that the internal audit director must report to the board or the audit committee. Nonetheless, once the audit committee has been formed by a group of outside directors, it is common for the audit director to report to it.
Audit committee	12.1 Is the audit committee chaired by an independent director?	The law only provides for the election of independent outside directors in certain publicly traded companies required to appoint at least one such director ⁶ and set up a directors' committee, headed by the independent director. The directors' committee is made up of three members, a majority of them independent. In the event that there are more directors entitled to join the committee, the directors themselves will determine its membership unanimously at the first board meeting after the shareholders' meeting where the election took place. If there is just one independent director, he or she will appoint the other committee members from the group of non-independent directors, who will have full rights as members. The chair of the board, unless an independent director, may not join the committee or its subcommittees. Functions and duties are as stated in note 12.

Table V.6 (continued)

Category	Standards for bonds	Legislation
Audit committee	12.2 Is the independent auditor engaged by the audit committee, and does it report to the committee?	In publicly traded companies, the independent auditor is proposed to the board by the directors' committee. If the board does not agree with the choice, it can propose another independent auditor. In both cases, proposals are put to the vote at the shareholders' meeting. In any event, the independent auditor is not engaged by the directors' committee but by the shareholders' meeting, and reports to the board.
	12.3 Does the audit committee approve the internal and external audit programmes?	No law or regulation prescribes or provides that the audit committee must approve the external or internal audit programme. The law provides that in certain publicly traded companies the directors' committee should be responsible mainly for analysing and evaluating the financial statements and recommending the services of an external audit firm. The internal audit programme is a board matter.
	12.4 Is there an effective reporting system on corporate financing?	No law or regulation prescribes or provides for a system of effective reporting on corporate financing, although some companies have a corporate financing committee.
	12.5 Does the committee prepare regular reports to the board and to general management on compliance with internal control policies on the use of financial resources for financing?	No law or regulation prescribes or provides that the audit committee must prepare regular reports to the board and to general management on compliance with internal control policies on the use of financial resources. In some companies, the internal compliance or auditing departments deal with these matters.
	13.1 Is the investment committee chaired by an independent director?	No law or regulation prescribes or provides for an investment committee. Nonetheless, companies may set up an investment committee staffed by board members, and the independent director may be a member and chair the committee, although the practice is not widespread.
Financial asset investment committee	13.2 Does the chair of the investment committee have proven experience in investment strategies?	No law or supplementary regulation provides for an investment committee. In companies that have set one up, it is commonly chaired by a professional with proven experience in investment strategies.
	13.3 Does the committee meet at least once a month?	If the committee exists, the company decides how often it is to meet.
	14.1 Is the committee chaired by an independent director?	No law or regulation prescribes or provides for a corporate finance committee. If there is one, there is nothing to prevent its being chaired by an independent director, although this is not common practice.
Corporate finance committee	14.2 Does the committee chair have proven experience in corporate financing?	Where such a committee exists, it is often chaired by a director with expertise in corporate financing.
	14.3 Is this the committee that defines the funding requirements of the company and how to meet them?	If there is such a committee, it often defines funding requirements and how they are to be met, and management is often well versed in these issues. Again, SVS General Regulation No. 30 requires reporting on the investment and financing policies that the issuer's managers must follow in accordance with its articles of association and the instructions of its principals. In particular, mention must be made of restrictions concerning types of instruments, amounts, rules on diversification by business sector and market, levels and forms of borrowing and/or any other policy the issuer has to comply with. If there are no policies on these matters, this must be expressly stated.
	14.4 Is this the committee that selects the financial intermediaries to place bonds issued by the company?	Bond placement is a matter for the shareholders' meeting, which entrusts implementation to the board, including a mandate to implement or delegate the decision on the selection of financial intermediaries.

Table V.6 (concluded)

Category	Standards for bonds	Legislation
Risk committee	<p>15.1 Is the risk committee chaired by an independent director?</p> <p>15.2 Does the committee chair have proven experience and expertise in comprehensive risk management?</p> <p>15.3 Is it the risk committee that is responsible for ruling on reports on the financial risks faced by the company?</p> <p>15.4 Is it the risk committee that explains the company's bond issuance risks?</p>	<p>No law or regulation prescribes or provides for a risk committee. If there is one, there is nothing to prevent its being chaired by an independent director, but such committees are often chaired by a board member with expertise in financial risk, although the practice is not widespread.</p> <p>If there is such a committee, it is often chaired by a director with expertise in corporate financial risk.</p> <p>If there is such a committee, it often determines funding requirements and how they are to be met, and management is usually well versed in these issues, although the practice is not widespread.</p> <p>Bond placement is a matter for the shareholders' meeting. The board usually evaluates issuance risks, and once the shareholders' meeting has determined on an issue it is the board that carries it out, including the selection of financial intermediaries.</p>

Source: Prepared by the author.

^a It also authorizes the board to implement this.

^b The committee will have the following functions and duties:

- (1) Reviewing the reports of the independent auditors, the balance sheet and other financial statements submitted by management to shareholders, and giving its opinion on these before they are submitted to shareholders for approval.
- (2) Submitting names for independent auditors and rating agencies to the board, so that they can be suggested to the shareholders' meeting. In the event of disagreement, the board will make a proposal to the shareholders' meeting.
- (3) Examining information on the operations referred to in Section XVI on Related Party Operations in Publicly Traded Companies and their Subsidiaries and preparing a report on these operations. It will send a copy to the board, which will read it in session so that the operation concerned can be approved or rejected.
- (4) Examining pay systems and compensation plans for managers, high-level executives and workers in the company.
- (5) Preparing an annual report on its actions, including its main recommendations to shareholders.
- (6) Reporting to the board on the advisability or otherwise of engaging the independent audit firm to provide services other than outside auditing, when these are not prohibited, in consideration of whether they might entail a loss of independence.
- (7) Such other matters as may be laid down in the articles of association or enjoined upon it by a shareholders' meeting or the board, as the case may be.

^c When the company's stock market value is equal to or greater than the equivalent of 1.5 million development units (UF) and at least 12.5% of its issued shares with voting rights are held by shareholders who control or own less than 10% of these shares apiece.

^d Anyone who has been in any of the following situations in the previous 18 months will not be deemed independent:

- (1) Any economic, professional, credit-related or commercial tie, interest or dependency, substantial in nature and extent, linking them to the company, other companies in the group it is part of, its controlling owner, or high-level executives in any of these, or anyone who has worked for these as a director, manager, administrator, high-level executive or adviser.
- (2) Anyone related up to the second degree of kinship with one of those listed in the previous point.
- (3) Former directors, managers, administrators or high-level executives of non-profit organizations that have received substantial contributions or donations from the persons indicated in point (1).
- (4) Anyone who has been a partner or shareholder directly or indirectly owning or controlling 10% or more of the equity, or a director, manager, administrator or high-level executive of an organization that has provided legal or consulting services for a substantial consideration, or external audit services, to the persons indicated in point (1).
- (5) Anyone who has been a partner or shareholder directly or indirectly owning or controlling 10% or more of the equity, or a director, manager, administrator or high-level executive of any the company's main competitors, suppliers or customers.

^e Mentioned in notes to point 3.1.

Four firms were then selected and analysed: Clínica Las Condes in the service sector, Compañía Manufacturera de Papeles y Cartones in the industrial sector, Codelco in the government sector and AFP Provida in the financial sector.

The following is a brief summary of the selected firms:

Clínica Las Condes (CLC) is one of Chile's leading private clinics. It was founded in 1978 and covers virtually all medical specialities. It has 257 beds and 14 wards and carries out some 22,000 hospitalizations and 486,000 medical consultations a year. In 2012, the firm's consolidated revenue was US\$ 266 million, net income was US\$ 35 million and net worth was US\$ 315 million.

Compañía Manufacturera de Papeles y Cartones (CMPC) was founded in 1920, initially specializing in the manufacture of paper. It is now present in Chile, Argentina, Peru, Uruguay, Mexico, Brazil, Ecuador and Colombia, and the areas it operates in now include forestry, cellulose, paper, tissue and paper products. In 2012, the consolidated sales of CMPC were US\$ 4.759 billion and retained earnings were US\$ 202 million.

The National Copper Corporation of Chile (Codelco) is Chile's leading State enterprise and the world's largest copper producer (10% of global output) and second-largest molybdenum producer. It has assets valued at about US\$ 33.355 billion and a net worth of US\$ 12.408 billion. In 2013, Codelco generated sales of about US\$ 14.954 billion and a surplus before taxes and charges under the Copper Reserve Act of US\$ 3.889 billion.

Provida, a pension fund administrator, was founded in 1981 and is the leader in the Chilean pension market. It has about 3.3 million members (a 34.9% market share) and 1.8 million contributors (a 33.0% market share) and administers pension funds worth US\$ 45.5 billion (a 27.9% market share). In 2012, it had revenues of US\$ 372 million and profits of US\$ 217 million.

The information collected is provided in table V.7. The analysis was supplemented with corporate governance practices, giving the following results:

1. All the companies comply closely with law and regulations.
2. Only Codelco has a structured financing committee, owing to the scale of its projects. However, the functions of that committee could be carried out by other committees or bodies reporting to the board.
3. Codelco and Provida each have an investment committee, basically because of the scale of their operations. However, the functions of that committee could be carried out by other committees or bodies reporting to the board.
4. No financial risk committee was found to have been structured in these companies as part of their boards. However, the functions of that committee could be carried out by other committees or bodies reporting to the board.
5. There is no indication in any of the firms selected that the audit committee has oversight over issuance. However, the matter is regulated by law.
6. The boards of the companies analysed have between seven and nine members.
7. Most directors are from the outside, the exception being Codelco, which as a State-owned enterprise has two workers on its board.
8. The usual rule is for there to be one or two independent outside directors.
9. Most outside directors have a background in business administration and civil engineering.

10. None of these companies' boards is chaired by an independent outside director.
11. Many outside directors have financial expertise because of their training and experience.
12. There do not appear to be any formal training programmes for outside directors, but there are various induction, involvement and participation arrangements implemented by the general manager or the chair of the board.
13. Directors' performance is not usually evaluated, except at Codelco, Nonetheless, each board is often monitored by its chair and accredited investors, who have to appoint directors periodically.
14. There are a number of firms that specialize in selecting directors for companies. AFPs usually enlist them to determine who they are going to support at shareholders' meetings. In the case of Codelco, some directors are preselected by an independent body, the Senior Public Management Council.
15. Internal and external auditors usually report to the directors' committee, chaired by the independent outside director.
16. The independent outside director has limited responsibilities that are no different from those of the other directors.
17. There is little information on conflicts of interest in debt issuance processes or the way financial intermediaries are chosen.

Lastly, the indices were estimated for the four firms mentioned. The data are given in table V.8. The analysis was complemented by corporate governance practices, yielding the following results:

1. The index scores for the different companies analysed range from 7.059 to 7.161.
2. In all cases, the index score is reduced by the fact that the chair of the board is not an independent director and the internal audit director is not a board member. Legally, they cannot be. Conceptually, there is no reason why the audit director should be a board member, which would only undermine the independence of the audit work.
3. The index scores for the different companies are partially affected by:
 - (a) The size of the boards: those of Clínica Las Condes and Codelco have more than eight members.
 - (b) Only Codelco carries out formal evaluation of directors.
 - (c) The investment committee is chaired by an independent director in the case of Provida.
 - (d) The regular sessions of the investment committee in the case of Codelco.

It should be pointed out, as a methodological comment, that the evaluation instrument was hard to apply, which inevitably reduces the accuracy of the conclusions. For example, the indicator includes legal structures in corporate governance arrangements that are exclusive to one jurisdiction; it specifies a number of committees that are found in one particular situation but cannot be assumed to be present everywhere, since the number and type of committees is a management decision for the board, so that by construction they will differ by firm, business sector, the main risks in the organization, etc. Furthermore, what is important is whether particular functions are carried out, not whether particular committees exist or not, and these variables are difficult to observe. In summary, the conclusions need to be viewed with a measure of detachment.

Table V.7
Analysis of companies

Standards for bonds	Service sector	Industrial sector	Government sector	Financial sector
	C linica Las Condes ^a	CMPC ^b	Codelco ^c	Provida ^d
1.1 Does it authorize the issuance of bonds, whether or not the regulator requires a placement memorandum?	By law, it is the shareholders' meeting that authorizes bond issuance and the placement memorandum is compulsory	By law, it is the shareholders' meeting that authorizes bond issuance and the placement memorandum is compulsory	It is the board that authorizes bond issuance	By law, it is the shareholders' meeting that authorizes bond issuance and the placement memorandum is compulsory
1.2 Does the bond prospectus comply with the regulator's requirements for public offerings?	As per the law and the regulator	As per the law and the regulator	As per the law and the regulator	As per the law and the regulator
1.3 Is there information on resource use, both in the business strategy and per project and/or debt restructuring?	As per the law and the regulator	As per the law and the regulator	As per the law and the regulator	As per the law and the regulator
1.4 Are the implications and actions relating to the company's issues and leverage levels known factors?	As per the law and the regulator	As per the law and the regulator	As per the law and the regulator	As per the law and the regulator
2.1 Are the design and analysis of the issue delegated to the corporate finance committee?	No information ^e	No information	Yes	No information
2.2 Is the analysis of the financial risks of the issue delegated to the risk committee?	No information	No information	No information	No information
2.3 Is the responsibility of management reports on issuance information delegated to the audit committee?	No information	No information	No information	No information
3.1 Does the board have between 8 and 15 directors?	9 directors	7 directors	9 directors	7 directors
3.2 Does the board have at least 50% outside directors?	All directors are outside directors	All directors are outside directors	Yes, 7 are outside directors and 2 inside directors	All directors are outside directors
3.3 Are more than half of the outside directors independent?	No, just 1 independent outside director / 9 outside directors	No, just 1 independent outside director / 7 outside directors	The category of independent outside director does not apply	No, just 2 independent outside directors / 7 outside directors
4.1 In the selection of some outside directors, is priority given to their expertise in finance, particularly in corporate financing?	2 directors have qualifications in business administration	3 directors have qualifications in business administration and 3 are industrial civil engineers	2 directors have qualifications in business administration and 4 are civil engineers	2 directors have qualifications in business administration and 2 have economics degrees
4.2 Is the chair of the board of directors an outside, independent director?	No	No	No	No
6.1 Do more than 50% of the directors have sound and updated knowledge of finance and corporate financing?	No, just 2 directors	Yes, 6 directors	Yes, 5 directors	Yes, 4 directors
6.2 Do more than 50% of the outside directors have sound and updated knowledge of finance and corporate financing?	No, just 2 directors	Yes, 6 directors	Yes, 5 directors	Yes, 4 directors
7.1 Is there a systematic training programme for directors?	Yes, operated by the general manager	Yes, operated by the chair of the board	Yes, formally approved by the board	No, there is just the "Manual del Director de AFP Provida S.A."

Table V.7 (continued)

Standards for bonds	Service sector		Industrial sector		Government sector		Financial sector	
	Clínica Las Condes ^a		CMPC ^b		Codelco ^c		Provida ^d	
7.2 Do they have certifications in financial matters on which they make decisions?	2 directors have professional qualifications and experience		6 directors have professional qualifications and experience		5 directors have professional qualifications and experience		4 directors have professional qualifications and experience	
7.3 Is the performance of each outside director regularly reviewed?	No		No		Yes, by external consultants		No	
8.1 Do the outside directors flag conflicts of interest in the bond issuance process?	No information		No information		No information		No information	
9.1 Are there three or more outside directors for each inside one?	All directors are outside directors		All directors are outside directors		Yes, 7 outside directors for 2 inside directors		All directors are outside directors	
9.2 Are the outside directors selected by a committee of independent directors?	No		No		3 directors appointed by the President of Chile; 4 directors appointed through the Senior Public Management Council; 2 directors appointed by staff		No	
10.1 Do the inside directors sign off, as legally and criminally accountable, on disclosures concerning a bond issue and its implications for the financial position of the company?	All directors are outside directors		All directors are outside directors		No information		All directors are outside directors	
11.1 Is the internal audit director a member of the board?	No		No		No		No	
11.2 Does the internal audit director report directly to the board or the audit committee?	Reports to the directors' committee		Reports to the audit department		Reports to the audit, compensation and ethics committee		Reports to the directors' committee	
12.1 Is the audit committee chaired by an independent director?	The independent director chairs the directors' committee		The independent director chairs the directors' committee		The category of independent director does not apply		The independent director chairs the directors' committee	
12.2 Is the independent auditor engaged by the audit committee, and does it report to the committee?	The external auditor is proposed to the board by the directors' committee and must be ratified by the shareholders' meeting		The external auditor is proposed to the board by the directors' committee		No information		The external auditor is proposed to the board by the directors' committee and must be ratified by the shareholders' meeting	
12.3 Does the audit committee approve the internal and external audit programmes?	The board approves the external audit programme, while the directors' committee approves the internal audit programme		The directors' committee approves the internal and external audit programmes		The organization chart shows a general audit department and there is an audit, compensation and ethics committee		The directors' committee approves the internal and external audit programmes	
12.4 Is there an effective reporting system on corporate financing?	No information		No information		No information		No information	
12.5 Does the committee prepare regular reports to the board and to general management on compliance with internal control policies on the use of financial resources for financing?	No information		No information		No information		No information	

Table V.7 (concluded)

Standards for bonds	Service sector	Industrial sector	Government sector	Financial sector
	Clinica Las Condes ^a	CMPC ^b	Codelco ^c	Provida ^d
13.1 Is the investment committee chaired by an independent director?	No information	No information	There is an investment projects and financing committee, the category of independent director does not apply	Yes
13.2 Does the chair of the investment committee have proven experience in investment strategies?	No information	No information	Yes	Yes
13.3 Does the committee meet at least once a month?	No information	No information	No information	No, quarterly
14.1 Is the committee chaired by an independent director?	No information	No information	There is an investment projects and financing committee, the category of independent director does not apply	Yes
14.2 Does the committee chair have proven experience in corporate financing?	No information	No information	Yes	Yes
14.3 Is this the committee that defines the funding requirements of the company and how to meet them?	No information	No information	No information	No information
14.4 Is this the committee that selects the financial intermediaries to place bonds issued by the company?	No information	No information	No information	No information
15.1 Is the risk committee chaired by an independent director?	No information	No information	The category of independent director does not apply	No, it is the risk management department
15.2 Does the committee chair have proven experience and expertise in comprehensive risk management?	No information	No information	Yes	Yes, but he or she belongs to the administration
15.3 Is it the risk committee that is responsible for ruling on reports on the financial risks faced by the company?	No information	No information	Yes	Yes
15.4 Is it the risk committee that explains the company's bond issuance risks?	No information	No information	No information ^f	No information

Source: Prepared by the author.

^a Information obtained from the 2012 annual report [online] http://www.clc.cl/Dev_CLC/media/Imagenes/PDF/Memoria-CLC-2012.pdf and response to General Regulation No. 341 [online] [http://www.clinicalascondes.cl/Dev_CLC/media/Imagenes/PDF/De%2015%20de%20abril%20en%20adelante%202013/Resposta-CCG-341-5\).pdf](http://www.clinicalascondes.cl/Dev_CLC/media/Imagenes/PDF/De%2015%20de%20abril%20en%20adelante%202013/Resposta-CCG-341-5).pdf).

^b Information obtained from the 2012 annual report [online] <http://www.empresampc.cl/wp-content/uploads/2012/06/memoria-anual-2012.pdf> and response to General Regulation No. 341 [online] http://www.svs.cl/documentos/pueag/sagco/sagco_2013060056044.pdf.

^c Information obtained from the 2013 annual report [online] <http://www.codelco.com/organigrama/memoria2013/2013-04-16/152408.html>, with further corporate governance information from [online] http://www.codelco.com/prontus_codelco/site/artic/20111227/asocfile/20111227/asocfile/20111227161526/presentaci_n_presidente_directorio_c_mara_final_f.pdf and information regarding General Regulation No. 32 at [online] http://www.codelco.com/prontus_codelco/site/artic/20130628/asocfile/20130628162453/svs_20130628.pdf.

^d Information obtained from the 2013 annual report [online] <http://www.provida.cl/empresas/reportes/memoria-anual/index.html> and response to General Regulation No. 341 [online] <http://www.provida.cl/assets/pdfs/politicas-de-gestion/practicas-de-gobierno-corporativo-al-31-dic-2013.pdf>.

^e No information publicly available.

^f The committee exists as such.

Table V.8
Results of applying the indicator

Category	Standards for bonds	Service sector		Industrial sector		Government sector		Financial sector		Benchmark	
		Clinica Las Condes		CMPC		Codelco		Provida		Average	
		Between 1 and 0	Index value	Between 1 and 0	Index value	Between 1 and 0	Index value	Between 1 and 0	Index value	Between 1 and 0	Index value
The role of the board of directors ^a	1.1	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
	1.2	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
	1.3	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
	1.4	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
The structure of the board of directors ^b	2.1	0.5	0.095	0.5	0.095	0.5	0.095	0.5	0.095	0.5	0.095
	2.2	0.5	0.095	0.5	0.095	0.5	0.095	0.5	0.095	0.5	0.095
	2.3	0.5	0.095	0.5	0.095	0.5	0.095	0.5	0.095	0.5	0.095
The role of the chair of the board of directors	3.1	1	0.031	0	0	1	0.031	0	0	0.5	0.016
	3.2	1	0.031	1	0.031	1	0.031	1	0.031	1	0.031
	3.3	0.5	0.016	0.5	0.016	0.5	0.016	0.5	0.016	0.5	0.016
The role and selection of executive (inside) and non-executive (outside) directors ^{c,d,e}	4.1	1	0.189	1	0.189	1	0.189	1	0.189	1	0.189
	4.2	0	0	0	0	0	0	0	0	0	0
	6.1	1	0.095	1	0.095	1	0.095	1	0.095	1	0.095
	6.2	1	0.095	1	0.095	1	0.095	1	0.095	1	0.095

Table V.8 (continued)

Category	Standards for bonds	Service sector		Industrial sector		Government sector		Financial sector		Benchmark	
		Clínica Las Condes		CMPC		Codelco		Provida		Average	
		Between 1 and 0	Index value	Between 1 and 0	Index value	Between 1 and 0	Index value	Between 1 and 0	Index value	Between 1 and 0	Index value
The role and selection of executive (inside) and non-executive (outside) directors ^{s,d,e}	7.1	1	0.189	1	0.189	1	0.189	1	0.189	1	0.189
	7.2	1	0.189	1	0.189	1	0.189	1	0.189	1	0.189
	7.3	0	0	0	0	1	0.189	0	0	0.25	0.047
	8.1	1	0.189	1	0.189	1	0.189	1	0.189	1	0.189
	9.1	1	0.189	1	0.189	1	0.189	1	0.189	1	0.189
9.2	0	0	0	0	1	0.189	0	0	0.25	0.047	
10.1	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377	
11.1	0	0	0	0	0	0	0	0	0	0	
11.2	1	0.189	1	0.189	1	0.189	1	0.189	1	0.189	
Audit committee ^f	12.1	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
	12.2	0	0	0	0	0	0	0	0	0	
	12.3	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
	12.4	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
	12.5	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377

Table V.8 (concluded)

Category	Standards for bonds	Service sector		Industrial sector		Government sector		Financial sector		Benchmark	
		Clínica Las Condes		CMPC		Codelco		Provida		Average	
		Between 1 and 0	Index value	Between 1 and 0	Index value	Between 1 and 0	Index value	Between 1 and 0	Index value	Between 1 and 0	Index value
Financial asset investment committee	13.1	0	0	0	0	0	0	0	0	0	0
	13.2	1	0.095	1	0.095	1	0.095	1	0.095	1	0.095
	13.3	0	0	0	0	1	0.095	0	0	0.25	0.024
Corporate financing committee ^e	14.1	0	0	0	0	0	0	0	0	0	0
	14.2	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
	14.3	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
	14.4	0	0	0	0	0	0	0	0	0	0
Risk committee	15.1	0	0	0	0	0	0	0	0	0	0
	15.2	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
	15.3	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
	15.4	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
Total		7.059		7.028		7.532		7.028		7.161	

Source: Prepared by the author.

^a For categories 2.1, 2.2 and 2.3, it is estimated that these matters are dealt with by the company, most probably in a specialized committee of the board of directors.

^b Two of seven are independent directors.

^c For categories 9.1 and 9.2 in Chile, all directors are outside directors and are elected by the shareholders' meeting operating independently of management, and the function of this committee has been aligned with that performed by the shareholders' meeting. At Codelco, three are proposed by the Chilean President, while four are selected from a shortlist presented by the Senior Public Management Council, one from a shortlist presented by workers, and one from a shortlist presented by supervisors.

^d The general manager and finance manager are not inside directors but are legally and criminally responsible for their decisions.

^e The internal auditor cannot be a board member by law.

^f The external auditor is appointed by the shareholders' meeting at the suggestion of the board of directors and the directors' committee, which carries out functions equivalent to those of the audit committee.

^g For item 14.4, it is the directors' committee that makes the proposal, or it may be an ad hoc committee set up by the board of directors.

G. Conclusions

Debt issuance is a factor that prompts good corporate governance through:

- Properly structured debt contracts, plus safeguards in the form of covenants, which impose disciplinary frameworks on management.
- Monitoring by the market, particularly institutional investors and investment banks, of the evolution and compliance outlook of debt issuance contracts.
- Monitoring by risk rating agencies, whose methodologies include elements of corporate governance evaluation. Regulations state that issues must have two ratings, so that the opinion of these bodies is publicly known and ongoing.

The regulations establish a system that enables and facilitates coordination between debt holders. In addition, the presence of accredited institutional investors operating within this regulatory framework makes this oversight work fairly effective.

For their part, shareholders enjoy proper legal protection, as the election of directors and the independent director, debt issuance and the sureties provided, and the appointment of outside auditors and risk rating agencies, among other things, are all matters for the shareholders' meeting.

As regards practice, there is little in the way of visible structure to support corporate governance on matters of investment, financing, risk and auditing. This does not mean that these functions are not performed but rather that the system relies on the experience and training of directors, with the proviso that these committees may be operating under different names.

There seems to be a need to involve independent directors even more in both internal and external auditing issues.

Lastly, the legal and regulatory environment is not adequate to produce high levels of corporate governance, and it seems advisable for firms to reconsider their internal structures, especially the board as regards the functioning of committees, so that a high level of performance and transparency in corporate governance can be achieved.

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VI. Corporate governance and corporate debt instruments in Colombia¹

*Eulalia Sanín
Santiago Arteaga²*

A. Introduction

In 2010, there was a significant deepening in the capital market, specifically bonds, and stock of this type of debt increased. In recent years, though, the situation for this type of debt has been discouraging, with the dominant trend being a decrease in the share of the transaction volumes and a departure of firms from the stock market. Furthermore, in 2012, Colombia's capital market was buffeted by the collapse of the brokerage Interbolsa, including its default on bond debt issued in Luxembourg, which had largely been placed in the Colombian market. This episode of failures in corporate governance, which led to the total collapse of the financial sector's lead firm, continues to impair investor appetite and confidence. Nevertheless, according to the latest available version of the Country Code Survey (2012), issuing firms have committed to improving their corporate governance standards by implementing more of the measures included in the Code, and they have taken the initiative to implement other corporate governance practices in addition to those recommended in the Code.

Given this outlook, the National Government and the Financial Superintendent of Colombia have set an agenda to resolve some of the aforementioned problems and support the development of the capital market. Notable measures include approval of the 2012 tax reform, approval of decrees related to

¹ This paper updates the 2011 work published under the same title, incorporating data from 2013 and the first half of 2014. All available data have been analysed in light of the original paper, but in some cases, figures are only available for earlier years. Likewise, the case studies correspond to corporate governance conditions around the time of the original research. It is important to note that the vast majority of the firms studied have continued to improve their corporate governance standards. Grupo Nutresa and Ecopetrol, for example, have implemented pioneering practices such as external evaluations of their boards of directors, among other improvements to their governance systems.

² The authors would like to thank Clemente del Valle, former Securities Authority of Colombia (Supervalores) for his comments on the document.

the custody of securities and reform of the secondary market, all of which are discussed in greater detail in the section on the evolution of corporate governance regulation in Colombia.

As for stock market performance, since March 2013, the Latin American Integrated Market (MILA) has been posting negative indicators, which can be explained by two differentiated effects. The first is a cyclical effect, due to the crisis in emerging markets. The second is a reduction in currency flows into the economy.³

Serving as a point of reference is the study published in 2009 by CAF-development bank of Latin America, ECLAC and IDB on capital markets and corporate governance in Latin America (Núñez, Oneto and Mendes De Paula, 2009), which discussed the relationship between corporate governance and capital market development and deepening in Colombia, with special attention to corporate debt instruments. The base case connecting the studies from Mexico, Brazil and Colombia (see chapter II) points up two hypotheses supported by the literature on capital markets and corporate governance: first, capital market deepening is positive for economic development,⁴ and second, more and better corporate governance standards promote and facilitate capital market deepening, particularly the debt securities market.⁵

Deepening the capital market, particularly the bond market, helps firms gain access to long-term financing, which lowers their financial costs (by improving their debt profile and contributing to an optimal gearing ratio), and increase overall microeconomic efficiency (IDB, 2007). Ocampo (2007) maintains that rising flows of foreign investment in local currency stock and bond markets have translated into more linkages between foreign and domestic markets and driven commercial and financial development in Latin America. It also seems likely that the evolution of a local bond market is particularly important for addressing the needs of small and medium-sized enterprises (SMEs) (IDB, 2007), inasmuch as SMEs that are able to obtain financing through bonds will have better yields on their debt during periods of crisis, which highlights the countercyclical nature of bond markets (Aguilar and others 2007). Also, with global conditions improving post-crisis, the Latin American economy has been performing strongly on the growth of capital markets in the region, among other factors (De Paula, 2009). While the boom in the financial markets has driven economic development over the past five years, the fallout from the global crisis nonetheless points to improvements that should be made to capital market structures (Gregório, 2009), especially in the debt market, which has been in a period of undeniable expansion since 2007, as discussed in chapter III.

The regulatory framework for companies, practiced through corporate governance, is a key factor that determines the development level of the capital markets in Latin America (La Porta and others 1998). The OECD (2003) postulates that corporate governance, in terms of adding value over the long run, helps boost the confidence of shareholders and future investors alike. In addition, good practices in corporate governance play a crucial role in investment decisions, which helps to instill the confidence needed for the capital markets to function properly (OECD, 2004). Good corporate governance increases the value of firms and minimizes investment risk (IFC, 2005), while also reducing information asymmetries between shareholders and promoting the transparency of information reported to the market (Malaquias, 2008). Accordingly, more and better corporate governance standards facilitate the effective development of capital markets (Oman, 2001).

Based on the foregoing, this paper explores and analyses the Colombian case in terms of corporate governance regulation and activities, as well as corporate performance with the issuance of debt instruments, seeking to improve understanding of the relationship between these two areas and propose

³ Despite the negative performance, in the second half of 2014, there was a slightly positive variation in the indicators, an improvement attributable to an uptick in the Colombian, Peruvian and Chilean markets on an increase in inward investment flows. Conditions are expected to improve with Mexico's entry into MILA, which is forecast to reach a capitalization of US\$ 1 billion, placing it on par with Brazil. Mexico's greatest contribution will be diversification (La República, 2014).

⁴ See among others: De la Torre, Gozzi and Schmukler (2006); *Dinero* (2002); Gregório (2009); De Paula (2009); and Ocampo (2007).

⁵ See among others: Becht, Bolton and Röell (2002); IFC (2005); La Porta and others (1998); Leal (2004); Malaquias (2008); De Paula (2009); De Paula and Stanley (2006); OECD (2003, 2004); and Salmasi (2007).

action for improved corporate governance regulation in Colombia. To this purpose, this chapter analyses the Colombian capital market —with a special emphasis on corporate bond issues— local regulation of corporate governance and publicly traded issues and the role of rating agencies. This chapter presents four cases of Colombian firms that issue corporate debt, to which an indicator suggested by the project coordination team is applied as a way of benchmarking the practices of these and other firms in the region.

This introduction is followed by an overview of the Colombian capital market, which is analysed through the lens of four characteristics: first, its shallowness, with some improvement over the past decade; second, the preponderance of government fixed-rate securities (treasury bonds (TES)) trailed at considerable distance by private fixed-rate securities; third, the small size of the variable-rate market (stocks) and its recent growth through stock exchange capitalization; and lastly, the weak appetite for risk associated with corporate bond issues on the local market (since 2006, 99% of corporate debt issues have had AAA or AA+ ratings), which is explained by a self-selecting phenomenon associated with costs and the crowding-out effect due to TES treasury bonds.

The third section documents the evolution of Colombian corporate governance regulation through four stages. During the first stage, shareholder protection rules were established in the Commercial Code, but there was no explicit treatment of corporate governance. The second stage was marked by the introduction at the regulatory level of the concept of corporate governance, through Resolution 275 (2001) of the Securities Superintendence. The third stage is also defined by the creation of the Corporate Governance Country Code and the administration of the annual Country Code Survey. Lastly, the fourth stage introduces the reform to the secondary market as a mechanism for giving small and medium-sized enterprises access to financing through private debt.

The fourth section studies the role of rating agencies in Colombia's corporate debt market and how they build corporate governance criteria into their ratings. This ratings component is "asymmetrical" insofar as a solid corporate governance framework is one, but not the only, prerequisite for a low-risk rating. The fifth section contains four case studies of Colombian firms and analyses their debt issues and corporate governance systems. The firms are as follows:

- Ecopetrol, S.A., the largest corporation in the country, extracts, refines and distributes hydrocarbons
- Bancolombia, S.A., one of the largest financial conglomerates in the country
- Nutresa, S.A., a business group in the food industry
- Colombina, S.A., a family-owned business group that makes confectionery and other food products

The section concludes with a comparative analysis based on the good practices index, which is used to determine strengths and weaknesses of the key aspects of corporate governance with respect to the issuance of debt instruments in Colombia. Lastly, the sixth section draws together the conclusions on corporate governance and the issuance of corporate debt, taking into account the case studies and market and regulatory analysis.

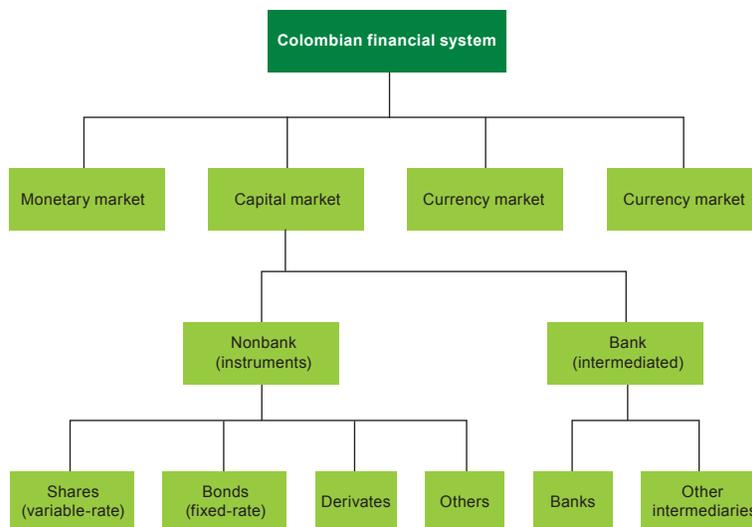
B. Capital market in Colombia

1. Overview of the capital market in Colombia

The capital market transfers medium- and long-term funds from savings to investment and consists of the intermediated market and the non-intermediated market. The intermediated or bank market transfers savings to investment through intermediaries, such as banks, mutual funds, etc. The non-intermediated market or public securities market transfers savings to investment directly through fixed-rate instruments

(bonds), variable-rate instruments (stocks), derivatives and other instruments in which buyers and sellers interact directly with each other (see diagram VI.1).

Diagram VI.1
Structure of the Colombian financial system



Source: Investor Relations Colombia (IRC), “El mercado de valores en Colombia” [online] http://www.irc.gov.co/irc/es/mercadovalorescolombiano/Mercado%20en%20Colombia%20Ene11_0.pdf.

Within the non-intermediated market, capital is traded on the public securities market via the mechanisms of the Colombian Stock Exchange (BVC), a private financial entity supervised by the Financial Superintendent of Colombia. The BVC acts as an intermediary for buyers and sellers of fixed-rate and variable-rate securities and derivatives, channeling public funds towards Colombian firms in need of capital.

By merging three stock exchanges in Colombia,⁶ the BVC sought to deepen its integration with other financial markets in Latin America. As a result, the Colombian Stock Exchange, together with the Santiago Stock Exchange (Chile) and the Lima Stock Exchange (Peru), advanced the MILA integration process. The process, which began in June 2010, has sought to diversify, expand and make the negotiation of assets in the three countries more attractive. The project became a reality on 30 May 2011 when the stock markets in Colombia, Chile and Peru began to operate jointly under the MILA (Colombian Stock Exchange, 2011).⁷

The Colombian stock market brings together a large number of actors whose participation allows for the issuance and negotiation of instruments (see table VI.1). In terms of corporate bonds, the issuance process involves a series of interactions between these actors. The issuer partners with a structuring agent that determines the type of security to issue, the term and the amount that should be placed. The structuring agent prepares the prospectus for the issue, describing the operation to potential investors and other actors participating in the process. Once the issue has been duly structured, it is rated, which signals the level of risk to investors. The prospectus must be approved by the Financial Superintendent (regulatory entity).⁸ Once it has been approved, the securities are dematerialized and

⁶ The BVC was established on 3 July 2001 following the merger of three stock exchanges, in Bogotá, Medellín, and Occidente (Cali) (IRC, n/d).

⁷ As of July 2014, 581 issuers participate in the MILA with a market capitalization of US\$ 602 billion, a slight increase of 0.16% over the same period in 2013. In this period, Chile accounts for 41.5% of the value of the listed companies, Colombia has 37.03% and Peru has 21.47% (MILA, 2014).

⁸ The Financial Superintendent was created when the Banking Superintendency and the Securities Superintendency merged, as established in Article 1 of Decree 4327 of 2005.

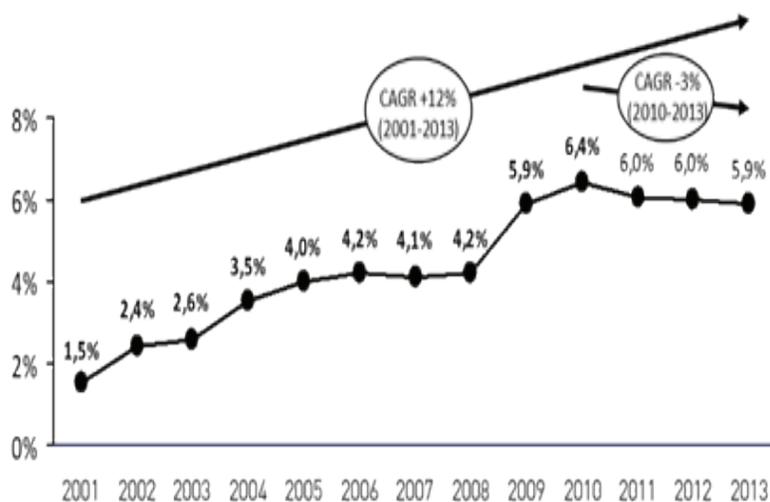
deposited with Deceval, and a placement agent then sells the instruments on the primary market, which are then traded in the secondary market through the BVC (see figure VI.1). This entire process is supervised and monitored by the Financial Superintendent of Colombia.

Table VI.1
Key actors in the public securities market in Colombia

Actors	Function	Examples
Issuers	Issuers are firms in the non-financial, financial and/or public sector that decide to issue debt to recapitalize, improve their debt profile, etc.	National and foreign corporations from all sectors
Structuring agents (investment banks)	These agents structure the placement of securities by determining the type of security, the terms of the issue and value thereof.	Corficolombiana Citibank Banca de Inversión Bancolombia
Rating agencies	These agencies rate the securities or risks related to the financial, insurance, exchange or any other activity related to the management, use and investment of funds captured from the public.	Fitch Ratings BRC Investor Services, S.A.
Placement agents (stock brokers)	These agents promote and place bonds, stocks and financial securities.	Valores Bancolombia
Underwriters	Underwriters perform custodial and administrative duties, act as the payment agent for the debt issuance and conduct operational activities related to the deposit of the issue.	Deceval
Stock exchange	Stock exchanges perform sales operations of securities on their clients' orders.	Colombian Stock Exchange
Investors	Investors purchase the bonds placed by issuers on the stock exchange.	Pension fund administrators (AFPs) Private investors
Bondholders' representative	The bondholders' representative is responsible for all administration and conservation activities needed for the bondholders to exercise their rights and protect their interests.	Helm Bank Fiduciaria Bancolombia
Control entities	Control entities supervise the financial system to identify possible risks to the stability of the system, the markets and other financial assets.	Financial Superintendent of Colombia

Source: Prepared by the author, on the basis of information provided from the Colombian Stock Exchange, Financial Superintendent of Colombia and BRC Investor Services.

Figure VI.1
Estimated stock of corporate bonds with respect to GDP, 2001-2013
(Percentages)



Source: Prepared by the author on the basis of information provided from Banco de la República.

2. Some characteristics of the Colombian capital market

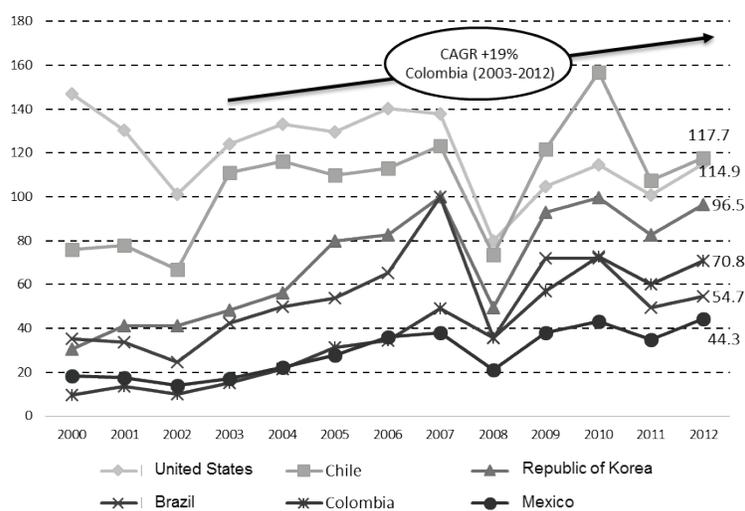
To describe the Colombian capital market, especially the fixed-rate (bond) market, four characteristics of the market (stylized facts) are analysed below.

(a) The Colombian capital market is fairly shallow but has tripled in size, as a percentage of GDP, over the past decade

In Colombia, the capital market has evolved slowly and has been shallower than other developing markets. Historically, the market capitalization to GDP ratio has been about half or less than half of the ratios observed in developed countries like the United States and in other emerging markets both in Latin America and Asia (Clavijo, González and Castro, 2009). In addition, for most financial development indicators, Colombia trails other countries such as Chile and Brazil (Hanson, 2008). As of 2013, this indicator was 1.8% compared with a regional average of 8% (see figure VI.2). This notwithstanding, there has been significant progress in the capital market since the late 1990s, largely due to robust economic growth, rising consumer and business confidence and improvements in the regulatory environment (Hanson, 2008).

Until 2010, the market capitalization to GDP ratio had grown at an annual rate of 20%, approaching the level seen in Brazil in 2010 (approximately 75% of GDP), while the stock of corporate bonds had expanded at an annual rate of 17% during the same period, climbing to a historic level of 6.4% of GDP in 2010 (Clavijo, González and Vera, 2011). However, over the last three years, the stock of corporate bonds has contracted by 3%, falling to 5.9% of GDP in 2013 (see figure VI.1), similar to the pre-2010 level. A number of factors have contributed to the decrease in market capitalization (see figure VI.2), including a departure of listed companies from the BVC (see figure VI.3), as will be discussed further.

Figure VI.2
Market capitalization to GDP, 2000-2012
(Percentages)

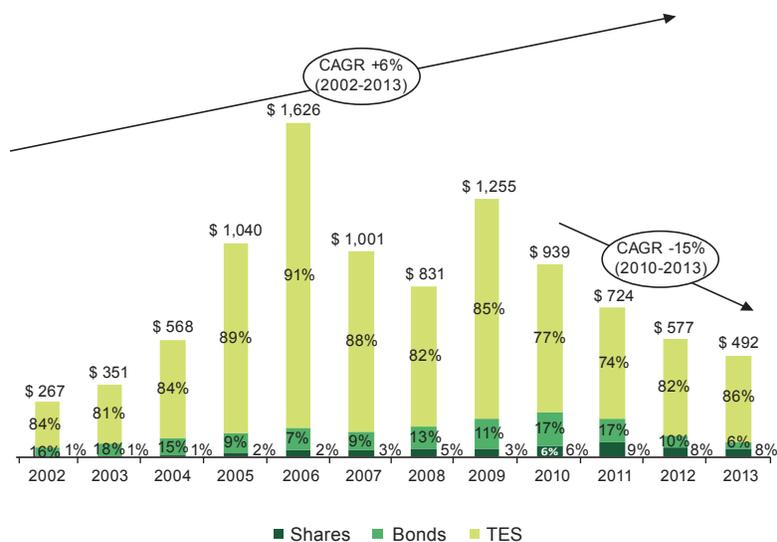


Source: Prepared by the author on the basis of information provided from World Bank indicators.

(b) Government fixed-rate securities (TES) heavily dominate the Colombian capital market. In the case of private securities, fixed-rate instruments are issued and traded more often than variable-rate instruments, from the Colombian capital market

The large volume of trade has been in government fixed-rate securities (TES), followed by private debt instruments (bonds) and lastly stocks (Sandoval, Campos and Malagón, 2007). The volume of trade rose considerably at an annual rate of 17% between 2002 and 2010. However, over the past three years, it has slowed to a rate of 6%. Although TES bonds still account for over 86% of the trade volume in 2013, since 2002, there has been a sizeable increase in the volume of trade in private debt securities and stocks. Whereas in 2002, stocks accounted for less than 1% of the trade volume, in 2013 they represented nearly 8% (see figure VI.3).

Figure VI.3
Volume of trade (stocks, bonds, TES) in the Colombian market, 2002-2013
(Billions of Colombian pesos and percentages)



Source: Prepared by the author on the basis of information provided from the Colombian Stock Exchange (BVC).

Meanwhile, private debt bonds, as a share of all issues in the local market, rose to a historic high of 36%. However, it is important to note that although it was a record year in terms of the absolute volume of new bond issues, their high relative proportion also had to do with the low volume of public debt issues in 2010. Private debt fell sharply to 6% in 2013. In the case of private bonds, a total of Col\$ 27.22 trillion were traded in 2013, just 51.34% of the volume registered in 2012.

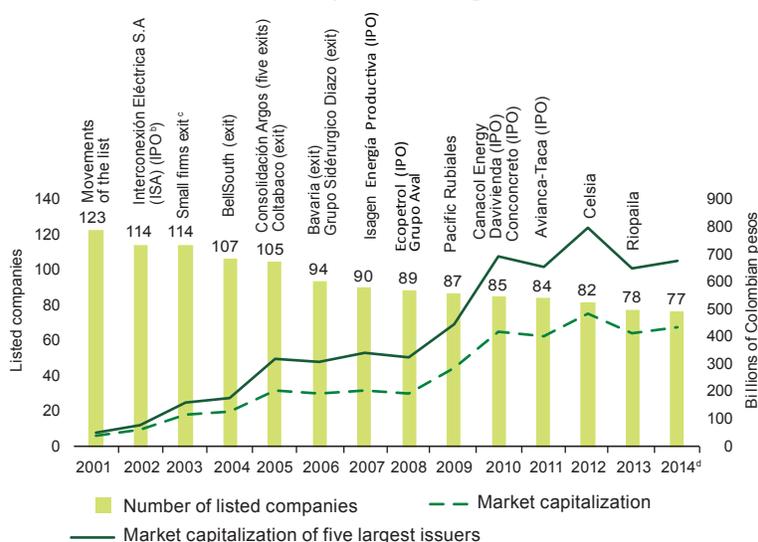
(c) The Colombian variable-rate (stocks) market is small, and its market capitalization growth has more to do with increases in the capitalization of listed companies than with the entry of new firms

The development of the variable-rate market in Colombia has been marked by an increase in the market capitalization of companies, the departure of firms from the stock exchange (since the late 1990s) and since 2007 the entry of new firms into the public market, with stronger participation by the energy and financial sector (see figure IV.4). In addition, the market share of the five largest companies has increased from 30% in 2001 to about 56% in the first half of 2014 (see figure IV.4).

In 2010, the departure of listed firms was partly due to the fact that several major economic groups in the country restructured their core businesses (Gutiérrez and Pombo, 2009). In addition, a number of local

firms were acquired by international companies that proceeded to delist them. There were also business group mergers that had the effect of reducing the list. The trend toward fewer listings continues. From 2010 to the first half of 2014, eight additional firms left the stock exchange. Measures such as requiring listed firms to invest in technology to apply International Financial Reporting Standards (IFRS) have contributed to the delisting trend and are reducing the number of new listings on the stock market (Enríquez, 2011, p. 12).

Figure VI.4
Market capitalization and number of companies listed
on the Colombian stock exchange, 2001-2014^a
(Billions of Colombian pesos)



Source: Prepared by the author on the basis of information provided from the Colombian Stock Exchange (BVC).

^a Only some movements from the list have been recorded.

^b IPO refers to an initial public offering of unlisted shares.

^c Exit means delisted shares.

^d Values as of 29 August 2014.

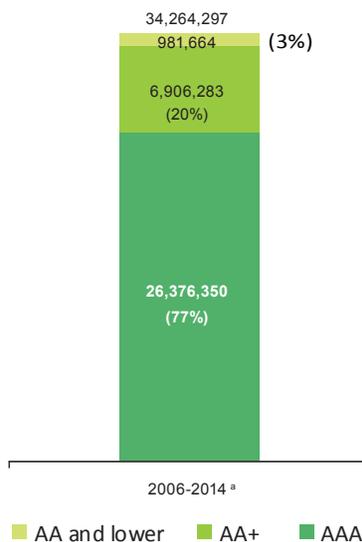
In relation to the market capitalization of companies in recent years, initial public offerings (IPOs) held by companies in the energy and financial sectors have been important for the local market, driving liquidity and deepening and diversifying capital ownership with small and medium-sized investors.

(d) The local market has little appetite for risk, and all corporate debt issues are low risk, with AAA or AA+ ratings, which means that only a small number of large experienced firms are willing to issue corporate debt in the market

As shown in figure IV.5, Colombia's capital market has no appetite for bond issues rated below AA+ (on the national scale). In recent years, over 97% of corporate bond placements were instruments with AAA or AA+ ratings. In contrast, the two issuances rated below AA+ accounted for just 3% of placements in recent years and were not successfully placed. The first of these issuances, rated AA- in 2006, was originated by a company offering pre-paid medical ambulance services, which only managed to place 18 million of the 35 million that it offered in 10-year bonds. For the second issuance, which was by a subnational government entity (the municipal government of Cali, the third largest city in the country), 30 million was placed in 2007 (the total amount of the offering). This operation was transacted by a special trust that issued bonds secured by promissory notes that were partially sovereign-backed, which may have contributed to the success of the operation.

This situation stands in contrast to other markets, such as the Chilean market, where only 9% of the issues placed between 2006 and 2011 were AAA or AA+ (see figure VI.6) (compared with 97% in Colombia). In that country, the market is well diversified in risk, with 5% of issues rated below BBB and just under half (46%) rated AA and AA-.

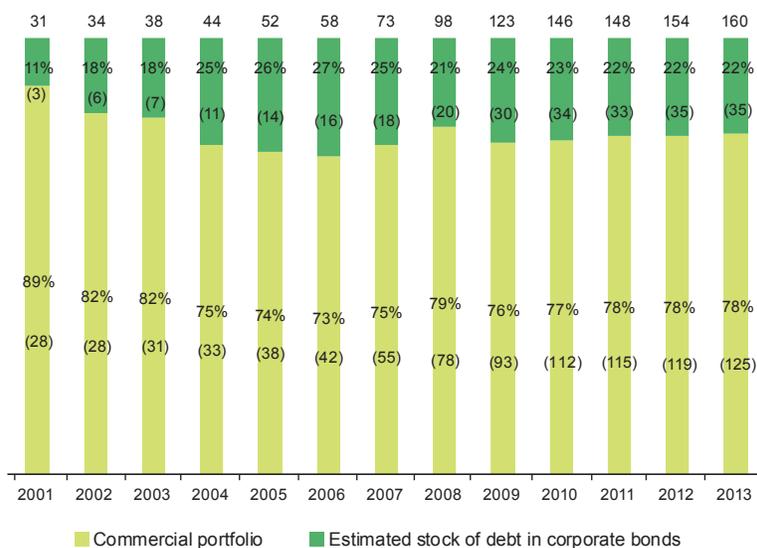
Figure VI.5
Corporate debt bonds placed in the market by risk rating, 2006-2014^a
(Millions of Colombian pesos and percentages)



Source: Prepared by the author on the basis of information provided from the Colombian Stock Exchange (BVC).

^a Figures for 2014 refer to the first half-year.

Figure VI.6
Estimated stock of corporate bonds with respect to the commercial portfolio stock, 2001-2013
(Billions of Colombian pesos and percentages)



Source: Prepared by the author on the basis of information provided from Banco de la República.

Given this situation, the Chilean case and the role of pension fund administrators (AFPs) are noteworthy, since the AFPs have played a key role in deepening the capital market in that country since the 1980s, as seen in the aforementioned level of risk diversification.⁹

⁹ In 2001, the individual capitalization system authorized the creation of pension multi-funds, which had the effect of deepening the financial system and the capital market (see Hernández & Parro, 2004, p. 9).

The concentration in Colombia of AAA and AA+ bond issues (on the national scale) by large corporations is explained by factors related to both supply and demand, which generate a vicious circle that limits access to this funding instrument. On the supply side, there is a self-selecting phenomenon at work, for three basic reasons:

- (i) The relative monetary costs (cost/percentage of funds raised) are higher for small issues, making bond issues more accessible for large companies, which are able to take advantage of large volumes of funds. For example, according to calculations by BRC Investor Services (2007), a bond issuance on the local market for Col\$ 10 billion (approximately US\$ 5.5 million) can cost between 3.11% and 8.44% of the funds raised, whereas in the case of an issuance 10 times larger, that is, for Col\$ 100 billion (approximately US\$ 55 million), the cost falls to somewhere between 1.4% and 3.4%.
- (ii) Regardless of the instrument chosen (stocks, bonds, securitizations) or the volume, the same minimum corporate governance standards must be met and the same obligations must be assumed when placing an issue in the Colombian public market. This means that from a regulatory viewpoint, it is not easier for a company to issue bonds than stocks, and furthermore a company issuing bonds has an additional obligation to get the instrument rated, which is not so in the case of stocks. Accordingly, the non-monetary cost of fulfilling the requirements for participating in the public market (time, disclosure of previously confidential information, constant supervision, reporting to BVC and the Superintendence, among others) is relatively higher in the case of small issuances.
- (iii) The financial systems of the United States and Europe have developed the syndicated loan instrument,¹⁰ largely in response to corporate bond issues, which are considered substitutes (Altunbas, Kara and Marques-Ibanez, 2009; Hale and Santos, 2008). In Colombia, the financial system has responded likewise, and there are several cases in which corporate debt issues by medium-sized and even large companies have been replaced by syndicated loans. These loans are sometimes more affordable for firms seeking limited funding, which are able to avoid the costs of issuing debt.

Alongside this self-selecting phenomenon, there are demand-side factors that explain the concentration in AAA and AA+ bonds:

- (i) Although the laws and regulations in effect (Article 2.6.12.1.3, Decree 2555 of 2010) allow investment in fixed-rate investment-grade instruments (i.e. BBB+ on the national scale, five steps below AA+), a “culture” has been created among the AFPs of investing exclusively in AAA and AA+ securities.
- (ii) TES government bonds have a crowding-out effect¹¹ on other investment options, including corporate debt instruments (Clavijo, 2003; Rodríguez Hernández, 2005). This can be explained by the fact that: the instrument is widely available (new TES bonds continually issued); it is the safest instrument in the local market; it is highly liquid; and it offers competitive interest rates. This crowding-out effect is particularly strong with respect to other fixed-rate options such as corporate bonds, because portfolio administrators (especially the AFPs) can stock their fixed-rate portfolio with TES bonds, which offer solidity, liquidity and acceptable rates. This leaves little room for lower-rated fixed-rate instruments, as there is no incentive to look for other options (the spread is not large enough). This situation contrasts with the Chilean case, where the relative absence of government debt securities creates an incentive for pension funds to purchase private debt.

¹⁰ Syndicated loans are used for large-scale loans in which one bank leads the operation, splitting the loan among other banks or investors and thus preventing any one client from being heavily exposed while still profiting by placing part of the loan and charging for structuring the operation.

¹¹ The crowding-out effect refers to a reduction in private consumption or investment due to an increase in the placement of debt by the State, which absorbs funds available in the market.

For these reasons, in practice in the Colombian market, if a corporate issue is to be rated below these risk levels (AAA or AA+), the investment bank (underwriter) conducts a structured issue with guarantees or another type of instrument, such as securitized assets, or looks for a loan in the banking system. Due to these restrictions, debt bonds are only used by a small group of firms that are large and sound enough to obtain AA or AA+ ratings. This conservative market stance in light of the risk also partly explains the fact that there has not been a single incident in the past decade of default involving corporate debt bonds. It is also reflected in the fact that small, medium-sized and even large Colombian firms get most of their funding in the intermediary market, though banks. The banking sector's commercial portfolio is three times the size of the stock of corporate debt in bonds.

Even with the aforementioned restriction, over the past decade there has been a significant increase in corporate bond issues. The stock of this type of debt rose from Col\$ 3.4 trillion in 2001 to nearly Col\$ 35 trillion in 2013 (see figure VI.6) at a compound annual growth rate (CAGR) of 22%. New issuances have been particularly robust in recent years, owing to factors related to supply, mainly the regulatory enhancements introduced in Law 964 of 2005, which have provided greater certainty for issues, as well as stronger demand among institutional investors (pension funds, insurers, mutual funds) (Clavijo and Verdugo, 2010) (Clavijo, González and Vera, 2010). These supply and demand dynamics have been bolstered by record low central bank rates, which have made long-term debt attractive and have increased spreads in the financial system (Clavijo and Verdugo, 2010). The convergence of these factors led to an unprecedented increase in new issues of corporate bonds in 2009 and 2010, although issues slowed again in 2011 on higher central bank rates (which made long-term debt more expensive) and a stronger peso relative to the dollar, which made bond issues in the local market less attractive (*Portafolio*, 2011c). However, the positive evolution seen over the past decade indicates that bonds are becoming a financing option for Colombian firms, a key factor for deepening the local capital market.

C. Evolution of corporate governance regulation in Colombia

The evolution of corporate governance regulation in Colombia can be divided into four stages. The first is distinguished by the inclusion of basic rules in the Commercial Code, without any explicit treatment of corporate governance. The purpose of these rules, set out in Law 222 (1995) and Law 446 (1998) (laws that amended the Commercial Code), is to protect minority shareholders and specify some of the administrators' responsibilities. In the second stage, the concept of corporate governance was introduced into the legislation, through Resolution 275 (2001) adopted by the Securities Superintendent.¹² This legislation set requirements stipulating good corporate governance for securities acquired by pension funds—pillars of the country's debt market. The third stage began with the creation of the Corporate Governance Country Code and is marked by the regulatory consolidation of corporate governance and attention to enforcement. Lastly, the fourth stage introduces reform of the secondary market, through Decree 1019 of 2014, as a mechanism for giving small and medium-sized enterprises access to financing through private debt.

An important aspect of corporate governance regulation in Colombia is its “all or nothing” nature. There are no differentiated levels of compliance or enforcement in corporate governance. All issuing firms in the public market are bound by the entire body of rules and regulations (regardless of the instrument), while non-issuing firms are not subject to these rules and regulations, but rather only to the general rules of the Commercial Code (Law 222).

1. First stage

Law 222 (1995) amended the Commercial Code with respect to rules on corporations and their constitution, corporate mergers, corporate breakups, functions of general assemblies or meetings of shareholders, administration and parent and subsidiary companies. This law introduced protections for

¹² The Financial Superintendent was created when the Banking Superintendent was merged with the Securities Superintendent, as established in Article 1 of Decree 4327 (2005).

minority shareholders and the first few elements of good corporate governance. It was innovative at the time for establishing that corporate officers—including members of boards of directors—could be held liable for the actions of the company. Likewise, Law 446 (1998) authorized the Securities Superintendent to protect minority shareholders of companies listed on public securities markets. The former Securities Superintendent set rules regulating the securities market, including bond issuances (e.g. Resolution 400 (1995)), with the focus on formal aspects for issuing bonds and some protections for bondholders.

2. Second stage

The second stage is characterized by the inclusion of the concept of corporate governance in local rules and regulations, through Resolution 275 (2001) of the Securities Superintendent, which established that issuers intending to have AFPs among their investors must have a corporate governance code. The code was to include protections for minority shareholders; criteria for the selection of legal representatives, directors and a statutory auditor; and mechanisms for information disclosure and resolution of conflicts of interest. Resolution 275 (Securities Superintendent, 2001) was an important step because it drew attention to the importance of good practices in corporate governance. Due to the fact that AFPs are the largest buyers of public and private debt issued in the local market, the resolution led to an important increase in the codes of good corporate governance among Colombian firms that issue bonds.

Subsequently, Law 964 (2005) entered into effect, establishing a comprehensive framework for regulating the securities market. The law introduced specific good corporate governance requirements for issuers of securities, which became obligatory in July 2006. For example, Article 44 establishes that 25% of a company's board of directors must be independent and defines the conditions for such designation (Law 964, 2005).

3. Third stage

The third stage began with Directive 055 of November 2007 of the Financial Superintendent, which partially repealed Resolution 275 (2001) and established the obligation that entities supervised by the Superintendent (issuers of securities, financial intermediaries and other companies) must adopt discretionary measures with respect to the recommendations of the Country Code of Best Corporate Practices (Financial Superintendent, 2007). The Code was the product of a joint initiative of the Financial Superintendent, the Colombian Stock Exchange, CAF, trade associations (ANDI, Asobancaria, Asofondos, Fasescolda, Asociación de Fiduciarias) and Confecámaras, the national network of chambers of commerce. Much of the content was based on the document “Lineamientos para un Código Andino de Gobierno Corporativo,” prepared by CAF.

The objective of this directive was to create a corporate governance standard and expand coverage of corporate governance rules, since the previous regulation—Resolution 275—only covered issuers that sought AFPs as investors. The directive operates according to the “comply and explain” principle, which is to say that corporations should adhere to the conduct suggested by the Code or report to the Superintendent and the market on the criteria they are using. The Code contains standards on: (i) the general assembly of shareholders; (ii) the board of directors; (iii) the disclosure of financial and nonfinancial information; and (iv) conflict resolution. In addition, in 2007, companies began to participate in a voluntary annual survey about the adoption of the Country Code.

In February 2011, the Superintendent amended Directive 55 (2007), in order to expand the scope of binding force to “all entities that are registered or have securities listed on the National Register of Securities and Issuers” (Financial Superintendent, 2011). Also, to strengthen the “comply and explain” principle, the Superintendent made it a requirement to participate in the annual “Country Code” survey (Financial Superintendent, 2011). Consequently, all entities registered with the National Register of Securities and Issuers (RVNE) must now comply. The Financial Superintendent, acting through the Issuer Supervision Office confirms the accuracy of the information reported on the survey

and is authorized to investigate and penalize issuers that do not complete the survey on time and in form, or that fail to provide accurate information. However, the point should be made that the Superintendent does not penalize failure to comply with the specific suggested standards but rather failure to complete the annual survey.

4. Fourth stage

The fourth stage has been characterized by a series of initiatives launched by the national government to develop the private debt market as a source of financing for companies.

In 2012, the tax reform was approved clarifying the tax structure of foreign portfolio investment in Colombia. The tax on foreign portfolio investment was reduced from 33% to 14% in order to attract international capital. In addition, reforms have been implemented that are related to the development of the capital and corporate debt market, facilitating the participation of collective investment funds¹³ (Leiton, Rassa and Rojas, 2014).

Given the limited access to the private debt market, the authority has promoted a series of policies aimed at giving more companies access to the Colombian stock market. As a result, regulations targeting the secondary market have been established. At present, with Decree 1019 of 2014, the government seeks to reform what it calls the secondary market,¹⁴ with a view to relaxing the standards for trading securities in order to create opportunities for small and medium-sized companies to raise financing in the debt market (see table VI.2).

Table VI.2
Reform of the secondary market

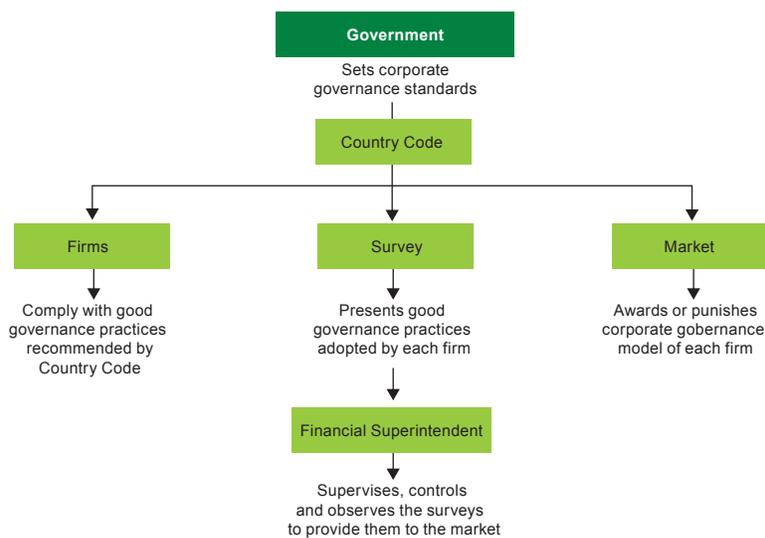
Current situation	Reform of the secondary market
<ul style="list-style-type: none"> The current regulatory framework has failed to achieve the objective of deepening the capital market. According to 2013 figures, only 3% of all corporate bond issues have been transacted through the secondary market. Medium-sized enterprises have been observed to have limited access to financing through the capital market. 	<p>Objective of change</p> <ul style="list-style-type: none"> Investor eligibility; Simplified disclosure requirements; Elimination of requirements for ongoing and periodic information disclosure; The information to release to the BVC should be simpler inasmuch as investors will be institutional or rated.
Causes of current situation	Effect
<ul style="list-style-type: none"> Strict information disclosure standards; Information asymmetries; Lack of incentives for investors to participate in issuances, or investors participate but demand is low; High regulatory costs associated with issuances. 	<ul style="list-style-type: none"> Increase in the share of corporate bonds in total transactions Expanded opportunities for small and medium-sized enterprises to gain access to resources channeled through the Stock Market

Source: Prepared by the author on the basis of information from the Ministry of Finance and Public Credit.

¹³ In June 2013, Decrees 1242 and 1243 were enacted, replacing Decree 2555 (2010) on the safekeeping of securities and the administration and management of funds. Reporting requirements were stepped up, in order to boost the confidence of investors in these funds and incentivize their participation.

¹⁴ The reform is based on international experiences documented by the World Bank and regulatory entities such as the Ministry of Finance and the Stock Market Self-Regulatory Agency. These reforms are based on regulations established by other countries with stock markets similar to Colombia's and economies that have seen significant growth in the corporate bond market.

Diagram VI.2
Colombia: Country Code of best corporate practices



Source: Prepared by the author on the basis of information from the Colombian Stock Exchange (BVC), Colombia Capital programme.

(a) Country Code Survey

The Country Code Survey has been administered in Colombia since 2007 in accordance with Directive 055 of the Financial Superintendent. However, since Directive 007 was established in 2011, issuers of securities that are registered with the RNVE¹⁵ have been required to complete and return the survey, which is administered every January, to the Superintendent. Since the publication of the Country Code in 2007, the corporate governance guidelines have been developed to bring Colombia closer to international standards. In 2014, an updated version of the Code was published following Colombia's accession to the Organization for Economic Co-operation and Development (OECD), for which corporate governance updating was a requirement. With regard to its structure, the new code shows similarities to the 2007 version of the Country Code.

The 2007 Country Code¹⁶ survey contains questions related to 41 specific corporate governance measures in the following four thematic areas:

- (i) Shareholders assembly: calling and holding meetings, approval of relevant operations, rights and equitable treatment of shareholders.
- (ii) Board of directors: size, conformation and functioning, duties and rights of each board member, functions of the board.
- (iii) Disclosure of financial and nonfinancial information: requests for information, market reporting, statutory auditor.
- (iv) Conflict resolution.

(b) Results of the 2012 Country Code Survey

The latest available report¹⁷ from the Country Code survey corresponds to 2012 and is based on the responses of 155 of the 160 issuers required to complete the survey. Of these 155 issuers, 60 are

¹⁵ National Register of Securities and Issuers.

¹⁶ The 2014 Country Code contains 5 thematic areas: (i) Rights and equal treatment for shareholders, (ii) Shareholder assembly, (iii) Board of Directors, (iv) Oversight architecture, (v) Transparency and financial and non-financial information. Within the 5 areas, 33 concrete measures are included, with a total of 148 recommendations.

¹⁷ The report containing the results of the 2013 survey will be published in the second half of 2014.

in the financial sector and 95 are in the real sector. At a consolidated level, the rate of adoption of the measures recommended in the Code has steadily risen from 2007, when the Code was first published and evaluated, to 2012, with a 15.11-point increase over the first six years, which reflects the issuers' commitment to implement better corporate governance standards (Financial Superintendent, 2012).

Of the four areas covered by the recommendations of the Code, the one in which issuers report the highest rate of compliance is the disclosure of financial and nonfinancial information area, followed by the board of directors area. The recommendations in the general assembly of shareholders area have been adopted at a slower pace (see table VI.3).

Table VI.3
Level of adoption of different chapters of the Country Code
(Percentages)

Chapter of Country Code	Level of adoption						Percentage change 2011-2012
	2007	2008	2009	2010	2011	2012	
General assembly of shareholders	39.30	43.50	45.80	52.21	52.76	55.31	2.6
Board of directors	47.90	53.50	54.20	58.55	61.17	62.11	0.9
Disclosure of financial and nonfinancial information	51.10	53.10	55.90	60.02	62.81	65.34	2.5
Conflict resolution	36.10	38.90	39.40	51.98	54.64	57.89	3.3

Source: Prepared by the author on the basis of information from Financial Superintendent, Country Code Survey.

(c) Results for issuers in the financial sector

Issuers in the financial sector have adopted 65.45% of the recommendations set out in the Code, a 1.34 point increase over the rate of adoption in 2011 (64.11%).

Regarding the four thematic areas of recommendations in the Code, the area in which issuers report the highest rate of compliance is the disclosure of financial information area, followed by the board of directors area and to a lesser extent the conflict resolution and general assembly of shareholders areas.

Since 2009, issuers in the financial sector have clearly continued to implement, at a 100% compliance rate, the measure requiring boards of directors to meet once per month and to refrain from appointing as statutory auditor any individual or firm that has received income from the company totaling 25% or more of their most recent annual income (Financial Superintendent, 2012).

Among issuers in the financial sector, 56.66% have additional corporate governance practices in place, including the following:

- (i) The end-of-year market report includes information on the performance of the executives.
- (ii) A set of corporate governance practices is in place for capital investments made in new companies.
- (iii) The corporate governance model has been strengthened to incorporate as a function of administrators the definition of fraud prevention and information security policies and associated compliance monitoring.
- (iv) Corporate governance entities are identified and expressly included in the corporate governance code. These entities are divided into the following groups: steering entities, administrative entities, external control entities, conflict resolution entities and dissemination and enforcement entities.

According to the survey results, in 2012 only 14 entities in the financial sector complied with 70% or more of the measures considered in the survey (see table VI.4) (Financial Superintendent, 2012).

Table VI.4
Entities in the financial sector with the most Country Code measures adopted

Name	Number of measures adopted	Rate of adoption
CFC Leasing Bolívar	37	90.24%
Bolsa de Valores de Colombia S.A	37	90.24%
Banco de las Microfinanzas Bancamía S.A	37	90.24%
Banco BBVA Colombia	36	87.80%
Bancolombia S.A	36	87.80%
Helm Bank S.A	36	87.80%
Factoring Bancolombia S.A C.F.C	35	85.36%
Leasing Bancolombia S.A C.F.C	35	85.36%
Banco de Comercio Exterior de Colombia (Bancoldex)	35	85.36%
BNP Paribas Colombia	35	85.36%
Protección S.A.F	34	82.93%
Giros y finanzas C.F.C	32	78.05%
C.F.C Sufinanciamiento	32	78.05%
Bolsa Mercantil de Colombia S.A	31	75.61%

Source: Prepared by the author on the basis of information from Financial Superintendent, Country Code Survey.

Bancoldex and Bancolombia have made remarkable progress, increasing their compliance rate, in terms of the number of measures adopted, by more than 7 percentage points. Leasing Bancolombia increased its rate by 5 percentage points, while Factoring Bancolombia SA. C.F.C slipped by 2.4 points.

(d) Results for issuers in the real sector

For 2012, issuers in the real sector report adopting 61.10% of the recommendations in the Code, which represents an 18.33-point increase in the rate of adoption (from 42.77% in 2007 to 61.10% in 2012).

In terms of subsectors, public utility companies report the highest rate of adoption of measures from the Code, at 70.85%, followed by investment companies and firms in the food and beverages sector (Financial Superintendent, 2012).

Issuers in the real sector have implemented over 95% of the measures related to the dissemination of information prior to shareholder meetings, independence of the statutory auditor and interest among the issuers in having points of service for their shareholders.

Meanwhile, the measures with the lowest rate of implementation among the issuers were Nos. 7 and 33, which suggests that in general, issuers are still not reporting to the market on the general assembly meetings for shareholders that cannot attend and the contracts between their directors, administrators, principal executives and legal representatives (Financial Superintendent, 2012).

Among issuers in the real sector, 52.13% report having additional corporate governance practices in place, including the following:

- (i) A shareholder-investor relations unit that is responsible for keeping the public informed through channels of communication.
- (ii) A social responsibility model based on sustainability.
- (iii) Application of grounds for disqualification or conflicts of interest with statutory audits at the firm.
- (iv) A manual on conflicts of interest to facilitate the resolution of conflicts between issuers and shareholders.

In 2012, only 15 entities in the real sector were in compliance with 75% or more of the measures in the Country Code (see table VI.5).

Table VI.5
Entities in the real sector with the most Country Code measures adopted

Name	Number of measures adopted	Rate of adoption
ISAGEN S.A E.S.P	38	92.68%
Grupo Nutresa S.A	38	92.68%
Sociedades Bolivar S.A	38	92.68%
Ecopetrol S.A	36	87.80%
Emgesa S.A E.S.P	36	87.80%
Codensa S.A E.S.P	36	87.80%
Celsia S.A E.S.P	36	87.80%
Cementos Argos S.A	36	87.80%
Renting Colombia S.A	35	85.36%
Construcciones el Condor S.A	34	82.93%
Valorem S.A	33	80.49%
Tablemac S.A	33	80.49%
Grupo Argos S.A	32	78.05%
Riopaila Castilla S.A	32	78.05%
Aerovias del Continente Americano S.A	31	75.61%

Source: Prepared by the author on the basis of information from Financial Superintendent, Country Code Survey.

Since 2009, some companies have shown good progress and commitment towards improving their corporate governance standards, including: Ecopetrol, which has adopted five more of the measures in the Code, Cementos Argos (4), Grupo Nutresa (2) and Seguros Bolívar (2).

D. Rating agencies and corporate governance

Rating agencies have been operating in the Colombian market for less than two decades. In 1994, Duff & Phelps entered the market (Resolution 0712 of 5 August 1994 of the Securities Superintendent) (Financial Superintendent, 2008). Four years later, a partnership between local shareholders and the United States rating agency Thomson Financial Bankwatch established the second rating agency in the local market: Bankwatch Ratings de Colombia (Resolution 0065 of 2 February 1998 of the Securities Superintendent) (Financial Superintendent, 2008). Then, in 2000, Fitch Ratings acquired the global operations of both Duff & Phelps and Thomson Financial Bankwatch, after which Duff & Phelps Colombia came to be Fitch Ratings Colombia, and new shareholders were admitted to Bankwatch Ratings de Colombia, which became BRC Investor Services, S.A. For nearly 10 years, these were the only firms operating the local market, until the arrival of the local agency Vale and Risk Rating, S.A., in 2008 (Resolution 0813 of 23 May 2008 of the Financial Superintendent).

Rating agencies in Colombia operate under the inspection and oversight of the Financial Superintendent (Article 75 (1) (3) of Law 964 (2005)) and are regulated by Resolution 400 (1995) of the Securities Superintendent (Financial Superintendent, 2008). To operate in the Colombian market, these agencies must have the authorization of the Financial Superintendent. They must also obtain an operating license and register with the National Register of Stock Market Traders (RNAMV) and must be constituted as corporations whose exclusive purpose is to rate either securities or risks related to financial, insurance, stock or any other activity related to the management, use and investment of resources collected from the public (Financial Superintendent, 2010). Resolution 400 (1995) (Article 2.3.2.1) stipulates, “any rating, as well as revisions thereto, must be adopted by a Technical Committee, subject to the regulations and methodologies defined by each risk rating agency, and each agency shall be responsible for establishing the operating process by which ratings are issued” (Superintendencia

Financiera, 2008).¹⁸ The experience required of members is “at least ten (10) years in activities related to corporate finance and/or credit analysis, or at least five (5) years in rating securities and/or risks” (Financial Superintendent, 2006).

The firms that have participated in rating bonds in the Colombian market operate in accordance with international standards and procedures. Fitch Ratings Colombia uses the same guidelines as its parent company, which is one of the top three rating agencies in the world, while BRC Investor Services, which had its origins in an international firm, operated under a technical assistance agreement with Moody’s between 2008 and 2011. Under these standards, corporate governance has an “asymmetric effect,”¹⁹ because if the issuer is considered to have adequate corporate governance mechanisms in place, it will not have a significant impact on the rating assigned to the bond, whereas if corporate governance mechanisms are found to be insufficient, it may indeed have an impact on the bond rating (Fitch, 2010).

In the local market, this “asymmetric” aspect of corporate governance does in fact play out in the ratings. In a local market, a solid corporate governance framework is a prerequisite for obtaining the highest scores and is explicitly included in the rating methodologies of local agencies (BRC Investor Services, n/d; Fitch, 2010).

1. Regulations for bond ratings

Current regulations (Article 2.22.1.1.4 of Decree 2555 (2010))²⁰ require that ordinary or general guarantee bonds receive a rating by an authorized agency (with the requirements mentioned in the previous paragraph) for purposes of registration in the RNVE and authorization for public issuance.

In addition, Colombian regulations are breaking legislative ground in the region by preventing the potential for rating shopping, defined as selectively approaching various rating agencies in search of the best rating for a particular instrument. With this purpose in mind, regulations in Colombia (Articles 2.22.2.1.3 and 2.22.2.1.4 of Decree 2555 (2010))²¹ require rating agencies to:

- Report to the Superintendent any rating issued as well as periodic or extra reviews within 24 hours following the meeting of the Technical Committee at which the respective rating is approved.
- The Technical Committee may suspend the rating review process pending receipt of more information from the issuer but in no case may reveal in advance a possible rating to the issuer.
- Remit the negotiation systems to the Superintendent and post the report supporting the rating to the Internet within eight business days after the rating is issued.
- Within 24 hours following the Technical Committee meeting, the issuer may request that the rating be withheld provided that it is the first time that the issue is being rated and that any securities corresponding to the rated issue will not be offered to the public on the primary market during the life of the rating. In addition, ratings that have been defined as private in the rating agency’s regulations prior to the start of the rating process will be exempt from publication and presented to the issuer exclusively for its internal use.
- However, if the issuer intends to offer securities publicly, it shall report as relevant information all ratings that have been obtained in the last year.

¹⁸ Regarding the Technical Committee, Resolution 2167 (2006) provides, “[the Committee] shall permanently comprise a plural and uneven number of principal members, with their respective alternates, to evidence the experience [...]” (Financial Superintendent, 2006).

¹⁹ According to Fitch’s methodology, corporate governance “operates as an asymmetric consideration: in cases in which it is considered to be adequate or solid, it generally has no impact (or a very slight impact) on the issuer’s credit ratings. However, in cases in which a shortcoming is observed that could weaken bondholder protection, it is possible that the consideration of corporate governance could have a negative impact on the assigned rating” (Fitch, 2010).

²⁰ Consolidated financial decree citing Article 2.3.1.4. Resolution 400 (1995), amended by Decree 1076 (2007).

²¹ Consolidated financial decree citing Article 5 of Decree 1350 (2008).

E. Case studies²²

1. Ecopetrol S.A

Ecopetrol, S.A., is the top grossing company in Colombia, has over 1.6 billion (barrels) of proven oil reserves and reported US\$4.4 trillion in earnings in 2010. The company was founded in 1951 under the business name Empresa Colombiana de Petróleos and functioned as a public enterprise responsible for managing hydrocarbon resources and operating reverse concessions around the country (Ecopetrol, 2011). It continued to have this dual role as regulator/administrator of petroleum resources and oil company until 2003.

In 2003 the Colombian government launched a restructuring process at the company under Decree 1760 (26 June 2003) and Law 1118 (2006), with objective of internationalizing the business and making it more competitive in the global oil industry. The restructuring process made the company into a public company by stock, changed its organizational structure, led to the voluntary adoption of good corporate governance practices and relieved it of its oil administrator functions, creating for that purpose the National Hydrocarbons Agency (ANH). Newly reorganized, the company was obliged to change its strategic orientation to expand its exploration and marketing operations and move into the international arena, becoming a major player in the global market (Colombia Capital BVC, 2010c). To expand and become an international company, Ecopetrol sought exploration concessions in countries such as Brazil, Mexico and Peru.

In 2007, in order to raise capital and free itself from dependence on the State, Ecopetrol, S.A., went public, offering 10.1% of its capital stock on the Colombian Stock Market. It issued 4.1 million shares totaling US\$ 2.74 billion and received over 400,000 additional bids for nearly US\$ 3.17 billion (Colombia Capital BVC, 2010c), excess demand on the order of 150%. The public offering brought great benefits to the company, giving it greater corporate, budgetary, administrative and financial freedom.

In 2008, Ecopetrol joined the New York Stock Exchange, listing Level II American Depositary Receipts (ADRs) and positioning itself as a solid company with international investors. Subsequently, it listed ADRs on the Lima Stock Exchange (2008) and the Toronto Stock Exchange (2010) (Obregón, 2011).

In 2009, capitalizing on international investor confidence, Ecopetrol issued unsecured and unsubordinated international corporate bonds totaling US\$ 1.5 billion and maturing in 2019, in order to finance its 2009-2015 Investment Plan and meet obligations with suppliers (Colombia Capital BVC, 2010c). The operation was extremely successful, generating demand equal to 700% of the available supply. That same year, Ecopetrol, S.A., acquired Hocol, an oil exploration company with operations in Colombia, for US\$ 748 million; acquired a stake in Enbridge (operator of oil pipelines) in Oleoducto Central, S.A. (OCENSA), increasing its share to 60% (Hoovers, 2011); and acquired Offshore International Group, Inc., which has a controlling interest in the Peruvian oil company Petrotech, in partnership with Korea National Oil Corporation (KNOC).

In 2010, Ecopetrol issued public debt bonds totaling US\$ 530 million to finance its 2010 Investment Plan. This plan included operations to drill 20 exploratory wells —13 in Colombia, 4 in the Gulf of Mexico, 2 in Brazil and 1 in Peru; to increase crude oil and natural gas production by 12% over 2009; and to invest in refinery modernization projects, the industrial services project and the plan to improve fuel quality (Ecopetrol, 2011). The bonds were floated in three series for terms of 5 to 30 years. The offering in the local market was equally successful, having been oversubscribed by 300%. In 2011, Ecopetrol, S.A., together with Talisman Energy, acquired BP Exploration Company Colombia Limited, increasing its production by 25,000 barrels per day.

In short, from a business standpoint, 2001-2011 was a very active and dynamic decade for Ecopetrol, partly owing to its entry into the capital markets and corporate governance reforms. These

²² The case studies presented below were prepared in 2011, so the financial date and corporate governance practices correspond to that year.

reforms took place at two junctures: first in 2004, when the company was restructured following its conversion to a public joint stock company; and subsequently in 2007, when a smaller adjustment was made in the corporate governance practices of the company in preparation for its entry into the capital market. Lastly, in 2008, some minimum corporate governance guidelines were introduced for the companies controlled by Ecopetrol (Obregón, 2011). At present, corporate governance practices at the company are based on three pillars:

- (i) Transparency: a constant flow of information within the company, with the market and with shareholders, achieved through quarterly reporting to the stock market.
- (ii) Corporate governance: a rigid pyramid structure with the assembly of shareholders at the apex, followed by the board of directors and then management.
- (iii) Internal and external control systems.

The first wave of corporate governance reforms at Ecopetrol, in 2004, was not in direct response to changes in national regulations (e.g. Resolution 275 (2001), which did spark a response among many national companies), as the company had no need to issue debt among AFPs. On the contrary, Ecopetrol first introduced changes in its corporate governance practices voluntarily in 2004, in a bid to make the company more globally competitive (Obregón, 2011). That year, after Ecopetrol was relieved of sector administration duties and the ANH was created through Decree 1760 (2003), Ecopetrol began to operate as an integrated oil company. Its corporate governance reforms entailed the establishment of a Good Governance Code. The code included the creation of a board of directors and nearly all the elements set out in Resolution 275 (2001) (Obregón, 2011).

The second wave of reforms was associated with the 2006 public offering of capital stock that authorized the capitalization of Ecopetrol, S.A. That offering prompted an update of the Good Governance Code to bring it in line with national and international standards for issuers of securities. Specifically, the code was brought into line with Law 964 (2005) and the Sarbanes – Oxley Act in the United States, as well as some recommendations from the Country Code. This prepared the company to participate in national and international stock exchanges.

With the transformation of Ecopetrol into a public-private company, in which the private sector held a 10.1% stake and the State held a 89.9% stake, there was an exceptional risk of “agency” between the majority shareholder and any minority shareholders. The criteria by which the State managed the company had traditionally been based more on political and fiscal logic (using oil operations to remedy fiscal deficits) than on a modern business management strategy. Reinvesting profits and growing the company were secondary to sharing out profits. To provide guarantees to the new minority shareholders that would participate in the IPO, the government released a statement in its capacity as majority shareholder in which it committed to the following over a 10-year period:

- To establish a dividend policy that includes guidelines for a minimum amount each year.
- To include on the board of directors a representative of the oil-producing departments (subnational entities) and of the minority shareholders.
- To support the inclusion of items of business proposed by 2% of shareholders on the order of business at regular meetings.
- To discuss in plenary at shareholder meetings the disposition of shares equal to or greater than 15% of the company’s stock capital, and to vote for such disposition only if 2% of the shareholders, or more, are in agreement.

This unilateral commitment by the State was an additional guarantee of good corporate governance above and beyond the applicable rules and regulations that helped reduce the risk of agency between a shareholder with an absolute majority and the new minority shareholders.

In short, Ecopetrol offers a unique example of a company that has succeeded in combining majority State ownership with solid corporate governance, instilling confidence in the market with respect to its corporate management. Although there is no doubt as to the company's solid position and its strong capacity to meet its obligations, ever since the company began to transition from a State-owned enterprise to a public-private company, it has understood that robust corporate governance is a powerful tool for becoming a globally competitive player. The market's confidence in the company is evident in its successful offerings of corporate debt in the Colombian and United States markets (over US\$ 2 billion), which have been met by impressive demand among investors.

2. Grupo Bancolombia

Grupo Bancolombia²³ is the largest bank in Colombia, with over 6.4 million customers, 700 branch offices and 2,300 automatic teller machines throughout the country. It has 100 branch offices in El Salvador as well as a presence in Panama, the Cayman Islands, Peru and the United States. In 2010, the group posted net earnings of US\$ 736.9 million (*América Economía*, 2010). It was founded as Banco Industrial Colombiano (BIC) in 1945 under the control of Suramericana de Inversiones (a holding company with businesses in the insurance and financial sectors, which later would become Grupo Empresarial Antioqueño). In 1994, BIC set itself the goal of becoming the largest financial institution in the country (Colombia Capital BVC, 2010a), which prompted a strategic decision, namely to pursue a strategy based on participation in local and international capital markets (Rosillo, 2011).

Pursuing its capital market strategy, in 1995 BIC became the first Colombian company to join the New York Stock Exchange, with a listing of American Depository Receipts (ADRs) (Camargo Gantiva, 2011). Three years later, in 1998, BIC merged with Banco de Colombia, acquiring a 51% stake in the institution through a US\$ 265 million loan from JP Morgan and a US\$ 150 million IPO on the local market (Colombia Capital BVC, 2010a). With that merger, Bancolombia was born, with a 11.51% share of the Colombian market. In 2000, Bancolombia conducted a second offering, issuing preferred shares under the ADR structure on the New York Stock Exchange, in an attempt to recapitalize after posting losses in 1999 following a major economic crisis that hit Colombia's financial sector hard in 1998 and 1999 (Colombia Capital BVC, 2010a).

Bancolombia's market-leveraged expansion constituted a major challenge in terms of governance, inasmuch as robust corporate governance was needed not only to meet the legal requirements of the capital markets but also to instill confidence in investors and thus guarantee the performance of the instruments in the markets (Rosillo, 2011). Accordingly, beginning in the mid-1990s, the company sought to adopt the latest corporate governance practices, which at the time was an area that was barely addressed in Colombia's business culture or regulatory framework.

In its attempt to become the country's premier bank, in 2004 Inversiones Suramericana decided to consolidate its three financial businesses —Bancolombia, Conavi and Corfinsura— into a single financial institution that would capitalize on the strengths of each one. The merger netted a 4.5 million client base and a 20% share of sector assets, making Bancolombia the largest bank in the country. That same year, Bancolombia floated 18-, 24-, 36- and 60-month corporate bonds totaling US\$ 152 million to finance the expansion of its long-term lending programme.

²³ Bancolombia and Nutresa are part of Grupo Empresarial Antioqueño (GEA), a business group that is controlled by three conglomerates in the department of Antioquia and was formed as a defensive strategy against hostile takeovers by corporations in other regions. Although this interwoven business model could raise concerns with respect to corporate governance, this would be relevant for shareholders, but for bondholders there is no agency among majority and minority interests, so this aspect is not covered in the corporate governance analysis of these two companies. Both Bancolombia and the Nutresa group —and the other companies under the GEA umbrella— have emphasized in recent years the modernization of their corporate governance practices. Several of them are listed on the Dow Jones Sustainability Index and are distinguished by various global sustainability practices.

By 2006, Bancolombia was the leading bank in Colombia, with an 18% share of the local market, offering a full range of services: retail banking, investment banking, leasing, factoring, fiduciary, stock brokerage and other services. In addition, it had three international offices, in Puerto Rico, Panama and Miami. The following year, Bancolombia conducted a third offering, floating 60 million preferred shares on the local market as well as on the New York Stock Exchange to attract international investors. The offering drew US\$ 467 million, of which 35.5% was purchased by Colombian investors, with the remainder issued in the form of ADRs in the United States market. The purpose of this offering was to finance the acquisition of Conglomerado Financiero Internacional Banagrícola, S.A., for US\$ 880 million. The success of the offering enabled Bancolombia to acquire a 98.9% stake in Banagrícola, expanding its operations in Central America and capturing a 30% share of the Salvadoran market (Bancolombia, 2011). The operation also impressed upon Bancolombia the impact that good corporate governance standards have on investor confidence in the case of issuing processes, both locally and internationally.

Based on its fund-raising success in the stock market, Bancolombia put together a plan in 2007 to issue bonds at various tenors and volumes, with the goal of placing US\$ 1.06 billion in ordinary and subordinated bonds (Colombia Capital BVC, 2010c). Under this plan, in 2009 Bancolombia floated ordinary subordinated bonds totaling US\$ 185 million, which was oversubscribed at US\$ 266 million, or 1.9 times the value of the offering (Bancolombia, 2011). The following year, Bancolombia issued ordinary bonds totaling US\$ 210.5 million, with bids outstripping supply by a factor of 2.8 (Bancolombia, 2011). Also in 2010, the bank issued US\$ 620 million in subordinated bonds at a yield rate of 6.125% and was oversubscribed 5.1 times over (Bancolombia, 2011). These were extraordinary operations, in both size and demand, for a Colombian company but were made possible by Bancolombia's solid position and clear corporate governance practices.

In 2011, Bancolombia conducted two successful bond issuances, in January and May. The first was for US\$ 520 million for a five-year instrument (Camargo Gantiva, 2011), and the second was for a record US\$ 1 billion, with a spread over U.S. Treasuries of just 290 basis points. These funds were intended to sustain the long-term growth strategy that has defined Bancolombia's business (*Portafolio*, 2011a).

Alongside this track record of successful issuances in the stock market that allowed Bancolombia to become a market leader and expand into markets throughout the region, the institution has also developed its corporate governance practices. In 2001, when the concept of corporate governance was first introduced into Colombia's regulatory framework (Resolution 275 of the Securities Superintendent), Bancolombia's corporate governance standards had already been put to the test by the United States market and were more rigorous than those required under the resolution (Bancolombia already had an audit committee, information disclosure practices, etc.). However, with this resolution, Bancolombia compiled its practices into a Good Governance Code, which was tailored to the resolution (Rosillo, 2011).

Again, when the Country Code was introduced into the regulatory framework, Bancolombia's internal practices required minimal adjustment to meet and exceed this standard. For Bancolombia, the new national standards and guidelines have provided an opportunity to fine-tune its corporate governance model but have not served as the benchmark since international markets and investors have proved more demanding in this regard (Rosillo, 2011). Consequently, Bancolombia's corporate governance standards go beyond what is required under local law. In the near future, it plans to overhaul its corporate governance practices to extend and standardize them throughout its subsidiary companies in and outside Colombia, as it seeks to remain at the cutting edge of corporate governance (Rosillo, 2011).

In view, Bancolombia has demonstrated that a company can use the capital market intelligently (combining corporate debt and shares) to position itself as a leader in a highly competitive industry. Moreover, the company's history is evidence that to pursue an ambitious strategy built on the capital market, it is essential to develop a corporate governance model that provides the market with full clarity. Thus, high standards of corporate governance are more of a competitive advantage than a burden on a company, supporting a strategy leveraged on debt and share securities. Accordingly, Bancolombia has endeavored to maintain higher standards than those required under national regulations, as it seeks to attract international investors.

3. Grupo Nutresa

The conglomerate Nutresa (known as Grupo Nacional de Chocolates until 2010) is one of the largest Latin American multinationals based in Colombia. It has a controlling stake in 44 companies —24 outside of Colombia— and a direct presence in 12 countries in Latin America, and it exports to 75 countries around the world. Its businesses are in six segments of the food sector: meat, cookies and crackers, chocolates, coffee, ice cream and pasta. The group had total sales of about US\$ 2.5 billion in 2010. The current Grupo Nutresa dates back to 1920, the year in which Compañía Nacional de Chocolates Cruz Roja was founded, which would later become Compañía Nacional de Chocolates, S.A. Between its founding and 1980, the company expanded by acquiring stakes in other companies or opening new businesses, specifically in the cookies and crackers, meat, chocolate and coffee markets.

In the late 1970s, Nacional de Chocolates, together with Suramericana de Inversiones and Cementos Argos, acquired cross holdings (known as *enroque*, from the chess move “castling”) to form the conglomerate Sindicato Antioqueño, which later came to be known as Grupo Empresarial Antioqueño (Londoño and Acosta, 2004). Around 2000, Nacional de Chocolates began to move in two parallel directions. First, like its partners in Grupo Empresarial Antioqueño, it reorganized under a holding company model to simplify administrative aspects, allow for a sharper business focus and provide greater transparency. Second, it pursued an aggressive expansion and internationalization process for which there was already a precedent in the acquisition of the processed meat company Hermo in Venezuela in 1996 (*Dinero*, 2002).

To advance in the first area (reorganization as holding company), Inversiones Nacional de Chocolates was created to manage the portfolio of investments in companies such as Colcafé, La Bastilla, Doria and Noel and the stakes in other companies in Grupo Empresarial Antioqueño, such as Suramericana, Argos and Corfinsura (*Dinero*, 2002). Meanwhile, industrial and commercial operations were transferred to the new Compañía Nacional de Chocolates, which was given the assets, liabilities and contracts associated with those activities. In 2005, Inversiones Nacional de Chocolates and InverAlimenticias, S.A., merged, marking the latter’s exit from the stock market and the consolidation of the holding company Compañía Nacional de Chocolates (González, 2011).

The reorganization process entered a second phase in 2008 with the migration of all subsidiary firms to a simplified joint stock corporate model. This was made possible by a regulatory change that allowed joint stock companies to have a single owner (Law 1258), ideal for the holding-subsidiary company model. This conferred advantages on the group, such as greater administrative flexibility, with a simple and flexible structure based on nonbinding rules and voluntary compliance (*Dinero*, 2011; González, 2011). From a corporate governance viewpoint, it should be noted that all corporate governance aspects that apply to the holding company are extended (though not a regulatory requirement) to all subsidiary companies. In other words, information on all subsidiary companies is disclosed and the same rules apply to them, for example in the case of a conflict of interest.

The second process —expansion and internationalization of the group— was launched with local strategic moves, including the acquisition in 2003 of 100% of the processed meats company Rica Rondo and InverAlimenticias, S.A. (formerly Galletas Noel and part of the group for 70 years) (*Dinero*, 2002). In 2004, the group acquired Nestlé’s cookie/cracker and chocolate production facilities in Costa Rica and with new investments and acquisitions established an international distribution network (Cordialisa) with a presence in: United States, Panama, Costa Rica, Nicaragua, Guatemala, El Salvador, Honduras and Puerto Rico. In 2005 and 2006, the group acquired pasta, mushroom and ice cream companies in the Colombian market and cookie/cracker and meat producers in Costa Rica and Panama. In 2007, the group entered the Peruvian market and acquired a chocolate, cookie/cracker and candy producer. Grupo Nacional de Chocolates continued its international forays, acquiring the Mexican chocolate company Nutresa,²⁴ S.A. de C.V., in 2009. Lastly, in 2010, it acquired Fehr Holdings,

²⁴ In 2011, Grupo Nacional de Chocolates, S.A., changed its name to Grupo Nutresa, S.A., in order to represent all food categories and businesses in the group, as well as strengthen the nutritional association with its brand names.

LLC, for US\$ 84 million, a company that makes and sells cookies and crackers in the United States. The Fehr acquisition consolidated the group's presence in that country, giving it two production platforms in Texas and Oklahoma, as well as establishing it as a multinational corporation.

Notably, most of this national and international expansion through 2009, which required investments totaling more than Col\$ 4 trillion (approximately US\$ 2 billion), was not financed in the stock market (González, 2011). Rather, the company made some important divestitures from businesses outside its area of focus (its share in the retail chain Éxito) and took out bank loans and used own cash to carry out its expansion plan.

The reorganization, expansion and internationalization of Grupo Nutresa was accompanied by an improvement in its corporate governance practices, prompted by regulations and by its need for capital to carry out its ambitious plans. This change entailed the company's transformation from a local firm, managed carefully but almost like a family business (though it never was), to a multinational conglomerate managed to the very highest standards of corporate governance.

2001 was a critical year, marked by the entry into effect of Resolution 275 of the Securities Superintendent, which established good governance rules for issuers seeking investments from AFPs. Nutresa was interested in AFP investors and believed in the model for channeling public savings to private companies (González, 2011). Consequently, given its need for financing and the type of actors that the new resolution authorized, it carried out a deep reform to bring the company's corporate governance practices up to standard (González, 2011). One result was the development of a Good Governance Code, which was in line with the resolution. However, because the company had a history of nearly 80 years in the local market and had been run conservatively in the sense that modern corporate governance practices had not been adopted, there was some initial resistance to the adoption of certain standards, which were seen as government meddling in the affairs of the company. Following a process by which the group's corporate executives came to understand and internalize the value and need for a solid strategy for good corporate governance, Nutresa made it a priority. Ever since, corporate governance practices have guaranteed the distribution of earnings consistent with corporate performance, as well as the timely disclosure of accurate, transparent and complete information on the company's condition (Nutresa, n/d).

Demonstrating this commitment, in 2007, following publication of the Country Code that replaced Resolution 275, the company adjusted its code and corporate governance practices and proceeded to place first in its sector in the adoption of standards in the 2008 Country Code Survey. As a result, the group's subsidiary companies have gone above and beyond the legal requirements, since in addition to complying with the Good Governance Code, they must disclose information to the market and follow the strict guidelines on ethics and conduct contained therein (González, 2011).

Since 2009, on the basis of its solid corporate governance framework, the group has successfully participated in the securities market in three different ways. First, it took advantage of the level 1 ADR programme (*Dinero*, 2009), launched in 2009 following the financial crisis that hit the United States economy. That transaction was seen by the company as a first exploratory foray into the United States market and one that would test its strength as a company and its corporate governance practices (González, 2011). In addition, ADRs increased the company's visibility among international investors, despite the fact that with ADRs, the company did not have to offer shares or list on the stock exchange (*Dinero*, 2009). In the long run, the ADR operation is intended to help the group rise to level three, that is, to be listed on the exchange (González, 2011).

Second, in 2009 the group issued US\$ 231.8 million in ordinary bonds on the Colombia market, with a view to changing its debt profile in advance of sizeable maturities coming due in 2010 and 2011. This transaction not only improved its debt profile over time but also lowered its borrowing costs due to the excess demand that was generated and the low rates at which it was able to place the bonds. It also made the group appreciate the importance of good corporate governance practices in building investor confidence for issuances in the national and international stock markets alike (González, 2011). Thus, the issuance of ADRs and bonds represented what the group's vice president and secretary general

characterized as “an in-depth evaluation of our good practices and the consolidation of the group’s corporate governance practices” (González, 2011).

Lastly, in March 2011, the group’s board of directors announced the approval of the Regulations for Issuing and Placing Company Shares, confirming an offering of its capital stock for the first time in several decades (E-Bursátil, 2011). The offering, conducted in July 2011, totaled US\$ 290 million and was oversubscribed at a record level for the Colombian market, at 17 times the value of available shares (i.e. bids totaling nearly US\$ 5 billion). The operation confirmed public confidence in the company and once more revealed the benefits to be reaped from a solid corporate governance framework.

In summary, the Grupo Nutresa case study shows how a company can use corporate debt to leverage its operations and optimize its financing options. The excellent reception in the markets to the bond issuance in 2009 and the share offering in 2011 points to investor confidence in the group and this is partly due to the peace of mind offered by solid corporate governance practices. From the company’s point of view, much of the expansion through 2009 was supported by divestitures and traditional sources of financing, but the forays into the capital markets beginning in 2009 proved to be an efficient way of financing future needs.

4. Colombina

Colombina, S.A., is a family business that is strongly positioned in Colombia’s food products market, with a portfolio spread across nine segments of that sector: cookie/crackers, cakes, candy, chocolate, chewing gum, salsas, preserves, snacks and ice cream. Leveraging its distribution network, the company also represents other food brands such as the “Van Camps” canned food line (leader in canned fish products) and Café Buen Día. At present, Colombina, S.A., has a controlling interest in 22 companies in Colombia, South America and Central America, maintaining a direct presence in Guatemala, Puerto Rico, Ecuador, Chile, the Bolivarian Republic of Venezuela and Peru and exporting to 44 countries (HelmTrust, 2010). In 2010, Colombina posted total sales of Col\$ 680.169 billion (US\$ 358 million), representing growth of 10.5% over 2009 (LaNota.com, 2011). The company is once again fully owned by the Caicedo family, heirs of the founder, having bought back a 7.6% stake from Corficolombiana (investment company) in December 2009 (Colombia Capital BVC, 2010b).

The company is predated by one of the largest sugar mills in Colombia, the Riopaila mill, founded in 1918 by Hernando Caicedo. Fourteen years later, in 1932, Colombina, S.A., was created to offer value-added products in the sugarcane industry, such as candies and sweets. In the mid-1960s, Colombina conducted its first expansion, seeking to position itself as a regional leader by incorporating European techniques to make candy bonbons and natural fruit preserves, which it began exporting to the United States in 1965. Beginning in the late 1980s, the company launched efforts to expand horizontally and internationally. Its expansion plan included partnering with other companies in the sector such as *Peter Paul* (chocolate bonbons), *Meiji Seika* (Japanese food products) and *General Foods* (soft drinks) (Colombina, 2011). It also acquired companies in various niches of the food industry (e.g. La Constancia salsas in 1990 and Robin Hood ice cream in 2004, among others) and negotiated distribution agreements with companies like Hershey’s and Van Camps (Colombia Capital BVC, 2010b). And in 2001, the company expanded into Guatemala, opening a factory in partnership with the group Pantaleón Concepción to make and distribute products for Central America and the Caribbean (Colombina, 2011).

As it expanded horizontally and internationally, Colombina, S.A., also worked to modernize its governance and management structure. Corficolombiana (an investment company) acquired shares in the company, such that for the first time it was not fully family-owned, although the family bought back Corficolombiana’s stake in 2009. Colombina attempted to set up a more efficient board of directors by hiring managers and executives from outside the family (by 2009, only one vice president and the CEO were members of the family) (Colombia Capital BVC, 2010b).

In 2006, Colombina, S.A., looked into the debt market as an attractive financing option. Until that point, its financing had primarily come from reinvested earnings and borrowing on credit (Colombia Capital BVC, 2010b). It had long-term investments that were partially financed with short- and medium-term debt, which presented potential risks in terms of refinancing. Moreover, the fact that the company was financing part of its growth with own capital had the potential to spark tension between shareholder needs and expansion plans (Colombia Capital BVC, 2010b). Hernán Darío Mejía, vice president of the company, commented that the decision to enter the capital market had four underlying objectives (Mejía, 2011):

- To obtain financing at better rates than in the intermediated market.
- To improve the debt profile through longer-term maturities.
- To send a message to the banking sector about the possibility of financing through other channels.
- To follow up on interest in participating in the capital market.

In March 2007, Colombina, S.A., placed Col\$ 50 billion in ordinary bonds with amortization periods of between seven and ten years (HelmTrust, 2010). The operation was successful, with bids totaling more than Col\$ 92 billion, which prompted the company to pursue another bond operation in 2009. In August of that year, it placed Col\$ 100 billion in ordinary bonds and received bids in excess of Col\$ 167 billion, which allowed it to obtain financing at a lower cost and proceed with its expansion plans. Despite the increase in the company's gearing level and the economic slowdown in 2009, the bonds were rated AA+, denoting the company's good performance and confidence in its corporate governance framework (Colombia Capital BVC, 2010b).

In addition to helping the company obtain its objectives, the bond offerings in 2007 and 2009 conferred a number of additional benefits. The company was able to demonstrate to the financial system that intermediate debt could be replaced with regular bond issues, which improved its bargaining position (Colombia Capital BVC, 2010b). Stricter corporate governance standards improved its profile among clients and providers and increased its visibility in the capital market. This also helped improve shareholder relations, made the company easier to run and boosted investor confidence (Mejía, 2011).

Colombina's foray into the capital market was shaped by the Colombian Stock Market's "Colombia Capital" programme, supported by the Inter-American Development Bank. The programme sought to support companies that had the potential to become new issuers, and in August 2006, Colombina, S.A., became one of the first group of companies to participate. Through the programme, Colombina benefited from training, technical support and above all exchanges with companies that already had experience raising funds in the capital market (Mejía, 2011).

Although Colombina was a company of considerable size in 2006, some of its corporate governance practices continued to resemble those of a family business. Resolution 275 of the Securities Superintendent had already been in effect for five years, but with the company uninterested in issuing debt in the public market, it had yet to adopt the corresponding measures. In 2006, Colombina drafted its Good Governance Code and came into line with the resolution and with Law 964 for issuers. Coming into compliance with these regulations entailed some additional responsibilities (greater visibility and disclosure of information) and the company had to overcome resistance among shareholders who felt that the costs might outweigh the benefits. The change entailed a commitment to disclose information, as well as establish mechanisms to protect minority shareholders and bondholders. In so doing, the company transformed from being a virtually family-run business to an industry leader with high corporate governance standards (Colombia Capital BVC, 2010b).

Unlike the other case studies, Colombina, S.A., is a family business that had little interest in the capital market for much of its history. As a result, there was some internal resistance that had to be overcome before it could participate in the market, and the company had to adjust its corporate

governance practices to comply with regulations for issuers. Upon entering the capital market, it gained access to a source of financing that better suited its financial profile (long-term investments) and at better rates. This case shows that although a first offering can be costly, access to the capital market has short- and long-term advantages that far outweigh the costs and are sometimes even unexpected.

5. Comparative analysis of the case studies

This comparative analysis focuses on the categories (benchmarks) proposed by the study coordinators as a way to look at the five countries in this study. The analysis is based on 39 standards of best practices, each of which has an indicator and a corresponding score, which is only awarded if the company is fully compliant with the standard. The information has been consolidated into the Good Governance Code reports, the annual corporate governance reports, statutes and interviews with corporate officers. It should be noted that these standards only refer to aspects of corporate governance that are critical for the issuance of corporate debt and do not cover key aspects of corporate governance in general, such as protection for minority shareholders or remuneration of directors.

At a high level, the results for the Colombian companies are far from the proposed benchmark, especially in aspects related to committees. For this indicator, the highest score obtained by a Colombian company was 6.1 on a scale²⁵ of 10, while the lowest score was 3.08, with an average score of 4.982.

The four Colombian companies largely comply with the proposed standards for boards of directors, their role and selection. In this specific area, the average for the four companies is 3.0, against a benchmark of 4.8. The companies performed less well on the indicators related to committees, with an average score of 1.82 against a benchmark of 5.2. However, because it is a regulatory requirement in Colombia, all the companies have an audit committee and comply with the standards of the proposed indicator. Furthermore, two have an asset/liability management committee (equivalent to the financial asset investment committee and obligatory for financial institutions in Colombia). However, only one company reports having a risk committee, which is not required by national regulations. Three of the companies have some other committee—generally the audit committee—that assumes the functions of the risk, corporate financing and financial asset investment committees.

An interesting and practical conclusion that can be drawn from this indicator is that some of these corporate governance aspects are not publicly reported or consolidated by the companies even though they comply with them and the information is not confidential. Thus, a mere review of the public documentation (essentially, the Good Governance Code and Statutes) would give the impression that a company is performing less well than it actually is. A comparison of tables VI.6 and VI.7 reveals that if only the codes and statutes are considered, the companies' compliance levels are drastically lower. For this study, the companies have been very open with their information, and as a result, when interviews are also included, their scores are much higher, since for the some of the standards, the interviews make it possible to verify compliance that is not necessarily documented in the codes and statutes.

Table VI.6
Summary of indicator results

Benchmark (maximum possible)	Minimum	Maximum	Mean	Median
10.0	3.08	6.10	4.82	5.05

Source: Prepared by the author.

²⁵ Colombian regulation is inconsistent with some aspects of the indicator, so the highest possible score for a company in Colombia is 9.4, against a benchmark score of 10.

Table VI.7
Summary of indicator results considering only the Good Governance
Code and Statutes

Benchmark (maximum possible)	Minimum	Maximum	Mean	Median
10.0	1.73	3.08	2.33	2.25

Source: Prepared by the author.

The indicator does not allow a direct correlation to be made between corporate governance performance and debt performance, or success with issuances. All the companies considered in this study have honored their obligations (no defaults or renegotiations), have been successful with their issuances and have ratings of AAA or AA+. This may be because of the kind of companies selected, which all comply with a series of basic corporate governance standards and are well positioned in the market in their respective industries. However, it can in fact be observed that the companies that have captured the most funds from the market and conducted market operations outside Colombia are the ones that have the highest corporate governance standards. Furthermore, the performance of the Colombian companies on the index is strongly linked to local regulation. The Colombian companies outperformed only Mexico and Brazil in those aspects that are required under local regulation (e.g. audit committee).

F. Conclusions

The case of Colombia shows that deepening the capital market depends on a multitude of factors requiring a convergence between effective regulation and micro and macroeconomic factors. The deepening of the Colombian capital market in corporate bonds that occurred between 2010 and 2013 was significant, with the stock of this type of debt rising from 3.4 trillion pesos in 2001 to nearly 35 trillion pesos in 2013. This increase can be attributed to the regulatory changes introduced by Law 964 (2005), which provided greater certainty for issuances, as well as increased demand among institutional investors. This coincided with lower central bank rates and wider spreads in the financial system, which incentivized long-term borrowing. All this unfolded during an expansionary phase in the local economic cycle, which encouraged issuers to pursue ambitious plans.

Although the deepening of the capital market for bonds was significant and stock of this type of debt increased in 2010, the outlook has not been as promising in recent years. As a share of the total volume of transactions, corporate debt has slipped considerably, from 17% in 2010 to 6% in 2013.

The Colombian market is concentrated in AAA and AA+ bonds (on the national scale) issued by large corporations, with strong participation by the financial sector. This makes it hard for small firms and even medium-sized and large companies to gain access to this type of relatively inexpensive and long-term financing. Overcoming this barrier will require breaking a vicious circle in which, on the front end, there is a self-selecting supply-side phenomenon in which small and medium-sized companies opt out because they would incur relatively high costs, they would have to meet the same corporate governance requirements that apply to large companies and above all they would risk issuing instruments that they likely would be unable to place. The vicious circle is clinched on the demand side, because the regulatory framework (Article 2.6.12.1.3, Decree 2555 (2010)) has created a culture among the AFPs to invest exclusively in AAA and AA+ instruments, and TES governments bonds have a particularly strong crowding out effect on other fixed-rate options such as corporate bonds.

The authorities have responded by promoting a series of policies to give more companies access to the stock market. Local regulations on corporate governance have evolved through four stages and

are now characterized by the Country Code on Corporate Governance, an annual Country Code survey and the rules established by Law 964. Most recently, the government is seeking to reform the secondary market, in order to relax the current standards on traded securities and create opportunities for small and medium-sized companies to finance their operations through debt.

The case studies (Ecopetrol, Nutresa, Bancolombia and Colombina) present four stories of Colombian companies that have achieved high standards in corporate governance and successful leveraging from corporate bonds placed in the local and foreign markets. In the case of Ecopetrol, it is especially interesting how the majority shareholder (the State) provides extraordinary guarantees of corporate governance to encourage the participation of other shareholders in the company. This was what allowed the company to issue corporate bonds in local and international markets and shares in the local market. Nutresa's experience demonstrates how a solid corporate governance framework paves the way for successful access to the capital market in the long run, even if there is no immediate need for financing. Nutresa had been incorporating the best practices in corporate governance set out in Colombian regulations, but it was not until 2009 that it decided to enter the capital market. Meanwhile, Colombina shows that a family business can also achieve high corporate governance standards and participate successfully in debt issuances. Moreover, the costs of entering the capital market can be rapidly offset. Lastly, Bancolombia is an example of a financial company that has successfully conducted large-scale issuances in national and international markets, securing its position as a leader in the local market and sustainably financing its international expansion. By leveraging the market in this way, Bancolombia has made up for the lack of savings in the local market to offer long-term loans. Meanwhile, the international market has recognized Bancolombia's good corporate governance, as reflected in the oversubscription of the securities offered by it on the New York Stock Exchange.

The standards of the indicator proposed for evaluating companies shows that in the case of these four companies, although they have been successful and are in compliance with domestic rules and regulations—and to a certain extent with those in the United States—they are far from the proposed best practices benchmark, especially with respect to committees. In 2011 it was found that some of these best practices were “buried” in internal documents or practices, which made it difficult to verify them. However, in recent years, the companies in these studies have implemented better mechanisms for public disclosure and easy access to corporate governance practices.

As seen in the case studies, the companies in Colombia that have successfully used bonds as a corporate financing instrument are large and have risk ratings of AA+ or AAA. It is expected that the reform of the secondary market will enable smaller companies to also participate in the capital market and take advantage of more diverse bond options in terms of risk, breaking the aforementioned circle. The reform of the secondary market is based on three principal areas of change: (i) investor eligibility; (ii) simplified disclosure requirements; and (iii) elimination of requirements for ongoing and periodic information disclosure.

Although these changes will promote the development of the capital market by facilitating access for more small firms, there are three additional aspects that are key: first, differentiated levels of corporate governance for issuers of bonds and shares; second, a private or semi-private channel for institutional investors; and third, regulations that allow or incentivize AFPs to become more diversified in their fixed-rate instruments. The first aspect could help lower the costs to a small issuer that, for example, only wishes to participate in the capital market with bonds, not shares. The second aspect would give institutional investors (AFPs, collective portfolios, etc.) an opportunity to invest in corporate bonds through direct contact with the issuer, sidestepping the public stock market and avoiding, for example, the need for a risk rating (the burden falls to the institutional investor to verify the risk associated with its investment). Lastly, the third aspect is key to ensuring that there is a positive response among demand, since making changes in supply would otherwise be futile.

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VII. Corporate governance in Mexico and the evaluation of risk in bond issuance

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A. Introduction

The financial crisis that broke out in September 2008 had major implications in the real economy, in particular by forcing highly leveraged firms, or those with portfolios of high-risk or undiversified projects, or both, into bankruptcy or debt-service problems.

This crisis, caused by a very loose monetary policy implemented by the Federal Reserve since the 2001 crisis, spread massively through the United States and European financial systems via the securitization of low-quality loans in a context of weak financial regulation.

There were direct and indirect responsibilities in this crisis, as discussed in the first chapter of this volume; but ultimate responsibility at the company level rested with corporate governance bodies, and the fact that shareholders delegate the companies' most important decisions (on business strategy, investment projects and financing) to them.

Efficient corporate governance is the chief guarantee for an investor (shareholder), or a creditor that the funds supplied will be properly invested. For that reason, the cost of capital is lower for more institutional firms, which tend to be those with more robust corporate governance structures.

The financial crisis that hit the United States had a major impact on the Mexican economy, because Mexico's exports rely heavily on the industrial performance of the United States economy. As result of the slowdown in its activity, GDP contracted by more than 6% in 2009, and unemployment and underemployment rates rose to very high levels.

The construction sector ground to a virtual standstill, and credit solvency had a major effect on financial companies that made loans without being able to generate deposits (*Sofoles*), Metrofinanciera, Hipotecaria Su Casita and Crédito Real, all of which have had to face a situation of financial restructuring or insolvency proceedings, or both. Another group of firms that were heavily impacted were those leveraged in dollars, or those that used derivative products for speculative rather than hedging purposes.

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In this context, corporate governance gained special importance in the agency problem between creditors and shareholders. This operated through the incentive to invest funds in high-risk investment projects with profits that would be capitalized by the shareholder, while the risk was transferred to the creditor; in other words, through the incentive to distribute dividends when the firm is in a critical situation, to the detriment of the creditors. To the extent that the interests of each stakeholder group can be harmonized in the firm's performance, particularly the interests of creditors, the firm will be more profitable and self-sustainable.

The debt market in Mexico, has grown significantly, and is increasingly important within the capital market and in the way enterprises finance their investment projects. Corporate debt has to be issued under stringent requirements in terms of the role of the different corporate governance bodies. Chapter I of this volume proposes a score to measure this. Its application in the case studies selected revealed the extent to which failure to achieve a satisfactory corporate governance score did or did not mean problems in the financial situation of the firms considered.

This chapter contains five sections following this introduction. Section B describes the debt market in Mexico —its size, the main capital market instruments, the leading issuers, and ratings. In Mexico, the use of bond financing intensified following the emergence of a type of tradable bond certificate known as the *certificado bursátil* in 2001; and in recent years these have been particularly important for the large corporations.

Section C analyses the importance of corporate governance in resolving agency problems between shareholders and creditors. The key features of the regulatory framework that characterizes corporate governance principles in Mexico, stem from the legal domain with the Securities Market Law (LMV) and specific legislation applicable to financial-system entities, along with the proposals made by the business sector through the code of best corporate practices, which was updated in 2010. An evaluation is made of the standards, which are thoroughly explained in chapter I, in relation to the Mexican cases selected, drawing on figures obtained from the July 2011 PricewaterhouseCoopers study.

Section D presents the four case studies, which were chosen as follows: two firms that suffered major impacts from the financial crisis, CEMEX and Comercial Mexicana, the first with a significant financial restructuring, and the second with an insolvency problem that resulted in its filing for bankruptcy. A third case, Grupo Financiero Banorte, which despite belonging to a sector that was heavily affected by the economic recession, successfully overcame its effects and had the chance to undertake mergers with other firms (Grupo Financiero IXE) and make progress in its corporate governance standards; and lastly, PEMEX, Mexico's largest State-owned enterprise, which in 2008 and 2014 underwent the two most far-reaching reforms, aimed, among other things, at strengthening its corporate governance structure. With the exception of PEMEX, none of the case studies were updated for this version of the document.

Section E calculates the corporate governance score for bond issuances proposed in chapter I, for each of these selected Mexican enterprises.

Section F sets forth a number of final thoughts, both general and on the application of the indicator to the selected firms.

B. The debt market in Mexico

1. Recent trends

In the wake of the 1994 economic crisis, the banking system drastically curtailed its supply of credit to firms; and bank lending to enterprises plummeted from 15.4% to 2.9% of GDP between 1995 and 2000. The subsequent recovery has been moderate at best, and by the end of 2010 it only represented one third of the amount recorded in 1994 (21.7%).

With firms facing tighter borrowing conditions, the most common source of financing in the subsequent 10 years was supplier credit; nonetheless, in 2005, the use of bond issues began to intensify, and it reached a level of 200 billion pesos, albeit with a pause in 2008 as a result of the financial crisis.

The 2008 financial crisis caused a significant widening of spreads in the securities issued both by State-owned enterprises and by AAA corporates. The relevant point is that, after this increase, spreads have stayed around 100 basis points for firms with investment grade above sovereign bonds, which means a steep rise in the cost of capital even for this enterprise segment.

2. Size and characteristics of the current debt market

Following the 1994 crisis, the subsequent macroeconomic stability enabled the debt market to evolve in terms of alternative instruments and maturities. The pattern naturally began with government securities, with alternatives in terms of real interest rate (Udibonos), long-term variable rates (IPAB bonds and Bondes), long-term fixed rates (M Bonds) and Eurobonds (UMS).

In this scenario, private bonds recovered, both on the national market and abroad for the leading corporates, especially with the emergence of bond certificates in 2001. Nonetheless, small and medium-sized enterprises (SMEs) continued to face major problems in financing their investment projects through this channel.²

The basic form of the capital structure of the firm consists of debt and shares. Long-term corporate debt and shares comprise the capital market, whereas short-term corporate bonds and government bonds make up the money market. The latter accounts for the largest share (84%) of the debt market, and the scope of opportunity this means for the long-term debt market, which, compared to the market for shares is just 17%.

Prior to 2001, long-term bonds were basically liabilities. Starting that year, the bond certificates known as *certificados bursátiles* (CBs) began to be issued, under the supervision of the National Banking and Securities Commission (CNBV); and these currently represent almost 13% of the total debt market and 76% of the long-term debt market.

Bond certificates have the advantages of their operational flexibility and wide-ranging use in financial structuring schemes.

In terms of flexibility, they can be placed in one or more issues, and the issuing firm can define the characteristics (amount, payment conditions, rate, and maturity) of each issue. Moreover, CBs make it possible to design financing schemes for the securitization of nonproductive assets (e.g. receivables).

In Mexico, State-owned enterprises and decentralized organizations (Infonavit, Fonacot and Fovissste) are considered corporate issuers; and it is precisely these organizations and development banks, such as Banobras, that are the leading issuers of corporate debt, accounting for 44% of the total amount issued. This means that the strictly private corporate market is still much smaller than indicated by the previous figures (US\$476 million).

In terms of the demand for debt instruments, the leading buyers are institutional investors, such as investment funds (*sociedades de inversión*) and pension funds (*Afores*), which accounted for 67% of the total in 2010.

In 2010, mutual funds had around 1,254 million pesos in assets, 83% of which was held in debt instruments; and of that amount, 33% represents purchases of corporate securities.

Pension fund management companies (*Afores*) started to operate in September 1996, managing pensions funded from compulsory contributions, in replacement of the pay-as-you-go system that existed previously. As of the end of 2010, they had 1,374 million pesos under management, with just 16% held in the form of domestic corporate bonds.

² This might represent a later stage of capital-market reforms which would make it possible to reduce capital costs for smaller firms.

The fact that institutional investors are the leading buyers of corporate debt, and that the long-term investment horizon aims to preserve the invested capital in real terms, is reflected in investment according to interest-rate structure, in real interest-rate securities (Udis), which in 2010 accounted for 36% of the total, and the equivalent in adjustable rates, which accounted for 46%.

Investors' need for ratings following the 2008 financial crisis is reflected in the rating of corporate debt in late 2010; 73% of private debt in circulation was AAA, while just 4.17% was rated AA+, the next category below. Issuers are generally rated by one of the international rating agencies, S&P, Moody's or Fitch, although Mexico also has its own national rating agency, HR ratings.

Firms submit to rating because it is a requirement imposed by the authority (CNBV) for public bond issues. In that rating, however, it is very important to strengthen the requirements of compliance with filters without conflict of interest in the corporate governance mechanisms. Nonetheless, any score such as that proposed in the second chapter of this volume will not have the desired importance unless it is accompanied by specific measures to enforce it in addition to reporting it.

C. Corporate governance in Mexico

1. The agency problem with creditors and the importance of corporate governance

According to OECD (2004), the term corporate governance refers to the way firms are directed and controlled. In its broadest sense, it includes different aspects of the relations between the various agents that participate in the firm's life, and how they relate, how their rights are respected, how the corporation's power structure is determined between them, and how their behaviour is regulated (de Paula 2009). A more pragmatic view is that "corporate governance is the defence of the property rights of those who are not the firms' managers or controllers" (de Paula, 2009).

If we transfer this latter approach to the relation between the suppliers of financial resources and the firm's managers, corporate governance defines the way profitability and dividends are guaranteed for the shareholders, and how principal and interest are paid to the creditors.

Both the theoretical and the empirical treatment of this aspect of corporate governance has focused particularly on the "agency problem" (conflict of interest), both between shareholders and managers and between majority and minority shareholders (Jensen and Meckling, 1976).

Nonetheless, the 2008 financial crisis revealed a clear "conflict of agency" between creditors and shareholders —in other words the incentive for shareholders to use outside resources to engage in high-risk investment projects, which are highly likely to render them unable to fulfil their commitments with creditors on time and according to contractual conditions.

When a firm issues debt, a conflict of interest arises between the shareholders and creditors, which is manifested in decision-making that involves adopting selfish strategies that translate into lower-cost investment alternatives for the shareholders in the event of failure but imposes a high risk on the bondholders. There are several situations that exemplify this conflict of interest, which is magnified when a potential bankruptcy occurs (Haugen and Senbet, 1988).

One example is that shareholders have the incentive to adopt riskier investment projects, although of a lower present value, with the aim of capitalizing higher gains in an economic boom situation; or, in the event of bankruptcy, pay only part of the funds due to the creditors.

Another "selfish" strategy by the shareholders, which involves expropriating value from the creditors, is the incentive to pay dividends in a financial-default situation, leaving fewer resources available for the bondholders.

Given the nature of their main activity, firms in the financial sector were particularly subject to the effects of long-term insolvency following the 2008 financial crisis. Nonetheless, commercial and industrial enterprises also felt the effects of the financial crisis on their cash flows and their ability to meet their financial commitments in relation to direct credits or the amortization and payment of interest on bonds issued by the firms themselves; and they certainly received less government support.

In Mexico, as we shall see below in the enterprise case studies, there were situations in which excessive leveraging became the main cause of their bankruptcy and need for profound financial restructuring. Nonetheless, other cases demonstrated greater organizational strength and ended up reporting operational and organic growth, despite the difficult times they had to deal with.

Prudence in the management of leverage, adequate use of derivative products to reduce or limit exchange-rate or interest-rate risks, and above all, the preparation of a consistent and well structured business plan, are aspects that to a greater or lesser degree relate to the corporate governance bodies and their composition under strict international standards.

2. Legal framework and corporate governance in Mexico

The evolution of corporate governance in Mexico has been described exhaustively in several recent articles (Viscencio, 2009). The following paragraphs outline the main points characterizing the current corporate governance legal and regulatory framework:

- (i) Corporate governance in Mexico has been strengthened through legal channels. The Securities Market Law (LMV) included in its 2006 update (the latest version is dated 2009), several of the proposals of the Code of Best Corporate Practices (CMPC) issued by the Entrepreneurial Coordinating Council (CCE) in 1999 and revised in 2010.
- (ii) The main regulatory documents defining corporate governance principles in Mexico are the Commercial Code, the General Law on Commercial Companies (LGSM), the LMV and the Insolvency Law (*Ley de Concursos Mercantiles*). For firms in the financial sector, the basic legislation is augmented by the following: the Credit Institutions Law, the Law Regulating Financial Conglomerates; the Law on Auxiliary Credit Organizations and Activities; the General Law on Surety Institutions; the General Law on Mutual Insurance Institutions and Companies; the Investment Companies Law and the SAR law.
- (iii) Companies are classified in specific groups to define the regulations applicable to them. Joint-stock corporations (S.A.s) and limited companies (SRLs) are governed by the LGSM, which was last amended in 1992. The LMV defines two other types of company in which the main difference consists of their corporate governance requirements, namely the Joint-stock Investment Promotion Company (SAPI) and the Stock Market Corporation (SAB).

Financial entities are subject to specific corporate governance requirements pursuant to their own legislation and on issues not specified in the LMV when they are public enterprises and the LGSM otherwise.

- (iv) SABs are public enterprises which are required to maintain a more complete corporate governance structure; a board of directors of up to 21 members, with at least 25% of them independent; a corporate practices committee formed and chaired by independent board members, and an audit committee.
- (v) The CMPC is not compulsory, but, as noted above, it has been the reference for corporate governance upgrades in the LMV. Its most recent 2010 edition contained recommendations with 51 practices following the format proposed by OECD (2004).

This version makes additional recommendations: avoid involving the board of directors in the daily activities of the firm, additional requirements to ensure the independence of

board members, having a formal succession plan in place, having a strategic plan that is consistent with the annual budget, and lastly, owing to the effects of the 2008 financial crisis on certain Mexican firms, the importance for the company's survival of identifying, managing, controlling, and disclosing the risks to which it is subject.

- (vi) Lastly, Mexican firms listed on the United States stock market through American Depository Receipts (ADRs) are subject to the corresponding regulation contained in the 2002 Sarbanes-Oxley Act³ (SOX), which was passed in the wake of problems caused by a number of large corporations (such as Enron, WorldCom, etc.) to protect investors from “corporate abuses”. Essentially, the SOX holds the management of the company responsible for the accuracy of the financial statements it presents.

3. Corporate governance standards in Mexico

As the second chapter of this volume describes corporate governance standards in relation to the board of directors and its corporate committees, the following paragraphs will outline the degree to which these are fulfilled, according to national legislation and the CMPC in Mexico.

They will also present the results of the survey of corporate governance in Mexico conducted by PricewaterhouseCoopers (PwC, July 2011), which was based on a survey of shareholders, board members, and directors of 72 companies, of which 23% were public (listed on the stock market) and 21% were from the financial sector.

The prevailing capital structure of firms in Mexico consists of family firms with ownership concentrated in a few hands (Viscencio, 2009). This has meant that the regulations and recommendations of the CMPC generate a significant bias, recommending, with certain nuances, practices which would be stricter in another business context.

(a) The role of the board of directors

- (i) The board of directors shall establish mechanisms to ensure the collection of timely and reliable information on all the investment (in financial and nonfinancial assets) and funding activities conducted by the company in its function in defining the firm's general strategy.
- (ii) The board of directors may delegate responsibilities and functions to board committees.

The corporate governance literature sees defining the firm's strategy as one of the most important functions of the board of directors.

Article 28 of the LMV states that one of the functions of the board of directors is to determine the firm's general strategies. Article 41 provides that oversight of the company is the responsibility of the board of directors, supported by two committees, the corporate practices committee and the audit committee, along with the external auditor.

For entities in the financial sector, the corresponding legislation requires a number of additional committees; for example, the communication and control committee (money-laundering) in lending institutions; the integrated risk committee; in pension fund managers (*Afores*), and risk committees in insurance companies.

Practice 7 of the CMPC recommends that the board of directors should define the strategic vision of the company; and practice 15 suggests that the board be supported in its functions by three committees: audit, compensation, and finance and planning.

³ The key points of the document are: (a) it prohibits the company from making personal loans to its directors; (b) Section 404 (2004) requires the company's annual report to be rated by the internal control structure and by the internal auditors; (c) directors must review and sign the annual reports and explicitly declare that the report does not contain false information or material omissions, that the financial statements adequately reflect the company's financial earnings, and that they are responsible for all internal controls; and (d) the annual report must list any shortcomings in the internal controls.

The PricewaterhouseCoopers study mentioned above, showed that of all firms surveyed, 94% have a board of directors, 80% recognize defining the firm's strategic vision as one of the board's strategic functions, 75% have committees related to audit, risk management, and compliance; and 57% have committees focused on functions related to corporate practices, finance and planning, or both.

(b) Structure of the board of directors

- (iii) The appropriate size of the board of directors must be such as to enable the board members to know each other, make contributions and take prompt and effective decisions. It will have between five and 15 board members, of whom over half should be outside, of these over half independent.

Article 24 of the LMV requires a maximum of 25 board members, of whom at least 25% must be independent. The description of the independence requirement contained in Article 26 of that law implies that being independent also means being outside, because the directors in question must not work in the firm or have economic or kinship links with the main directors and employees, or with persons related to their actions.

The Credit Institutions Law establishes that the number of board members must be between five and 15 members. In the case of *Afores*, the LSAR establishes a minimum of five board members of whom at least two will be independent; and if the number of board members is greater, the proportion of independent members must be maintained.

CMPC Practice 9 recommends that the board of directors consist of between three and 15 board members; and Practice 12 recommends that the independent board members represent at least 25% of total members. Its concept of independence also implies that they must also be from outside the firm.

The EGCM found that, of the total number of firms surveyed, the average size of the board of directors was 9.5 members, with 33% of them independent.

(c) Role of the board of directors

- (iv) The chair of the board of directors shall be an independent board member.

Given the family nature of firms in Mexico, the requirement of an independent outside board member is not explicitly stated in the regulations or proposed as a CMPC practice, which is clearly a "convenient" bias for the country's characteristic business culture.

In the aforementioned EGMC, the chairman of the board and the CEO are the same person in 42% of the firms in the sample. By type of firm, this situation is more common in public companies, particularly those that are also listed on foreign stock markets (60%).

(d) The selection of board members

- (v) The directors (both inside and outside) shall be selected on the basis of the value they can bring to the board of directors.

Article 26 of the LMV states that independent directors should be selected on the basis of their experience, capacity and professional prestige in the company's sphere of operations.

Serving as an independent director in financial institutions requires having prestige in financial, economic and legal spheres; and in the case of the *Afores*, also in social security. In addition, the directors' moral solvency and technical and administrative capacity need to be accredited.

CMPC Practice 14 suggests that the annual report to the board of directors should indicate the category of each director and mention each one's professional activities.

Once again, the family nature of companies in Mexico causes a bias in this standard. According to the EGCM, in 60.7% of the firms surveyed, the CEOs or their sons or daughters are major shareholders. Moreover, only 57.7% of the companies covered in the study report possessing an exhaustive definition of the profiles of their directors.

- (vi) The directors shall keep abreast of the needs of the company and its employees.

The directors should become involved in the company's strategic issues. CMPC Practice 19 recommends that directors have access to relevant information at least five working days before board meetings. Practice 20 recommends that when directors are first appointed, they be given the necessary information on the company's affairs. Lastly, Practice 22 recommends that directors who are also shareholders keep each other informed of the issues dealt with in the board meetings they attend.

On this point, technological progress would seem to make it possible to efficiently satisfy information needs, because the EGCM states that 85.4% of the companies surveyed have a reliable integrated information system.

(e) Outside directors

- (vii) Outside directors shall disclose to the board of directors any conflict of interest in relation to the company of which they are aware.

Article 26 of the LMV states that outside directors can fulfil their functions without conflict of interest and without being subordinated to personal, property, or economic interests.

Practice 22 of the CMPC recommends that the fiduciary duties of the directors should include notifying the board of any situation in which a conflict of interest exists or could arise, and refrain from participating in the corresponding discussions.

The EGCM revealed that only 58.5% of the companies surveyed reported that their board members issue or sign an annual letter recognizing potential conflicts of interest, or the absence thereof, as the case may be.

- (viii) The number of independent directors shall be equal to or greater than the number of other directors.

Articles 24 and 26 of the LMV describe the number of independent directors and their qualification requirements. It states that at least 25% should be independent. In financial entities, the proportion of independent directors is 40%.

CMPC Practice 12 recommends that independent directors should account for at least 25% of the total number of directors.

In the EGCM, the average proportion of independent directors in the company's survey was 33%, although only 59.2% provide the shareholders meeting with a signed statement on fulfilment of the independence requirement. Nonetheless, the figure is 85.7% in financial entities.

(f) Inside directors

- (ix) Inside directors shall sign affidavits making them legally and criminally accountable for the information they generate and disseminate, as well as for non-disclosure of information to the board of directors.

Article 31 of the LMV states that the information to be presented to the board by the relevant directors and other employees of the company should be signed by the individuals responsible for their content and preparation. Obviously, some of the inside directors will be relevant directors of the company, so the proposed standard is fulfilled in this respect.

In relation to their legal responsibility, Article 32 establishes the lack of due diligence of directors, which, in Article 33, implies responsibility for indemnification, as established in the Articles

of Association or by an agreement reached at the general shareholders meeting. In addition, Articles 34 to 36 list the reasons for disloyalty in which the directors could incur; and Article 37 establishes responsibility for compensating for damage and loss caused thereby, and possible dismissal from the post of those who committed the fault.

CMPC Practice 28 recommends that the financial information reviewed by the audit committee should be signed by the CEO and the director responsible for its preparation. Nonetheless, there is no mention of legal or criminal responsibility of the directors, because the code is not a law.

- (x) The audit director shall be a member of the board of directors and report directly to the board or to the audit committee.

Neither the LMV nor the CMPC require the audit director to be a member of the board; nonetheless, in *Afores* the comptroller (*contralor normativo*) is a board member with a voice but no vote.

(g) Audit committee

- (xi) The committee shall be chaired by an independent outside director with experience in internal control.
- (xii) The independent auditor shall be engaged by the committee and report directly to it.
- (xiii) The committee shall approve the internal and external audit programmes.
- (xiv) The committee shall be responsible for maintaining a system of timely generation of reports, especially on financial and risk control matters.
- (xv) The committee shall submit regular reports to the CEO and the board of directors on compliance with or violation of internal control policies.

LMV Article 25 establishes that the audit committee shall consist exclusively of independent directors, so the committee is chaired by one of them. Article 42 establishes the following as the committee's activities: evaluate the performance of the external and internal auditor; report to the board on the situation of the control and internal audit system, and investigate potential compliance failures among personnel who have knowledge of both.

CMPC Practice 15 recognizes that best corporate practices recommend the committee should consist exclusively of independent directors; nonetheless, it makes application of this conditional on the stage in which the company finds itself, so if we consider that a public enterprise is in a robust corporate governance stage, the recommendation applies to such firms. Practice 23 suggest that the committee should propose the conditions of contracting to the board and external auditor candidates, review the work programme, letters of observations, and internal audit report; verify observance of the mechanisms established for internal control, coordinating the internal auditor's tasks, and reviewing the work programme, letters of observations and internal audit reports, to ensure that the established internal control mechanisms are being observed.

The EGCM reports an average of 56.8% of independent directors on the audit committee of the companies surveyed.

LMV Article 42 establishes as activities of the audit committee, that of issuing an opinion on the report of the CEO regarding the advisability and sufficiency of the accounting policies and criteria, and whether this reasonably reflects the financial situation of the company. In addition, it will review reports relating to the preparation of financial information. Nonetheless, it does not explicitly require this committee to review risk control reports.

CMPC practices 23, 28, 30, 31 and 32 recommend that the audit committee give an opinion to the board on the policies and criteria used to prepare the financial information, validating its consistent application.

The EGCM shows that 85.4% of the firms surveyed have a business resources planning system, but only 56.9% have risk disclosure criteria (although the figure rises to 85.7% in the case of financial institutions); lastly, just 57.7% have a chart of indicators on the company's management.

Articles 42 and 43 of the LMV establish the following as audit committee activities: reporting to the board of directors on the situation of the internal control system and investigating potential compliance failures.

CMPC practices 33, 34 and 35 suggest that the audit committee submit for board approval the general guidelines of internal control and revisions thereof, as the case may be; support the board to ensure its effectiveness; and follow up on the letter of observations in relation to that control, in coordination with the internal and external auditors.

(h) Financial asset investment committee

(xvi) This committee shall be chaired by an independent outside director with experience in financial markets.

The LMV does not explicitly require the existence of this committee.

CMPC Practice 45 describes how the finance and planning committee functions in evaluating the company's investment policies. Practice 48 recommends that this committee should support the board in analysing cash and asset investment policies, ensuring that they are aligned with the strategic plan and the company's sector of business. While recognizing that best practices suggest that the committee should be chaired by an independent director, this is recognized as depending on the corporate governance stage of the company.

The EGCM shows that 60.8% of firms in the study replied that the committee involved in financial issues monitors and measures the return obtained from the investment projects in which the company participates. The percentage rises to 75% for financial institutions.

(i) Corporate finance committee

(xvii) The committee should be chaired by an independent outside director with experience in corporate finance.

(xviii) The committee shall rule on financing needs and mechanisms proposed by the CEO.

(xix) The committee must approve the selection and hiring of financial intermediaries required by the company for the placement of financial securities issued by it.

The LMV does not explicitly require the existence of this committee.

The CMPC, while recognizing that best practices suggest that the committee should be chaired by an independent director, this is recognized as depending on the company's corporate governance stage. Practice 45 describes evaluating the company's financing policy as a function of the finance and planning committee. Practice 48 recommends that this committee support the board of directors in analysing policies on the contracting of derivative products and liabilities, and ensuring that they are aligned with the strategic plan and the company's sector of business.

(j) Risk committee

(xx) The committee shall be chaired by an independent outside director who has experience in comprehensive risk management.

(xxi) The committee shall rule on the reports of financial risks of the company's portfolio of investments and debt security issues.

The LMV does not explicitly require the existence of this committee. Nonetheless, for financial institutions, particularly credit institutions, *Afores* and insurance companies, this committee is required.

CMPC Practice 50 recommends that the finance and planning committee assist the board of directors in evaluating mechanisms for the identification, analysis, management, and control of risks to which the company is subject; and Practice 51 recommends that each board meeting receive a report on the situation of each of the risks identified. It suggests that the committee be chaired by an independent director, although this will depend on the company's corporate governance stage.

(k) Evaluation of board performance

(xxii) An annual formal and rigorous evaluation must be made of the performance of the board of directors, its corporate committees, and the directors individually.

The LMV does not mention this point. Nonetheless, CMPC Practice 22 recommends setting up a mechanism to evaluate the director's performance and fulfilment of fiduciary responsibilities and duties.

The EGCM revealed that 51.5% of the companies surveyed have a development plan aligned with the evaluation of the directors' performance; and 53.1% have a mechanism for evaluating the directors' performance and fulfilment of fiduciary duties and those of the corporate bodies on a collegiate basis.

In short, although the legal framework and the code, on which most corporate governance activity in Mexico is based, is among the most advanced of Latin America and covers a large part of the activities of the different organizations or mechanisms involved, in relation to the support activity of the financing and risk committees (fundamental for the issuance of debt instruments) there are broad areas of opportunity as shown by the universe of firms surveyed in the EGCM.

A point to stress is the bias in the legislation and the CMPC towards respecting the family-based business tradition in relation to the demands of corporate governance standards. This means there will be a large proportion of companies in which the chairman of the board and CEO are the same person, and where most board members are family. This situation discourages the formation of managerial talent and raises the cost of financing within the organizations.

Progress in corporate governance through the legal channel could possibly be complemented with an incentive schemes such as Brazil's *Novo Mercado* [new market], to stimulate additional progress on corporate governance standards and overcome the influence of family structures, thereby improving business management in Mexico.

Lastly, this requires the professionalization of directors, particularly independent ones, and also an improvement in their remuneration.

Participation on multiple boards should also be restricted (according to the EGCM, in Mexico the average number of participations 10 to 15, whereas in other countries it is just between three and eight), to optimize the functioning of the committees on which the presence of independent directors is crucial, such as those involving debt issuance.

D. CEMEX case study

1. Introduction

CEMEX is a company serving the construction industry. It is integrated in all chains of the process of cement, aggregates and other construction materials; in other words it participates in production, distribution, marketing and sales. It was founded in 1906, became a publicly traded company in January 1976, and has been quoted on the New York stock exchange through ADRs since September 1999.

CEMEX has grown from being a local business to one of the leading companies in the sector (the third largest) worldwide. In December 2010, it had a presence in over 50 countries in America, Europe, Africa, the Middle East and Asia; and it maintains commercial relations with some 100 countries throughout the world. It generated over 50,000 jobs and obtained annual revenues on the order of 15.5 billion peso.

2. Corporate governance

As a result of being traded on the stock markets of Mexico and the United States, it has established governance standards according to the Mexican and North American regulations.

In particular, as it is a publicly traded company (SAB), the CNBV requires it to comply with the specific corporate governance guidelines set forth in the LMV. In addition, it has adopted the corporate governance practices of the 2002 SARBOX Act and its later amendments in the United States.

The following paragraphs make a comparison of the standards proposed at two points in time, late 2008 at the start of the financial crisis and late 2010, with the aim of detecting critical points in the situation which the company lived through following September 2008.

The source of the analysis consists of questionnaires on compliance with corporate governance principles delivered to the CNBV, together with the company's annual reports. The 2008 column only mentions events that are different from current ones.

Role of the board of directors	
2008	2010
The information was only validated for reliability. Audit, corporate practices, and finance committees consisted of directors of the firms and reported directly to the CEO.	The board is responsible for overall supervision of CEMEX operations, including the functions defined in Article 28 of the LMV, particularly in terms of defining the strategy and appointment of the CEO. Since 2010, a system has been in place to ensure that relevant information reaches senior management on a timely basis. Currently the board of directors is based on three committees. The audit committee, the corporate practices committee and the finance committee. These are delegated the functions of internal control and audit, contracting and compensation of the CEO and relevant directors, and the company's financial strategy.
Structure of the board of directors	
2008	2010
	CEMEX had 13 shareholder directors, of whom six are related and seven independent (54%), in addition to four alternates.
Role of the chair of the board of directors	
2008	2010
	The chair of the CEMEX board of directors has also been the company's CEO and main shareholder since its creation
Selection of directors	
2008	2010
	An independent director (member of the audit committee) fulfils the requirements of "financial expert". An understanding of generally accepted principles of accounting and financial reporting. (a) Experience in: preparation or audit of financial statements by comparable issuers; and in the application of accounting principles. (b) Experience in internal accounting controls. (c) Understanding of the functions of the audit committee.

Selection of directors	
2008	2013
The directors could request information and clarify either before or after each board meeting; nonetheless, they did not necessarily have access to relevant information five days before the meeting.	Since 2010, its annual report has announced the implementation of the system for supplying relevant information to the CEO, who is also board chairman. The other directors occasionally receive information on critical issues for discussion at board meetings.
Outside directors	
2008	2010
	The corporate governance questionnaire that CEMEX submitted to the CNBV reported that the directors notify the chairman of the board and secretary of any conflict of interest, and refrain from voting in the situations in question. The number of independent directors represented 54% of the total board.
Inside directors	
2008	2010
	CEMEX fulfils Article 404 of the SARBOX Act, which guarantees that the financial reports are signed by the CEO and the persons responsible for preparing them. The audit director is not a member of the Board.
Audit committee	
Pre-September 2008	2010
There is only an audit committee and a corporate practices committee. Only the evaluation of external auditors is delegated. No mention made of risk control	Independence of the audit committee and the corporate practices committee. The criterion of independence of the chair is not fulfilled in the audit committee and finance committee under the terms required by the LMV and CMPC. The evaluation and contracting of the external auditor is delegated to the audit committee. The audit committee is responsible for evaluating the internal control and internal audit system, as well as management of the external auditors, both in their audit function and in additional services provided to the company. The audit committee monitors the measures adopted in relation to observations made by auditors on the accounts and external and internal audit, although no emphasis is placed on risk control. The audit committee is delegated the monitoring of observations on the internal control system, along with any other complaint related to irregularities of the management team. There is a specific report on internal management of information presented in the financial reports which includes the approval of external auditors on the internal control relating to financial reports. The audit committee prepares an annual report for the board and shareholders meeting.
Financial asset investment committee	
2008	2010
The finance committee was chaired by a manager and not a board director, and reported directly to the general management. The risk management and steering committees were responsible for evaluating and ensuring the consistency of the company's investment policies and strategy.	The finance committee defines the financial strategy and is chaired by the same "independent" director as chairs the audit committee. In 2010 processes were put in place to detect misuse of the company's assets on a timely basis.

Corporate finance committee	
2008	2010
The finance committee was chaired by a manager and not a board director, and reported directly to the general management. The risk management and steering committees were responsible for evaluating and insuring the consistency of the company's investment policies and strategy.	The finance committee responsible for the strategy and evaluation of the financial structure of the company, chaired by the same "independent" director who chairs the audit committee.
Risk Committee	
2008	2010
To manage the financial risks, the risk management committee was set up, formed by the Executive Vice President of Planning and Finance, the Executive Vice President of Administration, the Vice President of Corporate Finance (CFO) the Corporate Director of Finance, North American and Trading presidency, the South American and Caribbean Presidency, and by the European, Asia and Africa Presidency.	The risk committee exists as an operational committee and not as a corporate committee. It meets every two months and focuses on monitoring the financial risk parameters of the derivatives portfolio. Consisting of the Executive Vice President of: Planning and Finance, Administration, Organization and Human Resources, Corporate Finance (CFO) and by the Corporate Oversight Director. The finance committee is responsible for analysing the risks related to the company's financial structure (those related to volatility of interest rates and currency), is chaired by the same independent director as chairs the audit committee, based on the Risk Management Committee. It is also responsible for the analysis of risks associated with interest rate and currency volatility.

Source: Prepared by the author.

3. The 2008 financial crisis and its effects on the financial situation of CEMEX

Until 2007, the growth of CEMEX was unprecedented, both organically and in terms of international presence. In 1987 it acquired Cementos Anáhuac, and in 1989 it took over Cementos Tolteca. In 1992 it entered international markets by acquiring assets in Latin America and Southeast Asia. In 2005, the company acquired the British enterprise RCM, and in 2007 it absorbed the Australian company Rinker, which had strong positions in the United States housing market, specifically in Florida and Arizona.

At the end of 2006, CEMEX was considered one of the Mexico's leading enterprises in terms of absolute sales growth (sixth), and out of profits (fourth), and in profit growth (15th); but its asset growth and corresponding leveraged prevented similar performance in the profitability indicators (*Expansión*, 2007).

The growth of CEMEX assets was based on higher leverage, particularly for the acquisition of Rinker (US\$15.3 billion) raised the main long-term solvency indicators as from 2007. CEMEX became the private company with the highest debt in Mexico.

When CEMEX is compared with the world's leading cement companies (table VII.1), it can be seen that its leverage indicators are very similar to those of its main competitors. The problem was in the generation of cash flow to service the debt.

In fact, the initial strategy to meet its growing obligations was to sell assets in Spain, the United States, Austria and Hungary to the Irish cement company CRH. Nonetheless, with a financial crisis that originated in the real estate sector of the United States in 2008, sales shrank and the agreements reached with CRH could not be carried out.

Table VII.1
Comparison of cement manufacturers

Ratio	2008			2010		
	CEMEX	HOLCIM	LAFARGE	CEMEX	HOLCIM	LAFARGE
Debt/Capital	1.1	1.04	1.27	0.96	0.70	0.95
Debt/Assets	42.23	41.27	45.86	39.76	33.32	40.66
Assets/Capital	2.63	2.51	2.77	2.41	2.10	2.33
EBIDA/Interest	4.49	5.32	4.47	1.80	5.33	4.00
ACP-INV/CP liabilities	0.21	0.62	0.44	0.37	0.83	0.68
ROE	1.29	10.44	13.37	-8.10	6.37	5.31

Source: Prepared by the author on the basis of information from Bloomberg.

CEMEX's share price plummeted by around 80% in the space of a year, and the company embarked on a financial restructuring process that involved lengthy negotiations with its creditors (70 banks and 25 private creditors).

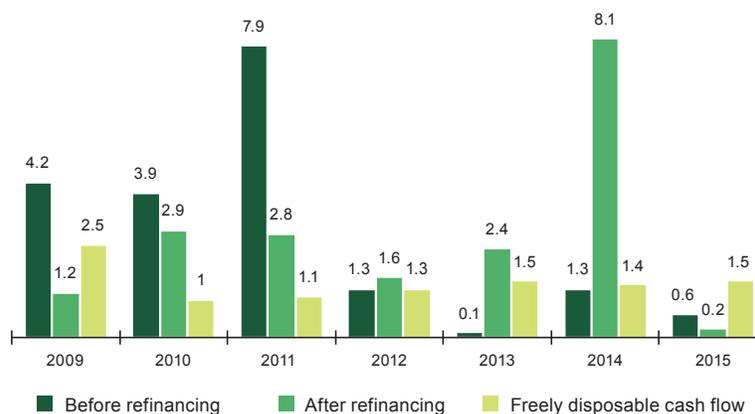
The company's long-term solvency problems became short-term liquidity problems.

In this situation, the Mexican financial authorities supported CEMEX. The most critical moments came after the bankruptcy of Lehman Brothers in the United States, and there were fears for the bankruptcy of large companies in Latin America. The Nafinsa development bank provided a 50% guarantee for the placement of the company's short-term bonds to overcome its immediate liquidity needs.

The CEMEX plan of action (August 2009) meant a series of agreements to restructure debt of roughly US\$15 billion, including the following:

- (i) Recapitalization of the company in September 2009. A total of US\$1.8 billion in shares was issued in November of that year, and US\$800 million in debt was swapped from convertible bonds into shares.
- (ii) Cost reduction amounting to US\$900 million per year. Sales and administrative costs declined by 8.8% (US\$1,345 million) in 2009, and by an additional 8% (US\$1,178 million) in 2010.
- (iii) Sale of assets and no new projects investments until 2013. Since 2008, CEMEX has sold its plants in the Canary Islands for US\$227 million. In 2009 it decided to sell its plants in Australia, for US\$1.7 billion.
- (iv) Restructuring of debt maturities signed in August 2009, enabling it to gain time to pay amounts owed, as shown in figure VII.1.

Figure VII.1
CEMEX debt, 2009-2015
(Billions of dollars)



Source: Prepared by the author on the basis of information from Expansión.

In terms of the effects of this process on CEMEX prestige, statements by the company's CEO and board chairman demonstrate the importance of having an efficient corporate governance structure to avoid these effects.⁴

4. Debt issuance in the problem faced by CEMEX

As noted above, the CEMEX growth model was based on relatively low-cost short-term credit, and high profit-growth expectations to amortize the debt.

The period 2006-2009 demonstrated the most impressive amounts of long-term bond issues on international markets (22,629 million pesos, US\$4 billion and 1,630 million euros). As from 2009, its critical financial situation after restructuring caused the high spreads that CEMEX had to pay, resulting from a substantial downgrade in the risk rating of its bond issues and compounded by the impossibility of flotation on the Mexican market as a result of corporate restrictions.

The effect of the crisis on CEMEX shares also was reflected in the price on secondary debt markets.

In this financial restructuring process, the loss of value for shareholders was substantial. The share price in 2012 was almost at the same levels as in the most critical stage of the financial problems in late 2008. Its results in terms of cash flow continued to be unfavourable, because recovery in its main markets (Mexico, the United States and Spain) remained weak.

Lastly, the problems that CEMEX had to face after the financial crisis of 2008 were to: (a) establish a business model for global growth, in an excessively leveraged scenario, and the context of sustained economic growth which suffered a significant slowdown in 2009-2010; (b) define a growth strategy for integrated countries (Mexico-United States) which, on falling into recession, affected a major part of the company's revenues.

These two problems partly relate to the corporate governance structure and its implementation because:

- (i) Defining the strategy is a function of the board of directors, but when the CEO is both owner and board chairperson, it is difficult to present realistic alternatives that counter the inertia of previous results.
- (ii) The problem is worse if the board of directors maintains a concept of director independence which does not respect kinship restrictions.
- (iii) The intermediate bodies (corporate committees) of corporate governance did not appear structurally, and with "some real support for the board of directors", until 2010. These include the possibility of foreseeing potential problems for the company in its strategic decisions.
- (iv) Excessive leverage for financing investment projects and increasingly risky growth in the context of a deteriorating global economy is a clear example of the agency problem between shareholders and creditors.

The rethinking of CEMEX strategy after 2011 meant renegotiating its Net Debt/ EBITDA ratio (7.75x). To improve its maturity profile, US\$1 billion in secured senior notes were issued, along with subordinated convertible notes in the amount of US\$1,667 million. The proceeds of these issues were used to pay bond certificates maturing in 2011 and 2012. CBs were issued that put accounts receivable on the stock market.

⁴ "... we did not see the crisis coming, we always wondered what would happen if there was a crisis, would we survive or not? But we did not imagine that the markets would seize up (*Expansión*, July 2009). On the purchase of Rinker, "... it was a very good deal, what was not good was the financing, we should have financed more with equity and taken on longer term debt ... it would have been more expensive financing but much more conservative" (*Expansión*, July 2009).

Nonetheless, all of that represented an effort to gain time to enable the company to restore its cash flow, and in the short term achieve economic recovery. In corporate governance terms there has been no progress, despite being a SAB quoted in the United States, with a still family-based operating mode.

E. Controladora Comercial Mexicana (COMERCI)

1. Introduction

Comercial Mexicana is a holding company that has operated in Mexico's retail sector since 1933. It has 232 stores distributed throughout national territory (80% of them in the centre zones and Mexico City). It has nine store formats, Comercial Mexicana, Mega, Cotsco, Bodega Comercial Mexicana, Sumesa, City Market, Fresko and Alprecio. It owns 50% of Cotsco México and operates a chain of 75 family restaurants under the California and Beer Factory brands.

As of December 2010, COMERCI had sales of 55,717 million pesos, generated 38,930 direct jobs, and had a portfolio of around 4,000 suppliers. Its shares have been traded on the Mexican Stock Exchange since April 1991.

2. Corporate governance

As COMERCI is a publicly traded company (SAB), the CNBV requires it to fulfil the specific corporate governance guidelines set forth in the LMV. It also adopted the corporate governance practices of the CMPC and CEE.

The following paragraphs make a comparison between the standards defined at two points in time—in late 2008 with the financial crisis and again in 2010. The aim is to identify critical points of the company's corporate governance after September 2008, and the impact on its corporate governance.

Owing to the financial restructuring of the company, which ended in its filing for insolvency in 2009 and 2010, the sources of the analysis are the corporate governance questionnaires of before 2009 and the 2010 annual financial and social accountability reports.

Role of the board of directors	
2008	2010
There was no specific body for this board function. The only bodies supporting the board of directors were the corporate practices committee and the audit committee.	The board has the functions, duties, and powers defined in Article 28 of the LMV. These include the definition of strategy and appointment of the CEO. It is supported by a collegiate body (the executive committee) consisting of board members, the functions of which are to review the corporate strategy approved by the board. The board of directors is supported by three committees. The audit, corporate practices, and executive committees. The board delegates the following functions to those committees: internal control and audit and evaluation of external auditors; contracting, compensation and evaluation of the executive staff and the firm's strategy.
Structure of the board of directors	
2008	2010
The board consisted of 12 shareholding directors and 12 alternates. Three (25%) of the shareholding directors were independent.	The board of directors has 13 shareholding directors, of whom five are related and four are independent (31%); there are also 10 alternates—fewer than proposed by the indicator.

Role of the board chairperson	
2008 The chair of the board of directors is the company's main shareholder.	2010 The post of honorary chair of the board of directors was created, held by the company's main shareholder. The chair of the board is the son of the honorary president and CEO, with kinship links.
Selection of directors	
2008	2010 The audit and corporate practices committees are chaired by experts in finance and human resources, although seven of the directors are close family members, which undermines the selection objectivity criterion.
2008 The 2008-2009 crisis showed that the directors were not duly informed of the activities of the financial area.	2010 The practices adopted by the board in 2010 include the need for directors (both shareholders and alternates), to be kept informed on the issues addressed in the board meetings they attend. Basically because of the implications of engaging in financial activities that do not pertain to the company's business sector.
Outside directors	
2008 Independent directors account for 25% of the total.	2010 Directors must notify the chairperson and other board members of any situation in which a conflict of interest exists or could exist, and refrain from participating in the corresponding discussions.
Inside directors	
2008	2010 There is no reference to the requirement for the company to hold inside directors legally and criminally accountable. The corporate audit area supervises fulfilment of the ethical code and proposes sanctions according to the infringement in question. In addition, there is a disclosure committee which is responsible for certifying the financial information issued to third parties. The audit director reports directly to the board chairperson (although he/she is not a board member) and to the audit committee.
Audit committee	
Pre-September 2008 There was no risk monitoring. The internal control system did not require board approval. Nonetheless, in 2004 the internal control framework was implemented in accordance with the COSO model (business processes) and COBIT model (information technologies).	2010 The audit committee is chaired by an independent director considered to be a financial expert. All members of the committee are independent directors. The board evaluates and recommends the contracting of the external auditor to the audit committee The audit committee gives its opinion to the board on the policies and criteria used in preparing the financial information and its reports. The corporate audit unit has a programme to review business processes which includes risk monitoring, which reports to the board and to the audit committee. The audit committee helps to the general internal control guidelines and evaluates their effectiveness. It is also responsible for the annual report to the board and to the shareholders meeting.

Financial asset investment and corporate financing committees	
2008	2010
There was no intermediate body (corporate committees) dedicated to investments. The finance area was responsible for advising board members on investments, corporate financing and the use of financial derivatives.	The executive committee evaluates the company's investment and financing policies. Nonetheless, it is not chaired by an independent director, although it forms part of the board.
Risk committee	
2008	2010
To safeguard the company's capital, the financial strategy was prepared by the finance area. The risk committee (consisting of staff from the finance area, including treasury) reported directly to the CEO.	General management presents mechanisms to the board for identifying, analysing, managing and controlling the company's risks, for its evaluation. These mechanisms are prepared in the finance area. There is no intermediate body such as a risk committee.

Source: Prepared by the author.

3. The 2008 financial crisis and its effects on the financial situation of COMERCI

In September 2008, COMERCI had implemented a business plan based on strengthening its presence in the retail market (it had the second largest market share after Wal-Mart México) and it successively entered the convenience store segments (City Market) and restaurants targeting the middle-income (Restaurantes California) and high-income (Beer Factory) consumption segments. In addition, with Cotsco de México, which was the market leader among membership stores, it had established a successful partnership with its United States counterpart.

The financial crisis changed the outlook radically. The main problem was speculation with derivative products outside COMERCI's main line of business, which led to the "bankruptcy of the company" and to a request to restructure its debt following nearly two years of intensive negotiations in insolvency proceedings, which was agreed to by its creditors.

The problem was that, engaging in operations with derivatives betting on a strengthening of the peso, the cash flow of the holding company exceeded the amount strictly needed to cover its risk position resulting from normal operations, and it did so by using structures which firstly obliged it to honour its short-term position and secondly meant a larger loss of potential profits should the exchange rate move in the wrong direction.

In fact, with the bankruptcy of Lehman Brothers and the consequent increase in risk aversion for international capital flows, the currencies of emerging countries were heavily affected, including the Mexican peso which rose from levels close to 11 pesos per dollar to about 15 pesos per dollar in less than a month. The positions held by COMERCI rapidly generated a loss of nearly US\$2 billion. In October 2008, the firm decided to apply for bankruptcy proceedings in respect of the holding company, but not for its subsidiaries, as a way of dealing with its creditors after failing to meet the corresponding bond coupon maturities.

The reasons underlying the company's lack of solvency increased significantly in 2008, exceeding the company's capital levels, and with a leverage multiplier in excess of 3.40 when, in previous years it had been falling and at levels close to 1.80.

The insolvency application was initially rejected, because the company filed for bankruptcy on the grounds of losses caused by operations with derivatives, but it wanted to reserve the right to not recognize their validity.

The effects for the investors (shareholders and bondholders) of this situation were catastrophic. The company's share price plummeted to below one peso, and bond coupons were defaulted on during the period (from October 2008 to August 2010), which forced the company to negotiate with its creditors.

The alternative was to seek a Pre-agreed Insolvency Proceeding with the creditors, a scheme that was added to the corresponding law in December 2007. Lastly, in August 2010, the application for insolvency was accepted, supported by 90% of its creditors.

In November 2010, COMERCI exited insolvency proceedings with a debt of US\$19,247 million, and the following agreements:

- (i) The holding company would pay for the delivery and exchange of new bank and stock market debt instruments amounting to 19,247 million pesos;
- (ii) A cash payment had to be made of US\$45 million.
- (iii) The negotiation of two credit lines for Comer, Cotsco or Restaurantes California, of 3,644 million pesos.
- (iv) A contribution from the NAFINSA development bank of 3 billion pesos for a trust fund to pay suppliers, guaranteed by the assets of the real estate firms owned by the holding company and its subsidiaries.

The company's liquidity situation during the two years of negotiations with the creditors was very critical, as the financial liquidity/working capital ratio fell to levels close to zero, according to Bloomberg figures.

The company's solvency and liquidity indicators compared to its main competitors in 2010 displayed extremely high levels of leverage and extremely low liquidity indicators.

COMERCI represents an extreme case of an agency problem between shareholders and creditors.

It is hard to determine exactly whether the company's treasurer acted without informing the board of directors. Nonetheless, the fact that, since 2007, the company's financial statements displayed significant profits on operations with derivative instruments (roughly US\$300 million) and that the hedging of its risk positions in 2008 did not imply an operation on the scale with which it eventually acted with the banks involved, shows that it was no secret. Possibly, in the final implementation, there was excessive use of discretion that was not so great for an employee of 15 years' service in the company.

The experts classified the case as a clear failing in the implementation of corporate governance principles (*Expansión*, December 2008), and the authorities viewed it in terms of a firm that had engaged in operations outside its line of business.

In late 2008, the company reported (Social Accountability and Sustainability Report, 2010) an intention to strengthen its corporate governance standards, and it obtained strong operational earnings results in the first half of 2011. Nonetheless, it still had a large debt, so its strategy was to sell non-strategic assets and use its cash flow to reduce the outstanding balance.

F. GFNorte

1. Introduction

Grupo Financiero Banorte (GFNorte) was created following the legislation on financial groupings in July 1992, and was first quoted on the BMV in October that year. At the end of 2010, it had assets worth US\$590 billion, 1,117 branches and roughly 20,000 employees. Its main subsidiary, Banco Mercantil del Norte (Banorte), accounted for 96% of those assets, and the size of its credit portfolio ranked it sixth in the country's banking system.

GFNorte is a holding company for shares of firms that provide financial services, namely Banco Mercantil del Norte (a lending institution), Afore Banorte Generali (a retirement savings manager), Pensiones Banorte Generali (a pensions manager), Seguros Banorte Generali (insurance company), Banorte Casa de Bolsa (stock brokerage), Arrendadora y Factor Banorte (leasing and factoring) and Almacenedora Banorte (warehousing). In addition, in 2006, it paid US\$259 million for 70% of INB Financial Corp, a subsidiary of Inter National Bank in the United States.

2. Corporate governance

Unlike the previous two cases (CEMEX and COMERCI) GFNorte has a reputation on the market as a company with a solid corporate governance structure.

A July 2011 study by Morgan Stanley defined it as one of the publicly traded companies with the best corporate governance, which supported a rising trend in its share price over the last few years. Between 2009 and 2010 (in the midst of the crisis) it grew by 310%.

Partly as a result of astute strategic decision-making, the recruitment of its managers and directors, and the progress made in its corporate governance, GFNorte was able to make progress in its operational level and gain recognition from its creditors, depositors and investors.

The recent-years progress of its corporate governance, both of the group as a whole and its main subsidiary (Banco Mercantil del Norte), is reflected in the results of the application of the proposed standard. The source of analysis are the questionnaires on compliance with corporate governance principles that are delivered to the CNBV and its annual reports.

Role of the board of directors

As GFNorte is an SAB, its board of directors fulfils the functions specified in Article 28 of the LMV, specifically the definition of the strategy of the financial group and its subsidiaries. It is supported by the management committee, the objective of which is to take decisions on strategic issues and follow-up on the most important matters for the performance of the group and its subsidiaries. The committee consists of the board chairperson, the CEO of the group, the director-general of the bank, and the alternate CEO on the board of directors.

The board of directors delegates responsibilities to the audit and corporate practices committee, the risk policies committee, the remuneration committee and the management committee.

In addition, the general management of GFNorte is based on 12 committees, operation, technology and investment, security, credit rating, credit recovery, assets and liabilities, money market and treasury, investments in financial instruments; communication and control, fiduciary businesses, investment projects and integrity.

Structure of the board of directors

GFNorte has 16 directors, of whom four are shareholders, three related and seven independent (44%); there are also 13 alternates.

Role of the chair of the board of directors

GFNorte is one of the few corporations that is listed on the stock market and has an outside and independent board chairperson.

Selection of directors

Over the last few years the selection of outside directors has been characterized by recruiting important ex civil servants, the most relevant case being the board chairperson (a former central bank governor). In addition, its CEO and at least three independent directors previously held posts as secretary and/or president of the CNBV.

The agenda for each board meeting is distributed to board members at least five days in advance, which does not mean that they cannot gain access to information they deem appropriate.

Outside directors

The directors notify the board of any situation in which a conflict of interest exists or could exist, and they refrain from participating in the corresponding discussions.

The number of independent directors represents 44% of the total number. Including shareholding directors, the percentage rises to 60%.

Inside directors

It is not explicit whether the inside directors sign as responsible for the information they disseminate, although, for the CEO, the reliability of information used in the annual report is validated by the external auditor.

The Director-General of Audit is not a board member, although he/she does maintain communications with the audit committee. There is no mention as to whether he/she reports to it.

Audit committee

The audit and corporate practices committee is chaired by and comprised entirely of independent directors.

One of its functions is to propose the contracting of the external auditor and approve the internal and external audit programmes.

Its responsibilities include:

- (i) Requesting from managers and other employees of the company and its subsidiaries reports on the preparation of financial information and any other type it deems necessary.
- (ii) An opinion on the report of the CEO on the performance of the company and its subsidiaries; on accounting policies and criteria, their consistency and the reasonableness of the financial information.
- (iii) It is responsible for reporting the performance appraisal of relevant managers.

The committee prepares an annual report on the status of the internal control system.

Financial asset investment committee and corporate financing committee

The board of directors approves the investment and financing programme every year. There is no corporate committee responsible for this. Independent directors are not involved in pre-authorization tasks.

The General Directorate of Planning and Finance (DGPF) presents the strategic basis for long-term planning and its periodic evaluation for board approval, through the CEO.

The policies presented by the CEO to the board on cash management, the contracting of financial derivative products, investment in assets and contracting of liabilities are prepared by the DGPF, supported by the money market and treasury committee, the financial instrument investment committee, and the assets and liabilities committee.

Risk committee

As a financial institution, GFNorte is governed by specific regulations in terms of financial and operational risks, which cover the subsidiaries, the credit institution, the *Afore* and the insurance company.

GFNorte is supported by an intermediate risk policies committee, chaired by an independent director with seven members, three independent directors, the CEO, three managers (of *Afore*, global markets, and leasing and factoring). The secretary is the director-general of risk management.

The committee manages the risks of the institution and its subsidiaries; and, among other functions, it proposes policies on integrated risk management and the global limits for different types of risks, to the board.

The DGPF, in coordination with the DGAR, evaluates the risks faced by the company and presents them for consideration by the risk policies committee, for its authorization.

Risk parameters are determined using financial simulation models; and the main mechanisms for the evaluation and control of the risks of investments and financing is managed through the risk policies committee, the credit committees, the assets and liabilities committee, and the investment committee.

Source: Prepared by the author.

3. The 2008 financial crisis and its effects on the performance of GFNorte

The 2008 crisis affected some financial institutions directly (owing to their position in United States mortgage-backed instruments), and others indirectly owing to their credit exposure to cyclical sectors in a context of economic recession.

In the case of GFNorte, its debt management was extremely prudent, and it delayed its acquisitions until moments that were advantageous in terms of price and/or economic context.

Its long-term solvency ratio rose sharply in 2008 from 1x to 6x, but thereafter it trended down towards its 2002 levels. Its leverage measured by the multiplier was also prudentially reduced after 2008.

Compared to the other financial group listed on the BMV, GFInbursa, table VII.2 shows that there are significant differences in their debt indicators; but these are explained by the acquisitions that GFNorte carried out between 2008 and 2010. Nonetheless, the trend is downward, without a significant reduction in profitability.

Table VII.2
Comparison of financial companies

Ratio	2008		2010	
	BANORTE	INBURSA	BANORTE	INBURSA
Debt/assets	43.33	0.85	37.76	4.90
Assets/capital	14.52	4.18	11.76	3.88
ROE	19.78	7.34	15.33	12.03

Source: Prepared by the author on the basis of information from Bloomberg.

The company's exposure by economic sector displayed management guided by diversification criteria; in December 2008 just 21% of the active portfolio was targeted on the corporate sector, and by 2010 this proportion had fallen to 18%. In terms of credit by economic sector in the same period, just 27% was in the construction and automotive sectors, those most affected by its operational leverage.

The company's market share remained virtually unchanged with an overdue portfolio index below the market average.

Beyond the commonplace that a crisis is an opportunity, during the period 2008-2010 GFNorte increased its professionalization and corporate positioning significantly, in a business climate that was complicated not only at the domestic level, but also and particularly on global markets. In that context, the company's progress in terms of corporate governance has been a difficult factor to evaluate, but it cannot be avoided.

- (i) Its corporate governance represents a model which, exploiting the contributions of the CEE and LMV, has represented a substantial advance in terms of the "Mexican business culture", biased towards a family-business approach.
- (ii) For GFNorte and its subsidiaries, the committees supporting the board (such as the risk committee) are extremely important in the results of the company's assets and liabilities exposures.
- (iii) The opportunity for organic business growth has been exploited in different segments. In 2009, GFNorte acquired the pension fund managers *Afore Ixe*, *Ahorra Ahora* of the *Monex* group and *Afore Argos*, thereby increasing its market share ranking from 10th to seventh in that segment. In 2011 also it merged with the *IMSS Afore*, which moved it into fourth place in the market in terms of assets under management, and first when measured by number of affiliates.
- (iv) In March 2011 Banorte merged its banking business with Banco Ixe, and it is currently ranked third, behind only Banamex and BBVA.

G. Petróleos Mexicanos (PEMEX)

1. Introduction

Petróleos Mexicanos (PEMEX) is Mexico's leading State-owned enterprise. It was created in 1938 as a result of the nationalization of the foreign companies that were operating in the country. It took over the activities exploration and drilling for oil, together with other hydrocarbons and basic petrochemicals.

It has four subsidiary organizations which, like PEMEX itself, are decentralized agencies of the federal government. These are: PEMEX Exploración y Producción (PMEP), PEMEX Refinación (PMR), PEMEX Gas y Petroquímica Básica (PMGPB); and PEMEX Petroquímica (PMPQ). It also has several affiliated companies, of which the most important is Pemex Internacional (PMI).

In December 2013 an energy reform was passed, with objectives that include allowing national and foreign private investment in the oil sector. This change turned Pemex into a productive enterprise owned by the State, with capacity to compete globally in refining, petrochemicals, and hydrocarbons transportation.

At the end of 2013, PEMEX had consolidated assets amounting to 2,041.1 billion pesos, with sales of 1,608.2 billion pesos, generated by about 140,000 workers. Its capital (equity) in 2013 was negative to the extent of 185.8 billion pesos. On this point, it is important to note the role played by the company's income in terms of its contribution to public revenues, which systematically causes the company to report negative earnings and thus gives rise to the aforementioned depletion of its capital.

The income earned by PEMEX and its subsidiaries has played an important role in generating resources for the public sector through duties and taxes which continually absorb more than 100% of its profits. For example, in 2013, the company made a pre-tax profit of 695.9 billion pesos, but taxes and duties on the order of 865.0 billion pesos meant its net profit was negative in the amount of 169.1 billion pesos.

Until 2008 investment funds available to PEMEX and its subsidiaries depended on the availability of resources in the public budget. Following the oil reform of 2008, the federal government promulgated changes in the PEMEX tax regime, aimed at strengthening the company's finances. The most important of these involved excluding the investment expenditure of the company and its subsidiaries from public finance accounting, to enable the company to manage its investment decisions more independently, and outside the federal government's budgetary targets. Nonetheless, the payment of taxes through oil revenues remains a major burden on the company's finances, representing roughly one third of all public-sector tax revenues.

2. Corporate governance implications of the 2008 oil reform and the 2013 energy reform

In 2008, the Senate passed the Petroleum Reform tabled by the government with the aim of strengthening the corporate governance, finances and operations of PEMEX and its subsidiaries. Five years later, in December 2013, the Energy Reform was passed, which includes the Federal Electricity Commission and PEMEX.

In the 2008 reform, the political interests of the different parties in the Senate prevented the reform affecting significant aspects of PEMEX operations and its possibilities for partnering private-sector firms; nonetheless, important contributions were made in terms of corporate governance. This represented a significant step forward in the attempt to align PEMEX and its subsidiaries more closely with the international practices of the OECD (2005).

In contrast, the most important contributions of the Energy Reform occurred in terms of the partnership with private firms for exploring and drilling for hydrocarbons, which entailed changes to the Political Constitution of the United Mexican States.

In general terms, the 2008 reform established the following points:

- (i) Planning and budget. The reform sought greater operational autonomy for PEMEX and its subsidiaries.
- (ii) Financing. PEMEX could seek international financing alternatives consistent with the public debt and without compromising the country's hydrocarbon resources. In addition, it was authorized to create Citizen Bonds —PEMEX debt securities, with a yield linked to its financial performance, and which could be purchased by the domestic investor public.
- (iii) Tax regime. The investment expenditures of PEMEX and its subsidiaries were excluded from the public finance records, and the rates of duty on hydrocarbons were lowered.

- (iv) Drilling and exploration. Technical strengthening of the activities of drilling and exploration by creating the National Hydrocarbons Commission (CNH), an autonomous body of the SENER, with the aim of regulating and supervising the exploration and production of hydrocarbons, aligned to best international practices. Contracts containing incentives were authorized, in which the interests of the contractors and the company are aligned through cash incentives.
- (v) Energy Regulatory Commission (CRE). The CRE is maintained as a decentralized SENER body, with specific functions for regulating natural gas sales, and the distribution, transportation and storage of gas and refined petroleum products.

Role of the board of directors

- (i) The powers of the board of directors are specified exhaustively in Article 19 of the *Petróleos Mexicanos* Law.
- (ii) For each subsidiary, a specific board of directors is set up, chaired by the Director-General.
- (iii) The mandatory existence of seven committees is established, irrespective of any additional committees that the board of directors may propose, such as audit and performance appraisal, strategy and investments, remunerations, procurements, leasing, works and services; environment and sustainable development; transparency and accountability, and technological development and research.

Structure of the board of directors

- (i) The Board is increased to 15 directors, with the incorporation of four professional directors, as follows: six directors representing the State (Secretary of the SENER, Secretary of the SHCP, an Undersecretary of the SHCP, the Secretary of Economy, the Secretary of the Civil Service, the Head of the Office of the President); and five STPRM representatives.
- (ii) Each board of the subsidiaries has eight members apart from the PMI which has 12. Directors include PEMEX staff, directors representing the State, and at least two professional directors (who may or may not be from the PEMEX board). The number of State representatives will always be more than the number of professional directors.

Role and selection of directors

- (i) The professional directors were proposed by the government and ratified by Congress.
- (ii) Two of the State representative directors (the Secretary of the SENER and of the SHCP) were appointed by law (the LPM and the Law on State-owned enterprises), the other four were appointed by the government.
- (iii) The five STPRM representatives had to be active and appointed by the union itself, and could not participate in any committee or on the board of any subsidiary.

Corporate committees

- (i) The internal audit committee became the audit and performance appraisal committee, and six other mandatory committees were added, as described above.
- (ii) An Accountability Committee was set up to strengthen the level of oversight of PEMEX and its subsidiaries, which consists of the board commissioner, the internal control body, internal auditor, external auditor and Supreme Auditor of the Federation.
- (iii) Each corporate committee consists of at least three members, and is chaired by one of the four professional directors.
- (iv) Each subsidiary may have its own committees.

The 2013 Energy Reform focused on the possibilities of partnership with private firms, whether national or foreign, for the exploration and production of hydrocarbons, rejecting the timid proposal of the previous reform of contracts with incentives.

It envisages different types of contracts for participation by private firms, in services, profit-sharing and/or production sharing agreements, and licences. Nonetheless, to maintain the ownership of the country's oil resources, the possibility of concessions was ruled out.

The role of the Energy Department was maintained as the governing body for energy policy, with the CNH responsible for supervising the management of contracts and the CRE as regulator.

In August 2014, secondary legislation was passed, which specifies the timeframes and specific processes for new partnerships between PEMEX and the private entities interested in participating in the new framework.

In addition, in 2015, the Mexican Petroleum Fund will be created, to manage the after-tax revenues generated from contracts with private firms, as well as the National Centres for the Control of Natural Gas and Control of Energy.

In corporate governance terms, the two most important changes compared to what was established in the 2008 Oil Reform are: (a) exclusion of the five union representatives from the board of directors and the addition of one "independent" director, reducing the number of State representative directors by one; and (b) the provision that, apart from SHCP's casting vote in respect of the resources that PEMEX would have to continue contributing to the public budget, the remainder of the company's business activity will be governed by the best international corporate governance practices, whatever that means.

3. Corporate governance in PEMEX

Unlike other cases in Latin America, particularly Petrobras (Brazil) and Ecopetrol (Colombia), PEMEX is not listed on the stock market. It is one of the State-owned enterprises indirectly supervised by the federal government, and it forms part of the public sector.

Its corporate governance criteria differ in some respects from those of private corporations. The guidelines for this type of enterprise on this subject are outlined in an OECD (2005), which complements the proposal for private firms (OECD, 2004).

The proposals for State-owned enterprises are summarized in the following guidelines:

- (i) A clear legal and regulatory framework needs to be defined for the action of state firms. A clear separation is needed between the different roles of the state exercises in markets in which it participates as an owner.
- (ii) The State, as majority or sole shareholder, must discharge its ownership functions actively and clearly in terms of defining policies and strategies.
- (iii) In the case of State-owned enterprises that have another shareholder, equal treatment for all shareholders must be ensured.
- (iv) State-owned enterprises must have the same transparency criteria as firms that are traded on the stock market, with timely disclosure of relevant information on the company's financial and operational performance.
- (v) A function of the board of directors is to achieve the objectives set by the State, approving corporate strategies and their implementation.
- (vi) Provide the board of directors with the authority to manage the company, independently of government policy.

- (vii) The management will be accountable to the board of directors for fulfilling the corporate strategies.

The reference legal framework on corporate governance for PEMEX is contained in the LPM, the organic Law on Federal Public Administration, the Federal Law on State-owned enterprises, the Energy Reform of 2013, and its secondary laws of 2014, and the SARBOX Act in the United States, for the issuance of dollar-denominated eurobonds on the stock market of that country.

The following table makes a comparison between the standards defined after 2010, because the vast majority of corporate governance proposals were implemented in 2009 and 2010, after publication of the LPM in November 2008.

The source of analysis are the questionnaires on compliance with corporate governance principles delivered to the CNBV, the annual report of the company and its subsidiaries, and the LPM itself.

Role of the board of directors

2010

Article 19 of the LPM defines the central conduct and strategic direction of the company and its subsidiaries as a fundamental responsibility of the PEMEX board of directors.

With regard to information, the transparency and accountability committee has a function of proposing to the board criteria for a determining information on PEMEX and its subsidiaries, along with regulations, and as the case may be, recommendations for disclosure. In terms of investment, information on assets and portfolios is generated by the strategies and investment committee; and, lastly, information on financing, which is delivered to the SHCP as will be noted below.

The board of directors is currently supported by the seven committees mentioned above, with full delegation, because PEMEX functions as a holding company for its subsidiaries, and these ultimately perform the operational functions of the company.

Structure of the board of directors

2014

PEMEX has 10 shareholding directors, of whom five are state representatives (secretaries and/or undersecretaries), appointed by the federal government, and four professional directors appointed by the government, who will serve as public servants.

In this case, the five State representatives and the five professional directors might be considered as outside, and the latter are assimilated to the concept of independent directors. Although the Senate approves the candidates, the director has a “debt” with respect to one of the parties represented in the Senate.

Role of the board of directors

2014

Following the Energy Reform, SENER maintains the chair of the board of directors, and is one of the State’s representative directors.

Selection of directors

2010

Article 11 of the LPM sets forth criteria for selecting the professional (independent) directors: being Mexican citizens, professionals in the field of law, economics, engineering, public administration, accountancy, or a subject related to the energy industry, with 10 years’ professional or academic experience in areas related to the functions inherent to the post, and not having links with political parties during the three years prior to their appointment.

These directors are appointed for six years in a staggered arrangement, with the possibility of reelection, but may not have alternates, and they are given a support team and specific remuneration, equivalent to that of the company’s top-level managers.

Outside directors

2010

The questionnaire on corporate governance delivered to the CNBV states that the directors notify the chair of the board and the secretary of any conflict of interest, and refrain from voting in such situations. Nonetheless, given the composition of the directors, each group represented in the board has “natural” incentives to defend their own interests.

The number of independent (professional) directors represents 50% of the total.

Inside directors

2010-2014

The only inside directors were the five STPRM representatives that were eliminated from the board in the 2013 reform. Nonetheless, Article 21 of the LPM requires managers and employees that provide information to the board of directors to sign as responsible for the content and preparation thereof, and when issuing bonds in the United States, the requirements for validating SARBOX information with the SEC are adopted.

In relation to the legal accountability of the directors, failure to fulfil the diligence and loyalty criteria described in Articles 36 and 37 of the LPM and Articles 40 and 41, establish possibilities for indemnification, criminal actions, and dismissal from the post. It is important to note that directors representing the State and professional directors are subject to the law on civil servants.

The Internal Audit Director is not a board member, and reports directly to the Civil Service Department.

Audit committee

2010

Article 23 of the LPM provides that the audit and performance appraisal committee must consist exclusively of three independent directors, and be chaired by one of them on a rotating basis.

Article 23 establishes that the committee is responsible for appointing, supervising and evaluating the external auditor; issuing an opinion on the certification of the financial statements; verifying the sufficiency of information, proposing to the board guidelines for the internal control system and its upgrading; establishing a risk management system, and requesting the research and audits deemed necessary at any time, with support from the external auditor and the internal control body.

Since 2009 there has been a project to implement financial operation controls to incorporate financial process business rules in the technological applications in which financial information is generated.

Financial asset investment committee

2010

The strategy and investments committee must be chaired by an independent director, and its main functions involve analysis of the business plan, definition of the investment portfolio and evaluation and monitoring thereof.

Corporate financing committee

2010

There is no corporate financing committee; that role is played by the Department of Finance and Public Credit (SHCP).

PEMEX must send its financing proposals to the SHCP, to be included in the financial programme that frames the General Public Debt Law, and is subject to the global annual financing ceiling approved by Congress.

Article 44 of the LPM makes clear that the public debt obligations of PEMEX and its subsidiaries do not confer on its holders any claims on the ownership, control or capital of PEMEX, nor on the ownership and exploitation of the State oil industry. It clarifies that PEMEX public debt is not guaranteed by the Mexican State.

Article 46 of the LPM establishes that the Director-General will notify the SHCP, with at least 15 working days' notice, of each public debt operation it intends to carry out. The SHCP can order the company not to make the issue, in view of the impact of the cost of debt issuance on the financing of the public sector and on the availability of funding sources for it.

In the case of Citizen Bonds, the LPM states that the SHCP will be responsible for establishing the forms of acquisition, mechanics of the operation and supervision to avoid a concentration greater than 0.1% of holders authorized for their acquisition.

Lastly, the financial resources committee, which was created in February 2010 and is chaired by the Corporate Finance Director, is responsible for authorizing counterparty contracts.

Risk committee

2010

The LPM does not specifically mention this corporate committee, but merely refers to risk management as a specific function of the audit and performance appraisal committee in paragraph IX of Article 23.

Nonetheless, in 2010, the board of directors authorized the creation of the financial risks committee, as a collegiate entity of consultation, opinion, and decision-making on financial risks; and in August 2010, General Policies on the Management of Market Risks were authorized for PEMEX and its subsidiaries (repealing those authorized in May 2003).

The committee is chaired by the corporate finance director, because the incumbent in the risk area is Head of the Subdirectorate of Risks, which is attached to the PEMEX Corporate Finance Department.

Source: Prepared by the author.

4. PEMEX and the debt market

PEMEX is one of the leading issuers of debt on the national market. At the end of 2013, it was the second largest national debt issuer (after Banobras), representing roughly 10% of total corporate debt in circulation. Nonetheless, in terms of debt flotations abroad (eurobonds) it is ranked first in the corporate category, accounting for 43% of the total.

The majority of the international ratings of PEMEX issues have the same rating as the sovereign debt, whereas on the local scale it has the highest rating.

The case of PEMEX is atypical from the financial-risk standpoint. It is an enterprise with negative capital, that receives demand almost without question from investors, and the highest ratings locally. Doubtless, the reason for this is that, for practical purposes, the debt is backed by the federal government, although it is considered as corporate paper, as mentioned in the second section.

Previous documents have made an exhaustive review of corporate governance in PEMEX and its subsidiaries. In particular, the OECD (September 2010) made a very complete study that included a review of documents, processes and interviews with several board members. The following paragraphs describe only the findings that relate to regulating the general corporate governance guidelines of this document:

- (i) In the LPM, ownership policy is confused by having several government parties participating directly on the board of directors.
- (ii) In the LPM, the objectives are vague, the company's purpose in the short term is to create economic value, and in the long term to strengthen the country's energy sovereignty and security.
- (iii) The State acts as an owner outside PEMEX, and in its board of directors through its State representative directors, which makes it both judge and jury. This situation is aggravated by the role played by the Secretary of SENER as board chairperson and the supervisor of the CRE and CNH, both with regulatory powers.
- (iv) In terms of legal framework, the LPM is highly detailed, so any minor adjustments to the corporate governance scheme that the board might approve require legislative amendments.
- (v) The board of directors does not consider representation of the director-general, nor does the LPM clearly define the responsibilities of each government body. It is also not the board's prerogative to dismiss the director-general. That decision rests ultimately with the federal government.
- (vi) The board of directors remains the forum for setting the firm's objectives, so each interest group places representatives in it to defend their interests. In particular, the SHCP, as entity responsible for the income and expenditure budget law, determines the PEMEX tax burden, creating conflict between the directors that represent that department, and other board members, who have to prioritize the interests of the company and the objective of value creation.
- (vii) The board of directors has inadequate support from the internal auditor, who does not report to it, so the directors tend to want to control the executives.
- (viii) The full-time commitment required for professional directors blurs the distinction between the responsibility of the board of directors and executive management. "shadow executives" are generated.
- (ix) The process of nominating the professional directors of PEMEX is centralizing the government, without explicitly indicating the efficiency criteria and competencies according to their responsibilities.

- (x) There is a clear bias in directors representing the State, with respect to the importance of supervising the contribution made by PEMEX to public-sector revenue (two SHCP directors, its head and the Under-Secretary for Revenue), and the control of the firm for government purposes (Head of the Office of the President and the Secretary of the Civil Service).
- (xi) There is no clear independence of directors, the State representatives display a wide ranging conflicts of interest, and the professional directors are linked to the parties that ratify them in the Senate.
- (xii) The number of mandatory committees, while excessive, is incomplete. Seven corporate committees seem too many compared to what is required of firms that are listed on the stock market. Apart from not defining the risk committee as such, which ends up being controlled by the finance director (judge and jury conflict).

Lastly, in PEMEX there is broad professionalism among the directors representing the State, but they do not receive remuneration. This often causes them to delegate to their alternates, to the detriment of their attention to relevant matters. The professional directors receive remuneration similar to that of an executive post, which has the undesired effect of creating “shadow executives”. The correct arrangement would be for all directors to have fair remuneration that would encourage their professional participation without generating these permissive attitudes towards corporate governance standards.

H. Corporate governance standards, weighted by category

The general categories of the indicator and the results of its application are shown in the following matrix:

Categories	Standards	Standards for bonds	Weight	Signature 1	Signature 2	Signature 3	Signature 4
The role of the board of directors	1. The board of directors shall establish mechanisms to ensure the collection of timely and reliable information on all the investment (in financial and non-financial assets) and funding activities conducted by the company.	1.1 Does it authorize the issuance of bonds, whether or not the regulator requires a placement memorandum?	0.377	0.377	0.377	0.377	0.377
		1.2 Does the bond prospectus comply with the regulator's requirements for public offerings?	0.377	0.377	0.377	0.377	0.377
		1.3 Is there information on resource use, both in the business strategy and per project and/or debt restructuring?	0.377	0.377	0.377	0.377	0.377
		1.4 Are the implications and actions relating to the company's issues and leverage levels known factors?	0.377	0.377	0.377	0.377	0.377
The structure of the board of directors	2. The board of directors may delegate responsibilities and functions in board committees chaired by an independent outside director.	2.1 Are the design and analysis of the issue delegated to the corporate Finance Committee?	0.189	0	0	0.189	0.189
		2.2 Is the analysis of the financial risks of the issue delegated to the risk committee?	0.189	0.189	0.189	0.189	0.189
		2.3 Is the responsibility of management reports on issuance information delegated to the audit committee?	0.189	0.189	0.189	0.189	0.189
The chair of the board of directors	3. The size of the board of directors shall be appropriate for prompt decision-making.	3.1 Does the board have between 8 and 15 directors?	0.031	0.031	0.031	0.031	0.031
		3.2 Does the board have at least 50% outside directors?	0.031	0.031	0.031	0.031	0.031
		3.3 Are more than half of the outside directors independent?	0.032	0	0	0	0
The role of the chair of the board of directors	4. The chair of the board of directors shall establish the mechanisms for selection of outside directors on the basis of the value they can contribute.	4.1 In the selection of some outside directors, is priority given to their expertise in finance, particularly in corporate financing?	0.189	0.189	0.189	0.189	0.189
		4.2 Is the chair of the board of directors an outside, independent director?	0.377	0	0	0.377	0
The role of the board of directors	5. The chair of the board of directors shall be an independent outside director.						

Categories	Standards	Standards for bonds	Weight	Signature 1	Signature 2	Signature 3	Signature 4
The role and selection of executive (inside) and non-executive (outside) directors	6. The directors (inside and outside) shall be selected on the basis of the value they can bring to the board of directors.	6.1 Do more than 50% of the directors have sound and updated knowledge of finance and corporate financing?	0.095	0	0	0	0
		6.2 Do more than 50% of the outside directors have sound and updated knowledge of finance and corporate financing?	0.095	0.095	0	0.095	0.095
	7. The directors shall stay abreast of the needs of the company and its employees.	7.1 Is there a systematic training programme for directors?	0.189	0	0	0.189	0.189
		7.2 Do they have certifications in financial matters on which they make decisions?	0.189	0.189	0	0.189	0.189
		7.3 Is the performance of each outside director regularly reviewed?	0.189	0	0	0.189	0
	8. Outside directors shall disclose to the board of directors any conflict of interest in relation to the company of which they are aware.	8.1 Do the outside directors flag conflicts of interest in the bond issuance process?	0.189	0.189	0	0.189	0
		9. The number of independent directors shall be equal to or greater than the number of other directors.	9.1 Are there three or more outside directors for each inside one?	0.189	0.189	0.189	0.189
	9.2 Are the outside directors selected by a committee of independent directors?		0.189	0	0	0.189	0
	10. The inside directors shall sign affidavits making them legally and criminally accountable for the information they generate and disseminate, as well as for non-disclosure of information to the board of directors.	10.1 Do the inside directors sign off, as legally and criminally accountable, on disclosures concerning a bond issue and its implications for the financial position of the company?	0.377	0.377	0	0.377	0
		11. The internal audit director shall be a member of the board of directors and report directly to the board or one of the board committees.	11.1 Is the internal audit director a member of the board?	0.189	0	0	0
	11.2 Does the internal audit director report directly to the board or the audit committee?		0.189	0.189	0.189	0.189	0

Categories	Standards	Standards for bonds	Weight	Signature 1	Signature 2	Signature 3	Signature 4
Audit committee	12. The committee shall be chaired by an independent outside director with experience in internal control. (i) The independent auditor shall be engaged by the committee and report directly to it. (ii) The committee shall approve the internal and external audit programmes. (iii) The committee shall follow up on the internal and external audit recommendations. (iv) The committee shall approve the design and operation of the internal control system, whose main function is the production of reports. The committee shall be responsible for maintaining a system of timely generation of reports, especially on financial matters, risk management and performance of the company and its managers. (v) The committee shall submit regular reports to the CEO and the board of directors on compliance with or violation of internal control policies.	12.1 Is the audit committee chaired by an independent director? 12.2 Is the independent auditor engaged by the audit committee, and does it report to the committee? 12.3 Does the audit committee approve the internal and external audit programmes? 12.4 Is there an effective reporting system on corporate financing? 12.5 Does the committee prepare regular reports to the board and to general management on compliance with internal control policies on the use of financial resources for financing?	0.377 0.377 0.377 0.377 0.377	0 0.377 0.377 0 0.377	0.377 0.377 0.377 0 0.377	0.377 0.377 0.377 0.377 0.377	0.377 0.377 0 0.377 0.377
Financial asset investment committee	13. The committee shall be chaired by an independent outside director with experience in financial markets. (i) The committee shall structure the strategy for investing the company's cash surpluses. (ii) The committee shall review the company's investment strategy with appropriate frequency.	13.1 Is the investment committee chaired by an independent director? 13.2 Does the chair of the investment committee have proven experience in investment strategies? 13.3 Does the committee meet at least once a month?	0.095 0.095 0.095	0 0.095 0.095	0 0.095 0.095	0.095 0.095 0.095	0.095 0 0.095

Categories	Standards	Standards for bonds	Weight	Signature 1	Signature 2	Signature 3	Signature 4
Corporate financing committee	14. The committee shall be chaired by an independent outside director with experience in corporate financing. The committee shall decide on funding needs and mechanisms proposed by general management. (i) The committee shall approve the selection and engagement of financial intermediaries required by the company for placing the financial securities it issues.	14.1 Is the committee chaired by an independent director?	0.377	0	0	0	0
		14.2 Does the committee chair have proven experience in corporate financing?	0.377	0.377	0.377	0.377	0.377
		14.3 Is this the committee that defines the funding requirements of the company and how to meet them?	0.377	0.377	0.377	0.377	0.377
		14.4 Is this the committee that selects the financial intermediaries to place bonds issued by the company?	0.377	0.377	0.377	0.377	0
Risk committee	15. The committee shall be chaired by an independent outside director who has experience in comprehensive risk management. (i) The committee shall engage rating agencies and receive from them regular reports on the company's portfolio of financial instruments. (ii) The committee shall rule on reports of financial and credit risks related to the company's portfolio investments in financial securities, carried out by its risk unit. (iii) The committee shall report regularly on compliance with or deviation from the investment strategy on the part of the company's treasury unit. (iv) The committee shall submit regular reports to general management and the board of directors on the effectiveness of the investment strategy. (v) The committee shall prepare an inventory of the relevant non-financial risks for the company and specify which are quantifiable and which not.	15.1 Is the risk committee chaired by an independent director?	0.377	0	0	0.377	0
		15.2 Does the committee chair have proven experience and expertise in comprehensive risk management?	0.377	0.377	0.377	0.377	0
		15.3 Is it the risk committee that is responsible for ruling on reports on the financial risks faced by the company?	0.377	0.377	0	0.377	0
		15.4 Is it the risk committee that explains the company's bond issuance risks?	0.377	0.377	0.377	0.377	0.377
			10.0	6.948	6.098	9.307	5.439

Source: Prepared by the author, on the basis of the weighting.

I. Conclusions

During the 2008 financial crisis, banks and investors forgot the fundamental principle of value creation in financial assets—in other words that an asset's worth is equal to the present value of the flows it generates. The banks packaged high-risk debts and sold them to investors who used short-term funding to purchase them, thereby creating a highly risky gap.

The assumption was that the securitization of high-risk debts increased the value of the debts without the cash flows to cover the mortgages increasing, so that the assets continued to have the same risk. This caused a financial impact of global dimensions, and brought to the fore the conflict of interest between shareholders and creditors.

Prudence in leveraging levels and the responsible use of derivative products in an enterprise are aspects closely related to its corporate governance structure. Certainty in its management, with transparency and professionalism, requires strict standards to be observed, such as those indicated in chapter II of this volume.

The corporate debt market in Mexico is small compared to the markets for government debt and for shares, roughly 16% in both cases. The size is smaller when the securities issued by State-owned enterprises, development banks and decentralized agencies are excluded, which in Mexico are considered to form part of the corporate segment and represent the main issuers.

Since 1994, a more complete government bond curve has been generated, with various maturity alternatives, both in the nominal rate and in the real rate. This phenomenon has been transferred to corporate securities, with bond certificates the most widely used alternative since 2001.

The main demand for corporate bonds comes from investment companies and pension funds (*Afores*), with 33% and 16%, respectively, of their portfolio held in corporate bonds, most of which are rated AAA.

In Mexico, governance strengthening has been promoted through the legal framework. Private companies (not publicly traded) are governed by the LGSM, while firms quoted on the stock market are governed by the LMV, which draws on several principals from the OECD and CMPC. In addition, there is a wide-ranging legislation applicable to financial entities, whether or not they are traded on the BMV. For firms listed in United States markets, the SEC legislation and SARBOX Act and its amendments are applicable.

In addition, the family nature of enterprises in Mexico has largely conditioned the definition of practices and applicable standards, whether legal (LMV) or voluntary (CMPC).

In terms of the standards proposed in chapter II, we can conclude that most satisfy them in theory, but the practical results reveal broad areas of opportunity.

The critical points of the legislation identified in terms of the structure of the board of directors are: validate the director independence criterion; include the internal auditor on the board; promote separation of the board chair from the general management of the company, and preferably give the chair to an independent outside director. Lastly, and importantly, ensure that the directors have knowledge on the relevant issues, particularly financial ones.

In relation to the intermediate corporate bodies, it is advisable that the audit, finance and risk committees be chaired by an independent director. The LMV should include the requirement of a specific finance committee and a risk committee, separate from the audit committee, as in the case of entities in the financial system.

Among the cases analysed, four firms were chosen that displayed specific characteristics in terms of corporate governance and its implications on their debt in circulation, CEMEX, COMERCI, GFNorte and the State-owned enterprise PEMEX.

CEMEX, the world's third-largest cement producer, had excessive leverage to finance acquisitions and geographic expansion that led it to a situation of insolvency and severe liquidity problems when the 2008 financial crisis broke out. This had enormous repercussions on the activity of the construction sector in the countries in which its production was concentrated (United States, Mexico and Spain). The bonds issued by the company received a general rating downgrade, and it needed support from development banks to fulfil its commitments. It continues to feel the effects of weak economic growth and the debt to be paid over the next few years.

The board of directors has been responsible for the business model applied since 2000, which involved high financial risk in the short run, owing to major acquisitions, and reliance on cash flow to meet capital requirements.

The second case, COMERCI, is one of the leading players in Mexico's retail market. Its problem was having engaged in financial activities that did not pertain to the business (derivative contracts), which generated major losses and the need to restructure its debts with its multiple creditors, and bondholders that saw default on their coupon payments and rating downgrades.

Responsibility fell on the board of directors, because the company's treasury acted without the relevant internal controls. Although the activities had been undertaken since 2007 with positive results, their members forgot the elementary lessons of this control for non-financial corporates (Hull, 2007). The limits need to be respected, even if they are overtaken by positive results. Corporate officers should never authorize stock market transactions that they do not fully understand. When a trader or treasurer is authorized to engage in operations in derivative products, it is important to prevent the hedging strategy becoming one of speculation. Lastly, it is inadvisable to turn the treasury into a profit centre.

The third case, GFNorte, is an example of major progress towards efficient corporate governance. It is significant that the entity belonged to the financial system, because it displays a number of corporate governance points that should be taken up for non-financial corporates, to be able to monitoring their potential risks more effectively.

The points to be highlighted in the corporate governance of GFNorte are as follows: having a enough committees to avoid having to share functions among multitask personnel; it is one of a few corporates whose board chair is outside and independent; the professionalization of its directors is guaranteed by recruiting staff that have held a regulatory post in several of the financial segments in which it operates; the essence of its activity in its different subsidiaries gives a specific role to the risk committee, which is not common in corporations from other sectors; lastly, there is a committee on asset and liability management policies.

GFNorte is a company which established a strong business growth strategy, both operationally and organically, in the midst of the economic crisis. Its results have generated the largest market share and highest profitability, whereas its corporate growth (mergers and acquisitions) has enabled it to make substantial progress in the banking market and pension fund management, all of this in a framework of controlled leverage, and debt that attracts high ratings and market recognition. Clearly, its progress and good performance in corporate governance has resulted in a relevant instrument for all of these achievements.

Even in financial entities, recommendations of a forward-looking culture cannot be avoided (Hull, 2007), including the following: setting clear and unambiguous risk limits; sanctioning the surpassing of limits above and below; always maintaining the criterion of diversification in business and investment portfolio; continually reviewing positions in the context of scenarios and stress tests; maintaining functional separation between front, middle and back office; taking care of the risk model in its function of valuing positions; and, lastly, taking care of liquidity risk as a priority in conditions of financial crisis.

Lastly, the case of PEMEX, an entity that plays a major role in generating foreign currency, in public finances, and in the demand for materials for the various investment projects it undertakes. In

corporate governance terms, the 2008 Petroleum Reform, among other objectives, sought to improve the corporate governance structure of PEMEX and its subsidiaries. The two most important changes implemented in the 2003 Energy Reform are: exclusion of the five union representatives from the board of directors and the addition of one “independent” director, reducing the number of State representative directors by one; and the provision that, apart from SHCP’s casting vote in respect of the resources that PEMEX would have to continue contributing to the public budget, the remainder of the company’s business activity will be governed by the best international corporate governance practices, whatever that means.

The main areas of opportunity for GFNorte relate to the number of independent directors, their role in the committees, and a more decisive role for the internal auditor. For CEMEX, the role of the risk committee, the fulfilment of director independence, separation of the board chair from general management, and technical training for the directors. In the case of COMERCI, it would be advisable for the board chair to be an outside director. It is necessary to fulfil the formality of documenting independence and the absence of conflict of interest, as well as the role of the risk committee. Lastly, we hope that the implementation of the ENERGY REFORM will resolve corporate governance shortcomings in PEMEX, including: increasing the number of independent directors, improving their independence criterion; improving the financial qualifications of directors responsible for the investment committees, and forming its risk committee at the corporate level chaired by an independent director.

Lastly, corporate governance is a necessary but insufficient condition for the success of a bond issue. It should not be directly concluded that an improvement in corporate governance standards necessarily implies an improvement in investors’ perception of the company’s bonds, because a market that is more committed towards corporate standards could involve a higher cost of capital. Nonetheless, what does decrease directly is the agency conflict between creditors and shareholders.

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VIII. Corporate governance, institutional investors and risk assessment for issuance of debt instruments in Peru¹

Jorge Echeandia

A. Introduction

This study is part of the third phase of a research project led by CAF-development bank of Latin America, the Economic Commission for Latin America and the Caribbean (ECLAC) and the Inter-American Development Bank (IDB) to analyse good practices in corporate governance in the capital markets of the largest countries in the Americas, four of which are members of the newly created Latin American Integrated Market (MILA).

With the consolidation of MILA and the strengthening of the Pacific Alliance, some important issues are emerging on the agenda, such as risk management at Latin American companies and the financing methods of Peruvian companies, especially their decision to obtain financing by issuing debt in the international market.

In recent years, Peru has become a very attractive destination for international investments and therefore its performance should be assessed continually on the basis of indicators that support decision-making by investors.

This analysis uses the indicator on corporate governance and the issuance of corporate debt, designed by ECLAC-CAF-IDB in an earlier phase of this project, to focus on the role that various actors play in the debt issuance process at four Peruvian companies in different economic sectors: services, industry, State-owned enterprise, and finance.

That approach reveals that corporate governance practices are applied with the same level of responsibility and importance in the different areas of business activity. This is not an exercise in

¹ The autor kindly thanks Dr. Fiorella Torres, supervisor at the Conduct Supervision Division of Peru's Superintendency of the Stock Market (SMV), for her comments.

which binding regulations set the standard; on the contrary, best practices in management and corporate governance are a manifestation of the intentions of the shareholders themselves and of the genuine commitment of the assemblies of shareholders and boards of directors.

B. Corporate governance in Peru

1. General background

Beginning in the late 1990s and especially following the 2008 crisis, corporate governance practices were established as basic indispensable tools for the transparent functioning of a company. A sustainable business is now understood to be one that in practice has established an effective organizational structure, introduced clear policies for decision-making, levels of empowerment for each corporate governance instance, respect and transparency between and among partners, effective management of the company's finances, real borrowing criteria, optimal control mechanisms and other aspects that transform a shared enterprise into a sustainable organization over time.

A survey of the well-known bankruptcies that have hit multinational companies, global banks and top audit firms is not necessary in order to understand the importance of corporate governance.² For that, it suffices to look at the number of companies that have closed their doors in quick order due to internal conflicts, others that have taken on commitments they could not pay, which end up destroying them, and still others that succumb to illegal practices perpetrated by some member due to ignorance of the policies and absence of operational supervision. This is nothing more than the fallout of poor management by corporate executives, driven by interests or ignorance, without considering the diverse variables of corporate governance.³

The Organisation for Economic Co-operation and Development (OECD) defines corporate governance as the system by which companies are run and controlled. For the purposes of this study, a definition that reflects the viewpoint of investors is used: “corporate governance deals with the ways in which providers of corporate financing reassure themselves that they will receive a return on their investment,”⁴ and it is precisely this position that prompts us to look at good performance in corporate governance as an instrument of growth for companies in a process of economic evolution of Peru.

2. Promotion of investment in Peru

The 1990s set the standard for structural economic change in Peru, which shifted to a liberal economic policy, identified in the 1993 Constitution as a social market economy.

This process strengthened free competition and generated a policy in support of it, which included the creation of one of the most representative institutions of the time: The National Institute for the Defense of Competition and Intellectual Property Protection (INDECOPI). This policy was also established in the Constitution.

² For more information on unlawful practices that originate with the board of directors, see Barkow and Barkow (2011).

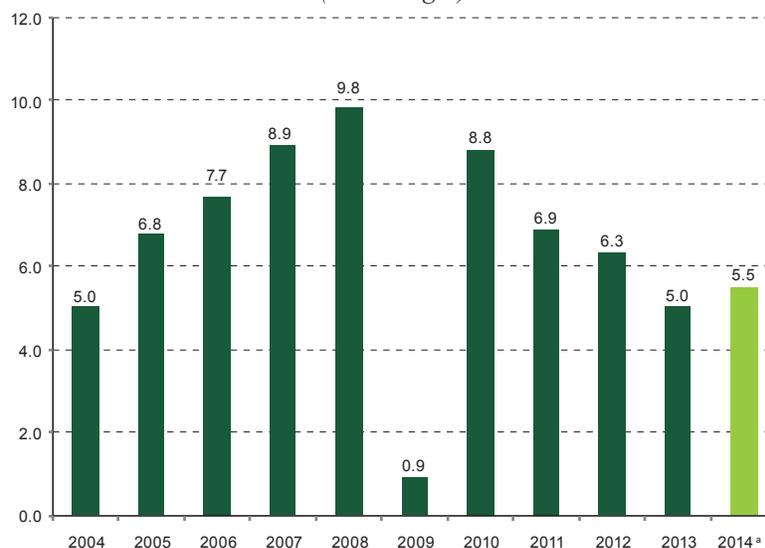
³ Dan Ariely discusses the implications of the type of dishonesty at companies and in everyday life that makes entrepreneurs believe in the “short term” in immediate results at any cost, establishing unsustainable policies over time. For more detailed information, see Ariely, Dan (2012), *The (Honest) Truth about Dishonesty. How we Lie to Everyone – Especially Ourselves*. New York, HarperCollins Publishers.

⁴ Shleifer and Vishny (1997).

It was an era in which Peru was nowhere near the radar of investors, due to exorbitant inflation and the uncertainty surrounding investments. In response, a constitutionally protected mechanism was established to ensure the stability of investments in the country.

That marked the moment in which the national economy opened its doors to local and international investment and embarked on a sustainable growth path that has lasted for over 20 years, as shown in figure VIII.1 on GDP performance over the past 10 years:

Figure VIII.1
Gross domestic product, annual variation, 2004-2014
(Percentages)



Source: Prepared by the author on the basis of information from Banco de Crédito del Perú (BCP) and National Institute of Statistics and Informatics (INEI).

^a Figures for 2014 are estimates by BCP.

Despite this “deregulation” of the economy, the financial and capital markets began to view the State as an ally and submitted to State regulation of their sectors. State supervision has lowered the risk of financial catastrophes such as the ones that have occurred recently (2008) in the world’s developed countries due to inadequate practices at the senior management level of corporations.

These appropriate efficiency- and transparency-based mechanisms allow more specialized investors to see the Peruvian capital market and business sector as an attractive investment destination. Accordingly, institutional investors increased their participation, generating three significant effects:

- **Division of control:** The State ceased to be the sole administrator and regulator of prices and contract conditions for products and services and instead strongly advocated for concessions and privatizations. A similar phenomenon occurred in the business sector, with business owners adjusting their original expectation of complete control and allowing foreign investment companies to acquire ownership stakes and share control.
- **Accountability:** Institutional investors came to participate actively on boards of directors, exercising their right to vote and requiring transparency of the companies.
- **International standardization:** Efforts were made to attract foreign capital to the country, which obligated the companies to adapt to the requirements and standards governing transactions abroad, an invaluable learning experience.

3. Corporate governance regulation

Corporate governance in Peru is specifically regulated in a wide range of legislation covering various areas of specialization. The General Law on Corporations (Law 26887), enacted in 1997, is regarded as the apex legislation on corporate governance, inasmuch as it regulates the organization of companies, ownership of shares and executive and management entities (general assembly of shareholders, board of governors and management), establishes the corresponding responsibilities, describes shareholder rights and obligations⁵ and sets guidelines on the sale of shares and the merger, acquisition and demerger of companies.

Legislative Decree 861, the Stock Market Law, and Law 30050, Law to Promote the Stock Market, establish the game rules for companies participating in the stock exchange and help ensure market transparency, requiring issuers to report to the market on use of confidential and privileged information, as well as the confidentiality duty that serves as the basis for regulating what are known as significant events.⁶

In addition, the Superintendency of the Stock Market (SMV), in its role as promoter and supervisor of good practices for the companies that participate in the capital market, is issuing a series of legal provisions to consolidate this important channel of business financing.⁷

C. Private initiative: Corporate Governance Index at the Lima Stock Exchange

The Lima Stock Exchange (BVL) has developed a practice rare in other stock exchanges around the world. In its role as promoter of good practices for listed companies, it has created an index that allows issuers of securities to rate themselves on their corporate governance practices. The self-rating system is based on a questionnaire titled “Information on compliance with good governance principles for Peruvian companies,” a document that can be required as an annex by the SMV. The content and evaluation parameters of the questionnaire will be completely updated in 2014.

According to the BVL, the Good Corporate Governance Index (IBGC) is a statistical indicator that reflects the behaviour of the securities of issuing firms that adequately comply with the principles of good corporate governance for Peruvian companies and also possess a minimum level of liquidity as established by the BVL.

The IBGC is a capitalization-weighted index, meaning that the weights of the shares in the portfolio are obtained based on the free float market capitalization of these shares, adjusted by the level of good corporate governance obtained. The higher the freefloat market capitalization, the higher the assigned weight will be for share on the index.

In order for a company to participate in the IBGC, it must follow the steps established by the BVL in diagram VIII.1.

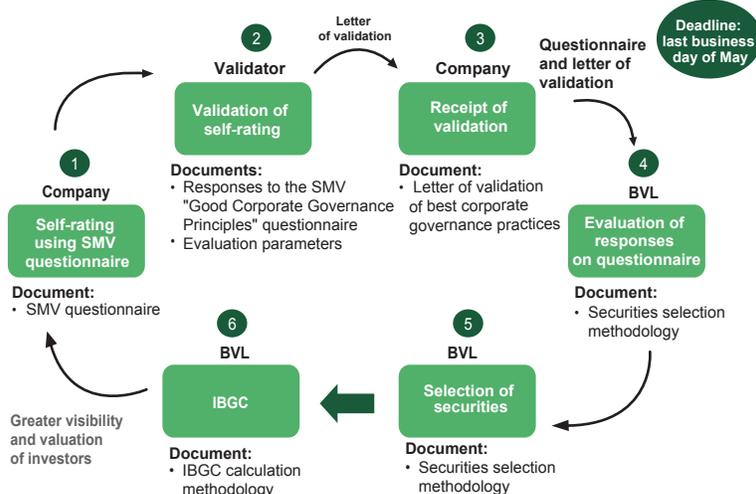
The IBGC benefits an investor by providing it with an additional tool to evaluate the good corporate governance practices of the company in which it seeks to invest so it can choose the most responsible companies and reduce its investment risk.

⁵ When a company is set up as a *sociedad civil de responsabilidad limitada* (SRL) [limited liability company], there are no shares but rather *participaciones*, a type of holding that eliminates the anonymity of the owners of the company. These companies are not authorized to list on the Lima Stock Exchange (BVL).

⁶ Recently, the SMV issued a new set of regulations on so-called significant events, which was necessary for achieving an efficient system of reporting to the stock exchange that promoted transparency without disincentivizing the participation of issuers in that market. The new regulations introduce a reduced list of matters that can be regarded as significant events, assuming they meet specific conditions, which replaces the long list of situations that had to be reported formerly.

⁷ To consult the SMV regulations, see <http://www.smv.gob.pe> (section titled “normas”).

Diagram VIII.1
Process for participation in the IBGC



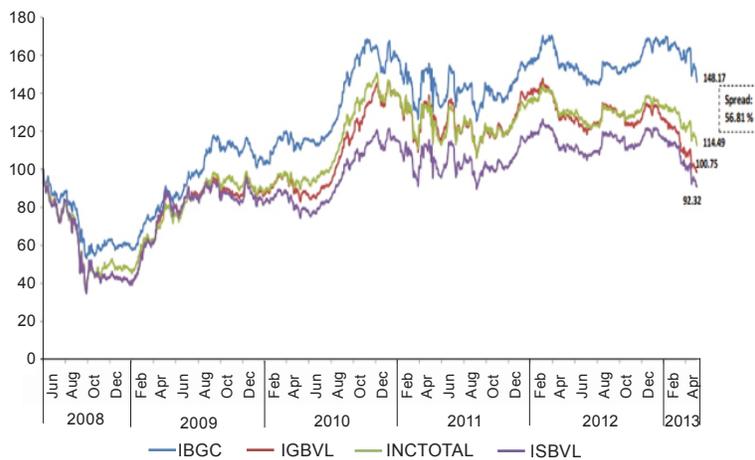
Source: Prepared by the author on the basis of information from Lima Stock Exchange (BVL).

For the issuer, a similar phenomenon is at work, since a good score on the index will be increasingly attractive to investors, increasing its market value.

Lastly, the index is useful for evaluating on an ongoing basis the degree of development of Peru’s capital market.

The impact on the earnings of the companies participating voluntarily in the IBGC is evident. Every year, the IBGC surpasses the rest of the BVL indicators by a wide margin, and there is a spread of 56.81%, as observed in figure VIII.2.

Figure VIII.2
Peru: index of good corporate governance and BVL index, 2008-2013^a



Source: Lima Stock Exchange (BVL).

^a IBGC refers to the index of good corporate governance; IGBVL, to the Good Corporate Governance Index of the Lima Stock Exchange; INCTOTAL, to the national index of total capitalization of profits; and ISBVL, to the selective index of the Index of the Lima Stock Exchange.

1. Joint initiative: Code of Good Corporate Governance for Peruvian companies

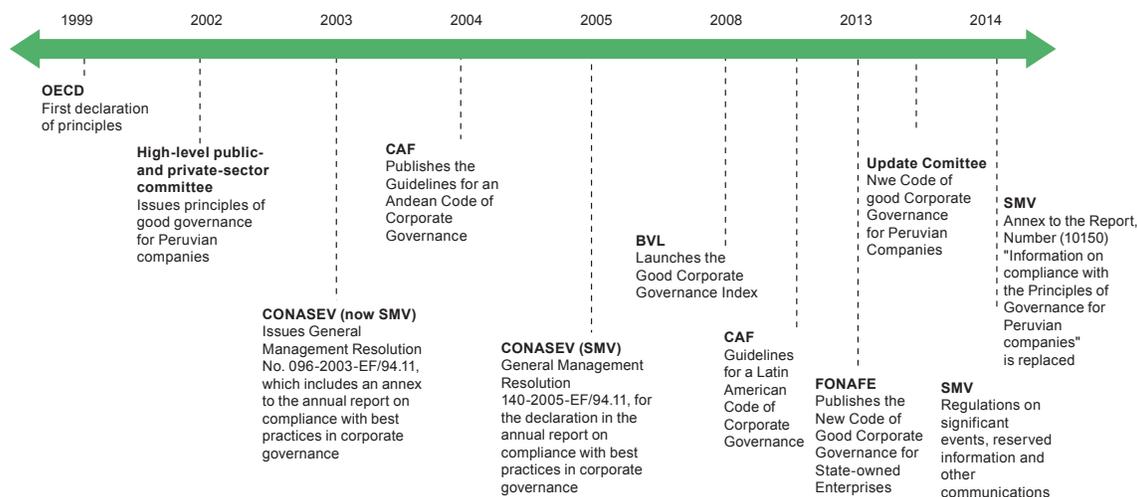
The adoption of corporate governance practices generates a range of positive effects such as: respect for shareholder and investor rights; generation of value, solidity, and efficiency at companies; better management of the risks to which they are exposed; increased access to the capital market; lower cost of capital; more and better access to sources of long-term financing and investment; and other advantages that can be seen in the solid standing and investment attractiveness of Peruvian companies with good practices, as well as in constant public evaluations of good corporate governance, sustainability, responsible investing, most admired companies in the country, most recognized brands, and the BVL's own IGBC indicator, shown in diagram VIII.2.

By applying good practices, investors preserve the real value of their investments over the long run and eliminate information asymmetries between those running the company and its investors, ensuring that the principal – agent relationship is fluid and transparent.

In the late 1990s, the main multilateral institutions conducted a series of studies that yielded solid regulatory proposals for countries that were embarking on a corporate governance path, as was happening in Latin America. CAF took a leading role, preparing documents for regional use that subsequently supported the development of good governance codes in a number of countries, including Peru.

As can be seen in diagram VIII.2, prepared by Deloitte, efforts to consolidate corporate governance in Peru began 15 years ago, but there is still work to do:

Diagram VIII.2
Regulatory evolution of corporate governance in Peru



Source: Prepared by the author on the basis of information from Deloitte, 2014.

The *Código de buen gobierno corporativo para las sociedades peruanas* [Code of Good Corporate Governance for Peruvian Companies], published in 2013, incorporates the best corporate governance standards identified globally and locally that are applicable to the Peruvian reality, with special emphasis on the dynamics of the executive board (owners), the board of directors (administration), and senior management (day-to-day management), as well as on effective risk management.

This code is intended to strengthen Peruvian companies, investors and related interest groups and to be used by all companies, regardless of type.⁸

In the words of its authors: *“The objective of the Code is to foster a genuine culture of good corporate governance in Peru to improve investor perceptions of companies, promote business development and contribute to the generation of value in the Peruvian economy, presenting a structure that seeks to adapt to the needs and characteristics of our stock market and, in particular, of Peruvian companies.”*⁹

The Code of Good Corporate Governance for Peruvian Companies is divided into five pillars:

- Shareholder rights
- General assembly of shareholders
- Board of governors and senior management
- Risks and compliance
- Transparency of information

It also has two special annexes: Annex A: Complementary Principles for State-owned Enterprises; and Annex B: Complementary Principles for Family Companies.

This code emphasizes the importance of a policy of transparency in the management of a company, with a major focus on risk management:

Principle 25: Environment of the risk management system

The Board of Directors approves an integrated risk management policy in accordance with the size and complexity of the company; defines the corresponding roles, responsibilities and lines of reporting; and promotes a culture of risk within the company, from the board of directors and senior management to the employees. In the case of business groups, the policy covers all companies in the group and allows for a global vision of critical risks.

The General Manager periodically supervises the risks to which the company is exposed and makes them known to the Board of Directors. With the integrated risk management system, risks can be identified, measured, managed, controlled and monitored.

The Board of Directors of the company is responsible for ensuring that there is an internal and external control system in place, as well as for supervising its efficacy and suitability. For that purpose, an Audit Committee will be formed.

What this principle does, along with the ones following that promote the existence of an Audit Committee, is to set the standard for risk management and self-control with a view to the issuer’s responsibility towards the other shareholders, or in the case that concerns us, towards the investors that trust that the company is being properly run.

D. Development of the alternative stock market

Peru’s stock market is seeking new actors in the market, for which it has strengthened its corporate governance practices, making it a more attractive venue for investors interested in considering Peru as a destination for their funds.

⁸ According to Peru’s General Law on Corporations, these can be corporations, open corporations, closely held corporations, professional partnerships, limited partnerships and general partnerships. Decree Law 21621 regulates the constitution of individually owned limited liability companies.

⁹ SVM, 2013.

In addition, it has developed special mechanisms to open the BVL to small and medium-sized enterprises (SMEs) to give them more opportunities for access to cheaper financing, with access costs to the BVL lowered for the participants. One of these mechanisms is the Alternative Stock Market (MAV), which initially will be subject to fewer requirements and obligations with respect to reporting.

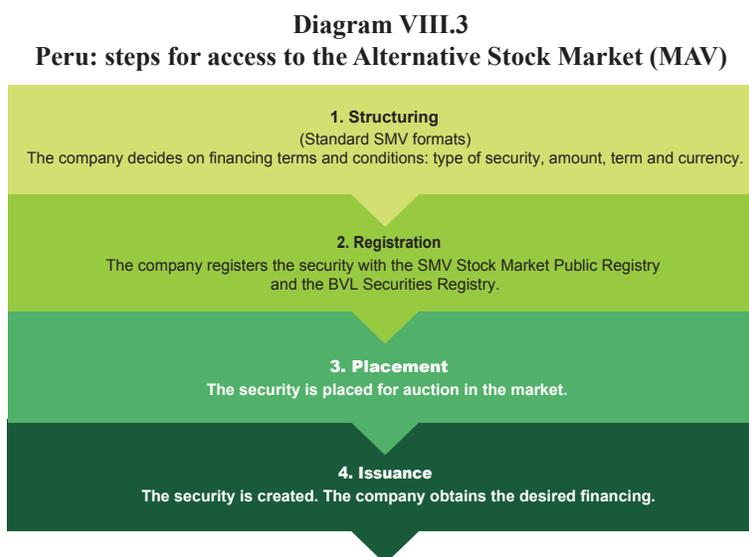
The regulation governing the MAV¹⁰ establishes admittance for companies with the following characteristics: (i) operations over the past three years; (ii) annual average sales over the past three years of less than US\$71.5 million without securities listed on the BVL or foreign exchanges; and (iii) not required to list.

The BVL thus allows for the participation of SMEs under this different financing model: access to money from people who are familiar with the business of the issuer, or institutional investors that upon weighing the risks see the financial opportunity in buying bonds from the SME.

It is neither support nor social responsibility but rather a financial opportunity for both parties, considering that SMEs tend to have limited access to credit. An SME thus gains access to more affordable credit mechanisms by issuing debt, with the company (debtor) as the party that sets out the credit payment conditions indicated in the placement memorandum.¹¹ Based only on its experience and understanding of its business spreads, risks, projections and opportunities can it offer what is financially prudent for it and for the investor.

Another way will be by issuing shares. The company will offer a percentage of shares for investors wishing to own part of the business. A share price is thus set so the company can buy and sell on the stock market. The idea is for the company to increase its value based on new investors' perceptions about its growth and internal activities.

For access to the MAV, the SMV simplifies the process as follows:



Source: Prepared by the author on the basis of information from Lima Stock Exchange (BVL).

¹⁰ Superintendency Resolution No. 00025-2012, “Regulations on the Alternative Stock Market – MAV/ Manual for meeting the requirements applicable to public offerings of short-term instruments issued by companies on the MAV,” published on June 29, 2012.

¹¹ The placement memorandum covers: characteristics of the securities, duties and rights of the title holder; issuance contract; description of the factors that constitute a risk for the investor; information on the structuring entity and the chief officer at the issuer; audited financial statements from the issuer, with explanatory notes and an opinion (two most recent years and intervening financial statements); description of the guarantees for the issue; and the procedure to follow for placing securities.

So far, three Peruvian companies have listed on the MAV, drawing interest from the market: Empresa Agrícola y Ganadera Chavín de Huántar; A. Jaime Rojas Representaciones, S.A., supplier of integrated medical equipment; and Tritón Trading, S.A., which leases, sells, and services machinery and equipment in the port, logistics and construction industries. According to the journal *Semana Económica*, these processes have sparked demand in excess of supply, at a rate as high as 280%.

E. Public offerings exclusively targeting institutional investors

Institutional investors undeniably play a prominent role in all issuances in the stock market, with the most active institutional players being pension fund administrators, investment funds and private banks owing to their expertise in private investment, which makes them more flexible when it comes to participating in a debt issuance.

The regulations governing the institutional investor market identify these investors as:

- (i) Banks, finance companies, insurance companies, savings and loan associations, small business and microenterprise development entities and savings and loan cooperatives authorized to take deposits from the public; companies in real estate capitalization, financial leasing, factoring, bonding, fiduciary services, and mortgage administration; brokers; private administrators of pension funds; corporate administrators of investment funds; corporate administrators of mutual funds; and titling companies.
- (ii) Foreign entities that conduct activities similar to those described in subparagraph 1 and/or to the qualified institutional buyer defined in Rule 144A of the United States Securities Act of 1993; health providers, the Social Protection Standards Office (ONP) and Social Health Insurance (EsSalud); entities organized under private or public law that invest in securities as one of their activities in accordance with the laws or conventions governing them. Non-State legal entities must have an investment portfolio equal to or greater than S/ 1 million (US\$ 357,142).
- (iii) Independent funds and assets managed by the entities indicated in the previous subparagraphs, provided that investment decisions reside with the entities and that the individual fund or assets have a net position equal to or greater than S/ 400,000 (US\$ 142,857).
- (iv) Individuals with assets of over S/ 2 million (US\$ 714,285) and a stock investment portfolio equal to or greater than S/ 1 million (US\$ 357,142).

Initial public offerings (IPOs) exclusively targeting institutional investors are subject to the following rules:

- (i) The jurisdiction of the SMV over the procedure for registering these public offerings and the respective securities or programmes is circumscribed only by verification of the presentation of documentation or requirements established in the Regulations.
- (ii) Administrative acts that provide for the registration of a security or programme cannot be challenged administratively or declared null and void by the SMV.
- (iii) Together with the issuer, joint and several liability vis-à-vis the investors attaches to the issuer's chief administrative, legal, accounting and finance officer, and in the case of a structuring agency, to both the agency and its representative, with respect to the scope of its professional and/or functional sphere of competence, for inaccuracies or omissions in the prospectus presented for the issuance.
- (iv) Once the registered security of an issuance or a programme has been placed and for as long as it remains registered, the following will apply: The issuer shall provide to

the SMV through MVNet the information indicated in the Regulations, regularly and as necessary and within the established timeframes. The issuer will make available to the holders of its securities the information it delivers regularly and as necessary to the SMV.

- (v) The regime established in the Regulations on Significant Events for the disclosure of information regularly and as necessary replaces the former regime and the financial information regime covered in the corresponding regulations, except where the issuer has registered securities that are protected under the general regime or the MAV.
- (vi) Securities issued in the framework of the present regime can only be offered, subscribed, acquired or placed—regardless of type or nature— among institutional investors.
- (vii) For transactions in which securities are offered, subscribed, acquired or placed, the following are discretionary and not mandatory: the participation of a structuring agent, the participation of a broker acting as a placement agent and the designation of a bondholder representative.

In Peru, pension fund administrators (AFP) are the most active participants in the institutional class, having acquired debt in the most number of issuances that have taken place in the Peruvian market. The role that AFPs play is extremely important owing to their position as top-tier specialized investors and to the impact that their investments have on the millions of people whose retirement funds they manage.

F. Issuance of international bonds

Bonds are debt securities with terms of more than one year. They can be issued by any entity organized under private or public law. Corporate bonds are issued by companies or corporations for the purpose of obtaining financing for their projects and operations.¹²

The general framework for corporate bond issues is established in the General Law on Corporations (Article 304 and subsequent articles) and the Law on the Stock Market (LMV). The main characteristics are as follows:

- (i) Corporate bonds are issued at face value, which in most cases is paid by the to the holder on a set date.
- (ii) Interest accrues on the amount of the bond and can be paid in full upon maturity or in regular instalments.
- (iii) They are securities issued primarily by corporations for a term of more than one year.
- (iv) If the amount of the issuance exceeds the company's net worth, specific guarantees must be arranged to cover the difference.
- (v) All corporate bond issuances require the designation of a bondholder representative.
- (vi) The procedure for retiring outstanding bonds should provide equal treatment for all bondholders.
- (vii) A broker must be used to place the bonds.

Bonds issued in the international market are registered in the market where they are placed, that is, with the United States Securities and Exchange Commission (SEC). Only in cases where the issuance is also marketed to Peruvian institutional investors will it also be registered with the SMV.

The Peruvian dollar-denominated issuances that have been carried out under United States regulation to date are listed below:

¹² See Procapitales (2014, pp. 22-23).

Table VIII.1
Peruvian issuers in the international market
(Dollars)

Rule 144A and Regulation S Issuers		
Issuer	Date of registration	Amount
1 VOLCAN COMPAÑÍA MINERA S.A.A.	17 January 2012	600,000,000
2 COFIDE	27 January 2012	500,000,000
3 COAZUCAR	18 July 2012	350,000,000
4 BBVA CONTINENTAL	22 August 2012	500,000,000
5 MAESTRO PERÚ S.A.	14 September 2012	200,000,000
6 SCOTIABANK PERU S.A.A.	03 December 2012	400,000,000
7 FONDO MIVIVIENDA S.A.	17 January 2013	800,000,000
8 PESQUERA EXALMAR S.A.A.	17 January 2013	200,000,000
9 BBVA BANCO CONTINENTAL	21 January 2013	300,000,000
10 CEMENTOS PACASMAYO S.A.A.	25 January 2013	300,000,000
11 ALICORP S.A.A.	07 March, 2013	450,000,000
12 GAS NATURAL DE LIMA Y CALLAO S.A.	14 March 2013	320,000,000
13 COMPAÑÍA MINERA MILPO S.A.A.	14 March 2013	400,000,000
14 BANCO DE CREDITO DEL PERU	22 March 2013	800,000,000
15 BBVA BANCO CONTINENTAL	02 April 2013	700,000,000
16 FERREYCORP S.A.A.	11 April 2013	400,000,000
17 TRANSPORTADORA DE GAS DEL PERU S.A.	15 April 2013	850,000,000
18 CONSORCIO TRANSMANTARO S.A.	24 April 2013	450,000,000
19 METROPOLITAN MUNICIPALITY OF LIMA	09 August 2013	189,285,714

Source: Prepared by the author on the basis of information from Ministry of the Economy and Finance (MEF).

In cases such as the Metropolitan Municipality of Lima, debt has also been issued in nuevos soles.¹³

According to the Research and Development Division of the SMV, as of December 2013 the outstanding balance of debt instruments placed through initial public offerings represented less than 3% of Peru's GDP, compared with 20% for the outstanding balance of credit issued by banking institutions. This is a highly concentrated market, with issues from just 10 companies accounted for more than 50% of the total outstanding balance as of the end of 2013. Of these, only slightly more than half are nonfinancial companies.

The volumes negotiated with private debt instruments have steadily decreased since 2008, coinciding with the subprime mortgage crisis in the United States, and have yet to recover. In 2013, the volumes negotiated in the securities market with these instruments represented only 0.4% of GDP, for a turnover rate of just 0.15 times per year. In addition, 91% of the total volume negotiated was transacted manually, that is, less than 10% of the total volume was transacted in continuous automated trading.

This position coincides with statements made by Pedro Cazorla in *Semana Económica*¹⁴ indicating that the high level of financing of Peruvian companies in the first four months of 2013 was largely due to the growth prospects for the Peruvian economy and the high liquidity worldwide.

However, in May 2013, the United States Federal Reserve introduced a monetary stimulus package that injected US\$ 85 billion¹⁵ (equivalent to 41% of Peru's GDP in 2012) into the United States economy, significantly halting the participation of foreign investors. Looking for higher returns than

¹³ In the case of the Metropolitan Municipality of Lima, the issuance was denominated in nuevos soles, but for standardization purposes, the value has been indicated in United States dollars based on the exchange rate.

¹⁴ <http://semanaeconomica.com/article/finanzas/130148-buen-bono/>.

¹⁵ The Federal Reserve began to taper the stimulus in June 2013, which led to the closure of positions in financial instruments (mainly fixed-rate securities) in emerging economies, and the immediate result was higher interest rates and upward pressures on the exchange rate in those countries.

those offered in the United States and European markets, these investors left and turned their attention towards emerging economies, including Peru's. In the first four months of 2013, the volume issued internationally by Peruvian companies totaled US\$ 5.375 billion.

Pedro Cazorla discusses the notable case of Alicorp, a company linked to Banco de Crédito, a case study in this report, which floated US\$ 450 million in 10-year bonds that year. This international bond operation closed at a rate of 3.875%, the lowest of any issuance by a Peruvian corporation, due to the strong demand totaling US\$ 3.92 billion, which was 8.7 times the available supply.¹⁶

Slower growth in the debt market has been reflected in the number of transactions observed following the tapering announcement, with not a single placement registered between May and September of that year.

The international market for Peruvian corporate debt was reactivated with the placement of US\$ 150 million by Inkia Energy at a rate of 8.38% in October 2013, and Eten, the power generation company, issued bonds (US\$ 132.8 million) in December 2013 to finance the construction and operation of a new cold reserve thermal power plant in Peru, the first greenfield initiative to be financed with project bonds in Latin America.

The cost of funding ultimately reached a breaking point. The average rate on international issues climbed from 4.54% before May to 8.7% after May. Meanwhile, the cost of local funding in nuevos soles rose from 6.15% to 6.96%, and the cost of dollar funding increased from 4.56% to 6.53%, as illustrated in the following table:

Table VIII.2
Peruvian debt issuers

	Market of issuance ■ National ● International	Currency		Term	Yield
		S/.	US\$		
January	● Fondo MiVivienda	500		10	3.50%
	■ CrediScotia Financiera	50		4	4.72%
	■ Edelnor	50		20	5.13%
	■ Interbank	150		10	5.81%
February	● BBVA Banco Continental	300		35	2.31%
	● Cementos Pacasmayo	300		10	4.50%
	● Pesquera Exalmar	200		7	7.38%
	■ Red de Energía del Perú	77		10	5.13%
	■ Red de Energía del Perú	10		5	4.63%
	■ Banco de Comercio	4		10	10.25%
	● Copeinca	75		4	6.99%
March	● Alicorp	450		10	3.88%
	■ Banco de Comercio	4		10	10.25%
	■ Unacem	60		7	4.94%
	■ Unacem	60		10	5.16%
	● Mipo		350	10	4.63%
	■ Banco Falabella	75		7	5.22%
	■ Banco Falabella	10		5	4.50%

¹⁶ As Cazorla says, “Much of this financing process was not in response to planned investments but rather to take advantage of conditions to reduce the cost of funding. In other words, the companies used the funds they raised to prepay on outstanding debt for the purpose of lowering their interest payments in the future. This (relatively) new international financing option led to a scenario in which corporations (precisely those that had the option) sought less funding from alternative markets, as well as local banks and the Peruvian capital market.”

Table VIII.2 (concluded)

	Market of issuance		Currency		Term	Yield
	■ National ● International	S/.	US\$			
April	● TGP		850		15	1.25%
	● Banco Continental		500		5	3.14%
	● Consorcio Transmantaro		450		10	4.38%
	■ Banco Financiero		70		13	6.90%
	● BCP		350		10	4.35%
	■ Saga Falabella		50		10	5.00%
	● Gas Natural de Lima y Callao (Cálidda)		320		10	4.38%
	● Ferreycorp		300		7	5.00%
	■ Cofide		100		30	5.35%
	● Corp. Lindley		260		10	4.46%
May	● BCP		170		14	4.97%
	■ Edyficar		62		4	5.28%
June	■ Banco Ripley		30		4	5.81%
	■ BIF		30		10	VAC + 4.09%
July	■ Mibanco		45		4	6.59%
	■ Banco Financiero		25		15	8.50%
August	■ Edifica		12		3	T.V. + 5%
	■ Edelnor		50		7	6.75%
	■ Edelnor		36		25	7.28%
	■ Mibanco		39		4	6.97%
October	● Inka Energy		150		8	8.38%
	■ BBVA Banco Continental		45		15	6.53%
	■ Banco Ripley		17		4	7.00%
	■ BIF		10		10	VAC + 4.35%
	■ Scotiabank		39		5	6.19%
	■ Efectiva		90		4	10.47%
	■ Luz del Sur		83		4	5.81%
November	● San Miguel Industrias PET		200		7	7.75%
	● Andino Investment Holding		115		7	11.00%
	■ Edelnor		50		7	6.50%
	■ Edelnor		30		25	7.38%
December	● Eten		133		21	7.65%
	■ Luz del Sur		84		8	7.03%

Source: *Semana Económica*, “Guía para financiarse”, No. 1415, 2014.

Fondo MiVivienda, a government institution, launched 2014 by issuing US\$ 500 million in bonds at an interest rate of 3.5%, to finance its mortgage lending operations. Equally significant was the issuance of bonds totaling US\$ 850 million by Transportadora de Gas del Perú (TGP), a company in the hydrocarbons sector that transports natural gas and liquefied natural gas from lot 88 (Camisea). That transaction was the largest of its kind in 2013, accounting for 14.2% of the total volume issued abroad. The bonds were issued at an interest rate of 4.25% and a 15-year term.

In the first quarter of 2014, corporate bonds have been seen as the most profitable investment, with yields far surpassing those of mutual funds and savings at banks, credit institutions and savings and loan associations.

However, despite the success of the issuances conducted to date, it is important to note the high transaction costs of these operations, which reduces the likelihood that more companies will use this financing strategy.

It is important to take into consideration the alternatives for opening the bond market, given that 178 of the 300 richest companies in the country do not participate in the capital market, either because they have not issued debt or because they do not have an instrument registered with the Public Registry of the Stock Market. With annual sales of over US\$ 100 million, these companies have sufficient scale, net worth and cash generation capacity and thus the minimum gearing ratios required to conduct an efficient operation in the capital market.

G. Companies analysed

In order to conduct an in-depth evaluation of corporate governance practices at companies that issue securities, the following section analyses four Peruvian companies in diverse sectors of the market that have issued debt in the international market. The companies are:

- Industrial sector – mass consumption: Corporación Lindley
- Services sector: Ferreycorp
- Government sector: Cofide
- Financial sector: Banco de Crédito del Perú

These companies provide the information requested by the SMV on compliance with corporate governance practices, which are documented both in their specialized reports on the subject and in their 2013 annual reports, which contain important information on the functioning and policies of senior management at each company.¹⁷

In addition, a valuable source of information is provided by the rating agencies, which have conducted studies on the day-to-day and overall management and control practices at each company in preparation for the evaluations they publish on each one.

It is important to note that two of the four companies are listed on the BVL's Good Corporate Governance Index (Ferreyros and Credicorp). Cofide is also regarded by the BVL as a company that complies with adequate corporate governance standards, but it is not listed on the index for reasons having to do with marketability.

The Peruvian stock market is highly concentrated among a small group of active companies. There are just over 200 Peruvian companies with securities listed on the exchange that could potentially issue debt in the capital market. According to financial information from the 2012 fiscal year, the smallest 10% of these companies had assets of less than US\$ 31 million, together accounting for 0.13% of total assets, while the largest 10% had assets of more than US\$ 2 billion in each case, together accounting for 62.5% of total assets.

Considering this scenario, in which there is a certain degree of homogeneity in the corporate governance practices of the few Peruvian companies that issue debt internationally, the selection criteria were based on the economic sector of each company, respecting the sample selected in the other countries in the project, the topic of analysis and the quantity and quality of public information that the companies make available to the market.

1. Corporación Lindley, S.A.

(a) Background

Lindley, S.A., was founded in 1910 with the soft drink plant La Santa Rosa de José R. Lindley e Hijos, S.A. Subsequently, related companies were created in the real estate sector, in the production

¹⁷ The two documents corresponding to each company are available for review on the SMV website (www.smv.gob.pe) and the BVL website (www.bvl.com.pe).

and marketing of fruit juices, nectars and purees, and in the distribution and transport of carbonated beverages and fruit juices and nectars. The company ultimately became known as Corporación José R. Lindley, S.A. (CJRL).

In 1999, CJRL signed commercial agreements with The Coca Cola Company, becoming part of Coca Cola's worldwide network.

On September 19, 2005, the CJRL board of directors approved a merger of the following companies: ELSA, EPSA, SOCAP and SIJRL. This strategic decision created synergies that were reflected in over 50 operational improvement and savings projects, with deep reductions in investment.

(b) Corporate governance

The CJRL business group consists of Corporación Lindley, S.A., and Embotelladora La Selva, S.A.

In March 2013, the position of vice chairman of the board of directors was approved and two new independent directors were selected, expanding the number of board members by one third. In November that year, a special meeting of the general assembly of shareholders decided to create the position of executive chairman, appointing Johnny Lindley Suárez, the general manager at the time.

As a family business, CJRL has a corporate governance policy with special variables, which requires separating the family and corporate sides of the business by setting up adequate mechanisms such as a family assembly and a family council, documenting family policies in a protocol and establishing channels for monitoring and control of decisions that impact the family members involved in running the business.

As documented in an earlier report by CAF, "Lindley's success is explained not only by its entrepreneurial efforts, proper planning, work and passion for excellence among its people, but also by its good corporate governance practices, which have been internalized over time by senior management and disseminated to all employees."¹⁸

(c) Placement of corporate bonds in the international market

In November 2011, CJRL successfully financed its investment and debt restructuring plan by issuing and placing US\$ 320 million in bonds on the New York Stock Exchange under Rule 144A of the United States Securities and Exchange Commission, drawing the interest of investors in Latin America, the United States, Europe and Asia.

A special meeting of the general assembly of shareholders held in April 2013 approved a financing operation in the international capital market for up to US\$ 260 million. This international financing operation, which consisted of a Rule 144A / Regulation S offering of 10-year bonds at 4.625%, structured by the banks J.P. Morgan and Citibank, sparked demand in excess of supply among international investors and was oversubscribed at a rate of 9.4 times the number of bonds offered.

CJRL has set itself a course to become a global company, an ambition that informed its decision to issue bonds to raise the funds needed to complete a fully automated warehouse for finished products at its Trujillo facility and launch the Pucusana megaplant project, designed to meet future demand in Lima and cities in the heart of the country. Construction of that megaplant and installation of machinery is in full swing, with operations scheduled to come on line at the end of the 2014 fiscal year. This infrastructure effort will be supplemented by the construction of megawarehouses in north, central and south Lima, a project slated to conclude in the 2014 fiscal year.

Having issued international bonds registered with the United States Securities and Exchange Commission, Lindley is subject to the transparency requirements and good corporate governance practices established in the United States Sarbanes-Oxley Act (2002).

¹⁸ CAF/BVL, 2014.

2. Banco de Crédito del Perú, S.A.A.

(a) Background

Banco de Crédito del Perú (BCP) is the leading institution in Peru's financial system. Founded in 1889 as Banco Italiano, it is the oldest commercial bank in Peru and the anchor company of the principal group Credicorp.

BCP is the group's main banking business and has a number of subsidiaries that offer specific products, including Financiera Edyficar and Banco de Crédito BCP Bolivia.

(b) Corporate governance

Credicorp is a holding company and the principal shareholder in Grupo Crédito, Atlantic Security Holding Corporation, El Pacifico Peruano Suiza, Credicorp Capital Ltd. and CCR Inc. Founded in Bermuda in 1995, its main objective is to coordinate the design and execution of the business plans of its subsidiaries for the general purpose of implementing universal banking and financial services in Peru and selectively diversifying throughout the region. Credicorp conducts its businesses exclusively through its subsidiaries.

In line with the evolution of the country's economy, dollar-denominated placements increased by 7.5% in 2013, net interest income grew by 13.7% that year and income from bank fees climbed by 4.6%. These figures have been adjusted for Peru's currency depreciation in mid-2013.

In 2013, the company posted good performance, mainly due to:

- A 13.7% expansion in net income from interest and dividends over the 2012 level, due to the expansion expressed in daily average balances of 11.9% in the wholesale banking portfolio and 9.3% in the retail banking portfolio, which offset the increase in provisions (+20%) and spending on interest (+14.4%).
- Growth of 5.7% in the main categories of nonfinancial income (excluding earnings on sales of securities and other income), with an expansion of 4.6% in fees for banking services and an increase of 9.6% in income from foreign exchange operations that can be attributed to greater exchange rate volatility in 2013.

At the level of corporate governance and management:

- It consolidated the deployment of corporate management of operational risk, market risk, insurance management and credit risk in the wholesale banking portfolio.
- It expanded the validation function by incorporating reviews of pricing tools in the retail banking portfolio.
- It created the models committee (technical committee) within the model framework for corporate governance to establish a step-by-step process for the effective development, implementation, integration with management, monitoring and validation of credit risk models.

The Corporate Compliance Division is responsible for ensuring that BCP complies with local and international regulations and upholds the highest standards of ethics, integrity and professional conduct for the companies in the countries where it has a presence. For that purpose, it has a team of 77 professionals located in Peru, Panama and the United States.

In 2013, a regulatory compliance programme was introduced, which has enabled the group to incorporate better internal controls into the processes of its companies and thus adequately comply with regulatory requirements.

This programme has also taken action on regulatory requirements with a major local impact—the Personal Data Protection Law (LPDP) and the Workplace Health and Safety Law (LSST)— and

international scope such as the Foreign Corrupt Practices Act (FCPA), the Foreign Account Tax Compliance Act (FATCA) and the Dodd-Frank Act.

BCP has a programme in place to fight corruption and bribery that is in line with the FCPA requirements, local regulations and other laws such as the United Kingdom's Bribery Act. This programme includes a grievance system that serves as a communication channel for employees, providers, clients, investors and other interested parties to report fraud, deceit, bad accounting practices or violations of the ethics code or other policies on conduct.

Monitoring of this system is centralized to ensure that it is consistent with the best practices in ethical conduct, transparency and compliance with the Sarbanes-Oxley Act.

(c) Placement of corporate bonds in the international market

Prominent among the structural funding operations carried out in 2013 were the issuance of BCP 2013 international corporate bonds for US\$ 350 million, the reopening of BCP 2027 subordinated bonds for US\$ 170 million and the swap of BCP 2016 bonds issued in 2011 for BCP 2023 bonds recently issued in an operation that added US\$ 366.3 million nominally to the BCP 2023 bond, for a total issuance amount of US\$ 716.3 million. These operations expanded BCP's base of international investors and allowed it to achieve an efficient currency hedge, while taking advantage of historically low rates in the international capital market.

In addition, in March, BCP conducted a syndicated loan operation for US\$ 150 million in the Asian market, which along with other measures helped it to efficiently manage its long-term debt profile and handle growth in the loan portfolio.

(d) Risk rating

The risk rating agencies Apoyo y Asociados Internacionales and Equilibrium Clasificadora de Riesgo gave BCP's bonds a AAA rating.

The international rating agencies—Moody's, Standard & Poor's and Fitch—gave BCP's bonds very healthy ratings: P-2, F-2 and A-2, respectively.

3. Comercio Ferreycorp S.A.A.

(a) Background

In its 91 years of existence (1922), Ferreycorp has undergone a series of transformations in order to adapt to a changing environment and meet the needs of its clients under better conditions, continue to create more jobs and ensure an attractive return on investment for its shareholders.

Since its early years, the company has been dedicated to marketing a series of consumer products, and in 1942 it began to represent Caterpillar in Peru, a business relationship that has been deepening for over 70 years. It is recognized today for the business it does on behalf of its principal client, a global leader in machinery.

Since the 1990s, Ferreycorp's companies have concentrated on providing capital goods and complementary services, which are used by their customers in extractive industries (mining, oil and fishing), productive industries (agriculture and manufacturing) and service industries (construction, energy, commerce and transportation).

A corporate restructuring in 2012 resulted in the repositioning of Ferreycorp as a holding company with 15 subsidiaries, each of which has a specific business focus and specialization within the general area of capital goods and related services.

As part of that restructuring process, in July 2012, the subsidiary Ferreyros, S.A., was created to take over the commercial operations of the company previously known as Ferreyros, S.A.A., and concentrate exclusively on its business activities, shedding its previous role of parent company.

The objective of Ferreycorp, acting through its subsidiary companies, is to meet the growing needs of its clients in the most dynamic sectors of the economy, by providing capital goods from top prestigious brands, as well as a range of services that help its clients achieve greater efficiency and productivity. The Ferreycorp companies seek to permanently boost the value proposal of their clients, by offering an increasingly comprehensive portfolio of products and services, supported by the development of new related businesses with strong synergies with the production of capital goods.

The knowledge that Ferreyros acquires from its clients and their critical factors of success are placed in the service of other subsidiaries in a position to meet other needs of the clientele, supporting their related activities with capital goods. The subsidiary companies supplement its coverage and logistics, among other capacities, achieving synergies that benefit the corporation's clientele. Ferreycorp's business strategy, in addition to achieving efficiencies for its clientele, is intended to drive the company's own growth and development, as it has for the past 10 years, with sales growth of more than 700%.

Ferreycorp's activities can be divided into three lines of business. The companies that represent Caterpillar and associated brands in Peru (Ferreyros, Unimaq and Orvisa) generated 81% of the company's total sales, while the companies that market Caterpillar and related brands abroad (Gentrac in Guatemala, Cogesa in El Salvador, Gentrac in Belize and Mercalsa in Nicaragua) accounted for 9% of its sales. Lastly, the companies that round out the supply of goods and services for the various productive sectors (Motored, Cresko, Mega Representaciones, Fiansa, Ferrenergy, Fargoline and Forbis) contributed 10% to sales.

(b) Corporate governance

Ferreycorp is a leading company in corporate governance and probably the most lauded in Peru. It is a member of the Companies Circle of the OECD Latin American Corporate Governance Roundtable, listed on the BVL's good corporate governance index (IBGC) and recognized internationally with World Finance Corporate Governance Awards in 2011 and 2012 and Garrigues-Affinitas Awards for Good Corporate Governance in Latin America. It has also received various awards and recognition in Peru.¹⁹

As part of activities to monitor and promote good corporate governance practices, Ferreycorp's structure includes a Corporate Governance and Organizational Development Committee, which is responsible for helping the company's leadership to adapt the organizational structure of the company to changes, as well as for supporting performance evaluation, training and professional development for executives and managers at the company. In the area of corporate governance, its function is to ensure compliance with good practices.

It has the following powers and duties:

- Supervise organizational development programmes, through reports on the administrative structure, and human resources programmes.
- Supervise performance management programmes, wage/salary policy, training and development policies, etc.
- Approve the hiring of key executives and the pay scale for executive and management positions, and monitor the supervision conducted by general management of their performance.
 - Supervise the effectiveness of the corporate governance practices by which the company operates, proposing or approving improvements to those practices.
 - Review the self-evaluations of the 26 good corporate governance principles presented in the company's annual report.
 - Supervise the policy for disclosure of "significant events" as well as the policy on privileged and reserved information.
 - Identify potential conflicts of interest between management, directors and shareholders and supervise their monitoring by senior management.

¹⁹ <http://www.ferreycorp.com.pe/gobierno-corporativo/reconocimientos/de-instituciones-locales>.

(c) Placement of corporate bonds in the international market

In 1962, in order to sustain its growth, the shareholders decided to go public and list the company on the BVL, the first step in converting it into a publicly held corporation that now has more than 3,000 shareholders.

In 1994, the company expanded its participation in the capital market by placing corporate bonds and commercial paper, becoming a successful major player in the market and in demand among investors. Since 1995, it has made significant investments to improve its offices and workshops, as well as to train personnel to service maintenance and repair contracts for the fleets of mining vehicles that are brought into the country for the open pit mines, an industry that is developing under concessions following privatization of the mining companies in the 1990s. Later, it started selling machinery for underground mining, after the Caterpillar purchase.

In 1997, building on this growth, the company conducted a successful public offering of shares on local and international markets, raising US\$ 22 million in capital.

Its biggest challenge in terms of financial management in 2013 was to carry out its first issuance of corporate bonds (for US\$ 300 million) in the international market. This operation, which took place in April 2013, was Ferreycorp's first involving fixed-rate instruments in the international market, after 30 years of participating in the Peruvian capital market.

As part of this process, it held a road show with investors in Latin America, the United States and Europe. It used the proceeds of this issuance, which was placed at an annual rate of 4.875%, to restructure its debt from an average maturity of three years with amortizations to a seven-year principal bullet payment. In so doing, the corporation freed up short-term lines of credit to cover its medium-term needs for two years.

The bonds were given a BB+ rating (stable outlook) by the international agencies Moody's and Standard & Poor's.

The investor response was very positive, as reflected in a level of demand that exceeded the amount placed by a factor of five, and in the backing of local and foreign investors.

The operation was carried out with the advisory services of Bank of America Merrill Lynch and J.P. Morgan, which participated as joint bookrunning and joint lead managers, with Credicorp Capital also participating as joint lead manager. Credibolsa was the local placement agent in Peru. Both the issuance and placement of bonds was conducted in accordance with Rule 144A and Regulation S of the United States Securities Act of 1933.

The bonds will have a term of seven years from the date of issuance, which has enabled the company's subsidiaries to improve their debt profiles and the terms and conditions of their loans, as well as free up lines of credit at the banks to cover their cash flow needs for operations, mainly imports of the goods they distribute. These bonds represent approximately 50% of the total financing required. The other 50% is in the form of lines of credit from local banks, foreign banks, Caterpillar Financial Services and the local capital market.

In April 2013, Ferreycorp issued US\$ 300 million in bonds on the international market. The company's total debt ratio as of 31 December 2013 was 0.75, compared with 0.36 a year earlier.

4. Corporación Financiera de Desarrollo, S.A (COFIDE)

(a) Background

COFIDE was created in March 1971 by Decree Law No. 18807 and is registered on Record No. 1108 of the Legal Entities Registry of the Lima and Callao Office of the Registrar.

It was originally created as a State-owned company in the economy and finances sector. Subsequently, through Legislative Decree No. 206 (Law on the System for Promotion and Financial

Support of Business Development), it became a State-owned corporation organized under private law, through a notarial instrument of transformation, reduction and paid capital.

Later, through Supreme Decree No. 25694 of August 1992, COFIDE was created as a merchant bank set up to provide support and financing for urban and rural microenterprises and small businesses.

In its capacity as a merchant bank, COFIDE is not authorized to take direct deposits from the general public, nor can it make any type of direct loan. Between 1992 and the present, the number of financial intermediaries has grown from 28 to 61, including banks, finance companies, leasing companies, municipal savings associations, rural savings associations, cooperatives and microenterprise and small business development companies.

As a merchant bank, COFIDE has streamlined and diversified its financing activities and become a driver of economic development in the country. It offers programmes that finance private activity in all stages and in all productive sectors, including investment support lines, working capital lines, special credit lines for foreign trade, mortgage programmes, technological development and training programmes and intensive support for the microenterprise and small business sector.

(b) Corporate governance

By law,²⁰ State-owned enterprises like COFIDE²¹ are guided by the principles of good corporate governance approved by the National Fund for the Financing of State-owned Enterprises (FONAFE) and act according to the criteria, restrictions and ethical duties that the conduct of their workers requires. Accordingly, the board of directors is committed to monitoring the performance and management indicators linked to the objectives of the institution.

With a corporate governance code approved by its board of directors, COFIDE commissions external evaluations to measure performance and identify areas of improvement to achieve the optimal level of responsible management and investment. A sign of that achievement has been BVL's recognition of the company for having scored higher than the minimum on the IBGC.

(c) Placement of corporate bonds in the international market

COFIDE is important in the money market and an active participant in the Peruvian capital market, administering its own resources as well as third party resources in trust funds and commissions.

In December 2013, the company administered its own US\$ 270.1 million investment portfolio, divided between an investment portfolio and a securities portfolio, which includes various types of debt instruments, at different terms, and in local currency (S/ 442.6 million) and foreign currency (US\$ 112.4 million), consisting of both United States dollars and euros.

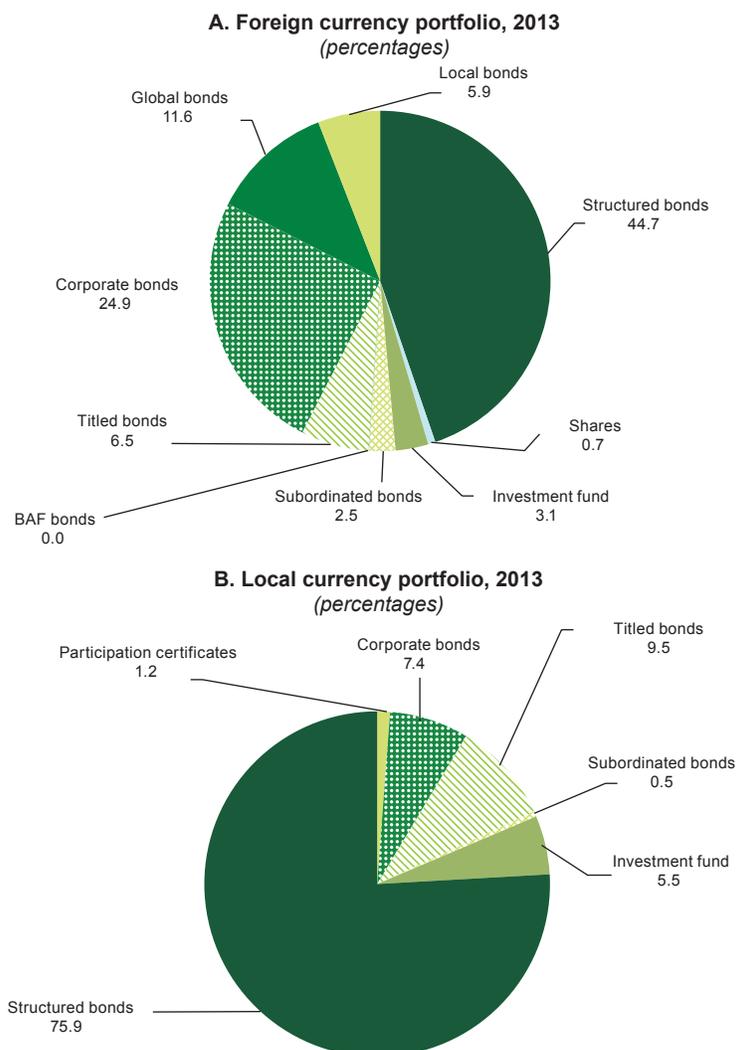
In order to finance infrastructure projects and productive investments, COFIDE participated in 2013 in an operation to finance the Eten Cold Reserve project (structured bonds) and the Los Portales project (titled bonds). COFIDE's portfolio consists mainly of structured bonds (62.9%) and corporate bonds (14.6%), denominated in Peruvian nuevos soles and United States dollars. It also includes leasing bonds, titled bonds, subordinated bonds, participation certificates, investment funds and equity shares (participation in Bladex).

In May 1999, the corporation's general assembly of shareholders approved the "First Programme" of debt securities for a maximum amount at issuance of S/ 700 million (US\$ 250 million), and upon receiving the favourable opinion of Peru's Banking and Insurance Superintendency (SBS) and approval of the proposed transaction, the framework prospectus was filed and the First Programme was entered into the Public Registry of the Stock Market of the National Supervisory Commission for Companies and Securities – CONASEV No. 091-99-EF/94.11.

²⁰ Supreme Decree No. 176-2010-EF and Regulations of Legislative Decree No. 2031.

²¹ In 1997, COFIDE became a semi-public company following the incorporation of CAF as a shareholder. However, it continues to be regulated and supervised by FONAFE.

Figure VIII.3
COFIDE portfolio structure, 2013



Source: COFIDE.

Under the First Programme, effective until July 2003, COFIDE issued bonds totaling US\$ 150.2 million. Of the total issuance, US\$ 100.18 million (S/ 280.5 million) corresponded to 5-, 6-, 8- and 10-year instruments in Peruvian nuevos soles at constant purchasing power, such that the capital from the bonds was readjusted based on constant purchasing power; and the remaining US\$ 50 million (S/ 140 million) corresponded to two-year fixed-rate instruments. As of December 31, 2011, all obligations under the First Programme had been met. The proceeds obtained from transactions under the First Programme were used in the corporation's financial intermediation operations.

In May 2004, COFIDE's general assembly of shareholders approved the "Second Programme" of debt instruments for up to a maximum amount at issuance of US\$ 150 million or an equivalent amount in local currency or another foreign currency. As with the First Programme, upon obtaining the favourable opinion of the SBS, Resolution No. 094-2005-EF/94.11 was issued, approving the proposed transaction, the first framework prospectus was filed and the Second Programme was entered into the CONASEV Public Registry of the Stock Market.

Under the Second Programme, US\$ 126.4 million in fixed-rate corporate bonds were placed, with terms between 25 months and 10 years, and as of December 31, 2013, a balance of US\$ 9.1 million was outstanding.

On April 11, 2008, the COFIDE general assembly of shareholders approved the “Third Programme” of debt instruments for up to a total amount at issuance of US\$ 200 million or an equivalent amount in local currency or another foreign currency. As with the First and Second Programmes, upon obtaining the favourable opinion of the SBS, CONASEV Resolution No. 094-2009-EF/94.06.3 was issued, approving the proposed transaction, the first framework prospectus was filed and the Third Programme was entered into the CONASEV Public Registry of the Stock Market.

Under the Third Programme, instruments totaling US\$ 184 million had been placed as of the end of 2013, thereby completing the issuance for the maximum amount approved by the COFIDE general assembly of shareholders, the entity authorized by law and the company’s charter for such purpose.

In September 2012, COFIDE’s general assembly of shareholders approved the “Fourth Programme” of debt instruments for up to US\$ 400 million or an equivalent amount in local currency or another foreign currency. As with the earlier programmes, upon obtaining the favourable opinion of the SBS, Resolution No. 029-2013-SMV/11 was issued, approving the proposed transaction, the first framework prospectus was filed and the Fourth Programme was entered into the SMV Public Registry of the Stock Market. Under the programme, instruments totaling US\$ 35.72 million had been placed as of the end of 2013.

The proceeds obtained from operations under the second, third and fourth programmes have been used primarily to (i) finance new intermediation operations at COFIDE through the National Financial System, and to a lesser extent (ii) to pay outstanding obligations in order to increase the corporation’s efficiency in managing its liabilities and (iii) to optimize financial results by financing negotiable investments in the capital market.

The total outstanding balance of securities as of the end of 2013 was US\$ 228.75 million, of which US\$ 9.07 million corresponded to securities issued under COFIDE’s second programme, US\$ 184 million corresponded to securities under its third programme and US\$ 35.72 million corresponded to its fourth programme.

The bonds issued under the second, third and fourth programmes were backed generally by COFIDE’s equity and listed on the registry run by CAVALI ICLV,²² S.A., and on the BVL floor session, and were registered as freely negotiable book-entry securities.

In addition, COFIDE took out two bilateral loans for US\$ 100 million each from the Bank of Tokyo – Mitsubishi UFJ, Ltd., and HSBC Bank USA. The two banks structured a syndicated loan for COFIDE with the participation of 22 banks from around the world for a total amount of US\$ 200 million. As of the end of December 2013, the total outstanding balance on bank loans, deposits and securities was US\$ 1.9259 billion, a US\$ 298.2 million increase over the outstanding balance at the end of 2012, due to greater short-term liabilities (US\$ 106 million), medium-term liabilities (US\$ 177.7 million) and issuances in the local and international markets (US\$ 14.6 million).

(d) Risk rating

In August 2013, the rating agency Standard & Poor’s upgraded the rating on COFIDE’s long-term debt in local currency (BBB+) and in foreign currency (BBB+). Likewise, in October 2013, Fitch Ratings updated the rating on the company’s long-term debt in foreign currency (BBB+) and in local currency (A-). Meanwhile, the rating agency Moody’s assigned an initial Baa3 to instruments issued by COFIDE.

The firms Equilibrium Clasificadora de Riesgo, S.A., and Apoyo & Asociados Internacionales, S.A.C., ratified their institutional ratings of COFIDE at A+ and A, respectively. These ratings reflect the company’s considerable financial strength. In addition, they have maintained the AAA rating assigned to debt instruments issued by COFIDE.

The COFIDE financial profile reflects the good quality of its assets and its strong level of capitalization and reaffirms its essential role as a development bank that is helping strengthen and implement the public policies of the Peruvian government.

²² This is the abbreviation of the full business name CAVALI Institución de Compensación y Liquidación de Valores Sociedad Anónima. This institution has been absorbed by the Lima Stock Exchange (BVL).

5. Corporate governance compliance indicator for the issuance of international bonds

Standards for bonds	Company 1		Company 2		Company 3		Company 4		Benchmarking	
	1 or 0	Index	1 or 0	Average						
Does it authorize the issuance of bonds, whether or not the regulator requires a placement memorandum?	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
Does the bond prospectus comply with the regulator's requirements for public offerings?	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
Is there information on resource use, both in the business strategy and per project and/or debt restructuring?	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
Are the implications and actions relating to the company's issues and leverage levels known factors?	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377
Are the design and analysis of the issue delegated to the corporate finance committee?	1	0.189	0	0	1	0.189	1	0.189	0.75	0.14175
Is the analysis of the financial risks of the issue delegated to the risk committee?	1	0.189	0	0	1	0.189	1	0.189	0.75	0.14175
Is the responsibility of management reports on issuance information delegated to the audit committee?	1	0.189	1	0.189	0	0	1	0.189	0.75	0.14175
Does the board have between 8 and 15 directors?	1	0.031	1	0.031	0	0	1	0.031	0.75	0.02325
Does the board have at least 50% outside directors?	1	0.031	0	0	0	0	1	0.031	0.5	0.0155
Are more than half of the outside directors independent?	1	0.032	1	0.032	0	0	1	0.032	0.75	0.024
In the selection of some outside directors, is priority given to their expertise in finance, particularly in corporate financing?	1	0.189	1	0.189	1	0.189	1	0.189	1	0.189
Is the chair of the board of directors an outside, independent director?	0	0	0	0	0	0	0	0	0	0
Do more than 50% of the directors have sound and updated knowledge of finance and corporate financing?	1	0.095	1	0.095	1	0.095	1	0.095	1	0.095
Do more than 50% of the outside directors have sound and updated knowledge of finance and corporate financing?	1	0.095	1	0.095	1	0.095	1	0.095	1	0.095
Is there a systematic training programme for directors?	0	0	0	0	0	0	0	0	0	0
Do they have certifications in financial matters on which they make decisions?	0	0	0	0	1	0.189	1	0.189	0.5	0.0945
Is the performance of each outside director regularly reviewed?	1	0.189	1	0.189	1	0.189	1	0.189	1	0.189
Do the outside directors flag conflicts of interest in the bond issuance process?	1	0.189	1	0.189	1	0.189	1	0.189	1	0.189
Are there three or more outside directors for each inside one?	0	0	1	0.189	0	0	1	0.189	0.5	0.0945
Are the outside directors selected by a committee of independent directors?	0	0	0	0	0	0	0	0	0	0

Standards for bonds	Company 1		Company 2		Company 3		Company 4		Benchmarking		
	1 or 0	Index	1 or 0	Index							
	Average										
Do the inside directors sign off, as legally and criminally accountable, on disclosures concerning a bond issue and its implications for the financial position of the company?	0	0	0	0	1	0.377	0	0	0	0.25	0.09425
Is the internal audit director a member of the board?	1	0.189	0	0	1	0.189	0	0	0	0.5	0.0945
Does the internal audit director report directly to the board or the audit committee?	1	0.189	1	0.189	1	0.189	1	0.189	1	0.189	0.189
Is the audit committee chaired by an independent director?	0	0	0	0	0	0	0	0	0	0	0
Is the independent auditor engaged by the audit committee, and does it report to the committee?	1	0.377	0	0	0	0	0	0	0	0.25	0.09425
Does the audit committee approve the internal and external audit programmes?	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377	0.377
Is there an effective reporting system on corporate financing?	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377	0.377
Does the committee prepare regular reports to the board and to general management on compliance with internal control policies on the use of financial resources for financing?	1	0.377	1	0.377	1	0.377	1	0.377	1	0.377	0.377
Is the investment committee chaired by an independent director?	0	0	0	0	0	0	0	0	0	0	0
Does the chair of the investment committee have proven experience in investment strategies?	1	0.095	0	0	1	0.095	1	0.095	1	0.75	0.07125
Does the committee meet at least once a month?	0	0	0	0	1	0.095	1	0.095	1	0.5	0.0475
Is the committee chaired by an independent director?	0	0	0	0	1	0.377	0	0	0	0.25	0.09425
Does the committee chair have proven experience in corporate financing?	1	0.377	0	0	1	0.377	0	0	0	0.5	0.1885
Is this the committee that defines the funding requirements of the company and how to meet them?	1	0.377	1	0.377	1	0.377	0	0	0	0.75	0.28275
Is this the committee that selects the financial intermediaries to place bonds issued by the company?	0	0	0	0	0	0	0	0	0	0	0
Is the risk committee chaired by an independent director?	0	0	0	0	0	0	0	0	0	0	0
Does the committee chair have proven experience and expertise in comprehensive risk management?	1	0.377	0	0	1	0.377	1	0.377	1	0.75	0.28275
Is it the risk committee that is responsible for ruling on reports on the financial risks faced by the company?	0	0	1	0.377	1	0.377	1	0.377	1	0.75	0.28275
Is it the risk committee that explains the company's bond issuance risks?	0	0	1	0.377	1	0.377	1	0.377	1	0.75	0.28275
Total		6.038		5.157		7.170		5.945			6.078

Source: Prepared by the author.

6. Comments on the results of the index

All four companies in these case studies submitted the self-evaluation document on compliance with the principles of good governance for companies. Each one responded to all the requirements indicated in the document, which focuses more on good management of the company than on financial practices, specifically the borrowing policy.

In all cases, the boards of directors are seen to play an active role, authorizing the issuance of corporate bonds on the express instructions of the general shareholders assemblies, which determine the degree of autonomy exercised by the boards of directors.

In all cases, the companies meet the requirements set by the regulator for the issuance of bonds, included in the debt placement memorandum.

The funds raised by the companies by issuing bonds have primarily gone to support their main business activity. In the case of Ferreycorp, the proceeds are used to acquire goods, especially heavy machinery for the extractive, construction and infrastructure industries. Corporación Lindley has been pursuing an ambitious plan in recent years to build mega-plants for the production and bottling of its beverages, so proceeds from previous issuances financed construction of the now-completed plant in Trujillo (northern Peru) and proceeds from the more recent operation are being used to build its plant in Arequipa (southern Peru).

The financial institutions COFIDE and BCP issue debt for the purpose of supporting lending operations in their respective portfolios.

The role of risk rating agencies is important because they instill confidence in investors interested in buying bonds. The four companies in this profile publicly disclose the ratings they have received for both previous and current issuances.

The number of directors on the companies' boards of directors varies, but in three of four cases, there are a very prudent number of independent directors. In the case of COFIDE, four of the five directors have an employment relationship with the State that makes them inside directors despite the fact that in terms of ownership, this cannot be the case since the institution is owned by the State and CAF (1%).

The boards of directors analysed in these studies give priority to the profile of financial director. For all four companies, a review of the profiles of the directors shows that there is a bias in favor of professionals with solid finance and investment expertise. However, this does not mean that knowledge of the business is overlooked. The most instructive example is the case of Corporación Lindley, which reports experience in the industrial sector, and in the nonalcoholic beverage sector specifically, as among the criteria used to select its directors.

Both inside and outside directors are elected by the general assembly of shareholders. The companies have not yet instituted any policies to appoint independent or outside directors through a specific selection committee.

The audit committees are not in all cases part of the board of directors. In the case of BCP and Corporación Lindley, these committees are independent of the boards of directors but report regularly to them, serving as a very valuable source of information for decision-making at the strategic level.

There is no information on investment, finance or risk committees in the case of these companies. Evaluation of these committees is important in terms of board decision-making and the issuance of debt.

The low scores for the indicators for Ferreycorp and Corporación Lindley have more to do with the lack of specific information on the existence of committees than on a low level of compliance.

Lastly, Peru's solid regulatory framework governing corporations and the stock market has contributed to the high level of compliance reported by the four companies in these case studies.

H. Conclusions

In the wake of the 2008 global financial crisis, major investors migrated to emerging markets, including Peru, a country that has maintained a balanced macroeconomic position for the past 15 years and taken advantage of international opportunities, signing various free trade agreements, locking in Europe and Asia as trading partners (commodities) and capitalizing on swings in the United States economy and rising domestic demand.

The most representative Peruvian companies have responded responsibly to market demands, charting a prudent business path that has included adopting responsible investment policies and best practices in corporate governance. Through these actions, the companies have succeeded in drawing the attention of the global financial market.

In addition to attracting investments, Peruvian companies have been playing a more active role abroad. Not only have they issued securities in the world's major stock markets, but also they have acquired full or partial stakes in companies throughout Latin America and successfully placed debt in international markets.

In the case of the companies in these case studies, each belongs to a different sector of the national economy and represents a different size and ownership structure, from family businesses to State-owned enterprises and holding companies. All are aligned with the good corporate governance practices established by the SMV and publish annual reports and a self-evaluation indicative of their health, revealing a higher rate of compliance every year with good governance practices, market transparency and shareholder protections.

In relation to international bond floats, thanks to the favourable risk ratings for the issuer companies, demand is quite strong, with bond offerings regularly oversubscribed.

As indicated by the Central Reserve Bank of Peru (BCR), access to financing in foreign capital markets has been facilitated by Peru's investment grade rating and its strong macroeconomic performance of late. As a result, Peruvian companies have issued debt abroad with considerable success, gaining access to financing in amounts far greater than what they would get from similar operations in the local market, a fact owing to the diversity of investors in international markets, in contrast with the local market where demand is concentrated among four pension fund administrators and five mutual fund management companies. Moreover, the former group of institutional investors is subject to limits on purchases of these instruments.

Accordingly, the first issuances under a major initiative such as the newly created Alternate Stock Market (MAV) have felt the positive impact of Peru's system, with demand coming in at 1.2 to 2.8 times the supply of securities issued in this still little-known market.

As noted, despite the emphasis on transparency, there are still weaknesses in the Peruvian market, which become evident upon a detailed analysis of the evaluations of risk and audit areas and the structures that issuers have set up in this regard. Very few companies have adequate and independently staffed risk, audit and corporate finance committees in place.

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IX. Concluding remarks

The development of capital markets over the last few decades has opened up corporate financing alternatives other than the traditional bank loan. These include issuing shares and bonds, which figures published by the Bank for International Settlements (BIS) show have become attractive ways of financing long-term projects.

Specific features of the Latin American economies, such as their ownership structure, continue to impose constraints on the region's capital markets. Apart from the growing importance of institutional funds (pension funds, particularly), there has been no significant change in corporate ownership structures, despite capital-market reforms and progress in developing regulatory frameworks. The analysis of 22 firms in five of the region's countries covered by this project reveals a concentrated and family-based structure, except in the case of State-owned enterprises.

Among Latin America's corporate debt markets, apart from Brazil and Mexico most countries still have few issuers, low levels of secondary-market liquidity, and high transaction costs, among other constraints.

The study found that bond issuers are large firms with risk ratings of AAA or AA+. In this connection, one of the project's recommendations is that, to increase the number of smaller firms accessing this market to finance themselves at a lower cost, it would be advisable to implement differentiated corporate governance levels, along with a private or semi-private channel to enable institutional investors (pension funds) to acquire private corporate bonds without accessing the public securities market, thereby avoiding risk rating. This means addressing and gradually changing a financial-culture problem.

In 2013, Mexico and Brazil, in that order, had the two largest stocks of international corporate debt.¹ Between them, these two countries accounted for 66% of the region's total corporate debt stock in 2011-2013; and, in the case of domestic markets, the proportion amounted to 88% in the same period.

If corporate debt is measured in relation to GDP, Chile has the largest share. Under this criterion, in 2012 Chile's international corporate debt stock represented 10.3% of its GDP. In Mexico (the second largest in relation to GDP) the equivalent figure was 7.5%; in Peru and Venezuela it was 6.1%, in Brazil 4.4%, in Colombia 3.3%, and in Argentina 1.6%.

¹ In Brazil, the stock of private bonds grew from 2.4% of GDP in 2004 to 9.5% in 2010, reflecting the fact that it became easier to issue debt in that country as from 2009.

A specific analysis of corporate debt issuance shows clearly that taking account of the impact of key agents, such as investment banks, rating agencies and institutional investors, completes the analysis of the role of corporate governance in capital market development, particularly debt issuance. This analysis also enhanced the approach used in the case studies. Each of these players has gained increasing importance in the different levels of debt issuance decision-making. For example, there are increasing numbers of independent directors elected by the shareholders meeting, supported by institutional investors. This creates a more effective control environment within the board of directors, a mechanism that is crucial for deciding the company's borrowing policies, among other issues.

The analysis made by Avendaño and Nieto in the third chapter of this volume shows that Latin America accounts for roughly half of the total number of bond issues and about 40% of the total amount issued. The same analysis concludes that there is still limited access to firm-specific information, so several indicators have to be calculated using macro-data. The corporate spread of the issues depends on macroeconomic variables (including the sovereign risk rating); but company variables are more important for explaining placement fees, since fees are a decreasing function of the reputation of the banks that underwrite the bonds and the risk rating agencies' perception of the issuing firm. This finding suggests that institutional investors (which determine the price or primary spread of the securities issued) pay less attention to the financial sustainability of the issuers than the investment banks (which determine the underwriting fee).

In recent years, while the capital market has become increasingly dynamic, at the same time there have been cases of a lack of transparency, information asymmetry and conflicts of interest in firms. Accordingly, this project stresses the need to improve corporate governance performance, as a key requirement for further capital-market development. In addition to contributing to the healthy development of businesses in question, this is also a useful and efficient tool for supervision and application of the law, in other words enforcement. It should be noted that the index proposed in this project, in no way aims to measure corporate governance in its entirety; the spirit in which the index is constructed is as an initial approximation to the reality of corporate governance quality among participants in the international corporate debt market.

The actions of the board of directors and its committees, along with the independence of the directors and the internal control system, are all decisive for assessing the risks assumed by the firm and, hence, its financing costs. Having said that, the second phase of the methodological approach developed in this project involves assigning specific weights to each of the indicator's constituent components, in order to produce a matrix of corporate governance-index and debt-issuance benchmarks.

The indicator designed was applied to 22 debt-issuing firms (both private and State-owned) from the following sectors: financial, manufacturing/industry, services, and State-owned enterprises, in five countries of the region: Brazil, Chile, Colombia, Mexico and Peru. The results revealed a number of governance shortcomings in the debt issues of certain firms, but also significant progress in terms of improving the corresponding regulatory frameworks. The topics covered by the indicator are: the composition of boards of directors, the number of outside and independent directors, the creation of ad hoc committees responsible for financing and investment decisions, as well as for internal control and audit; and the identification and control of business-related risks.

Several shortcomings in the firms' performance on governance and debt issuance revealed by the exercise concerned the corporate committees proposed in the indicator. Only a few firms have audit and risk committees. Apart from a few State-owned enterprises, almost no firm has investment and corporate financing committees. Furthermore, it was also found that, in most countries, the different committees fulfill their functions only partially, owing to the fact that each firm has its own structure and governance organization.

For example, the four Colombian cases studies displayed good performance, with high corporate governance standards and successful debt issuance processes on both the local and the international market. Nonetheless, one of the conclusions of the case studies is that despite the success achieved

by the firms, they did not approach the benchmark value of good practices proposed according to the standards of the project indicator, particularly in relation to the committees. Sanin and Arteaga found that “some of these best practices are buried in internal documents, which make them hard to verify”. Interviews with senior executives of the firms improved the indicators collected merely by revising corporate governance codes. Accordingly, one of the recommendations was to improve access to other international corporate governance standards, which are not specified in the local codes.

When the indicator was applied to the four firms selected in Mexico, the initial finding was that most of the categories are satisfied, in theory. Nonetheless, in practice there are still large areas of opportunity to improve performance.

The results of the 2011 PriceWaterhouseCoopers survey of corporate governance in Mexico, covering 72 firms (23% public) from various sectors, reaches the same conclusion. The vast majority (94%) reported that they had a board of directors in which 33% of the directors are independent. In 42% of the cases, the chair of the board and CEO of the company are the same person; while 61% of these posts were occupied by majority shareholders or their relatives. Only 75% had an audit committee and 57% had corporate practice or planning and finance committees, or both.

Regarding the indicator proposed by ECLAC/CAF/IDB, the best-rated category was the role of the board of directors, with an average score of 1.65, which means that the firms attained 80% of the benchmark value for the category (2,075). Moreover, for the category relating to the structure of the board, the firms attained 71% of the benchmark, whereas for the audit committee, the value was 60%, and lastly for the role and selection of inside and outside directors, the benchmark was attained to the extent of 49%.

In contrast, the least satisfactory results were: the risk committee (40%), the financial asset investment committee (36%), the corporate financing committee (32%), and the role of the board chairperson (31%).

These results identify the four points that need to be prioritized to improve corporate governance performance in corporate bond issues, even in relatively better-placed countries, such as Chile, Mexico and Peru.

To conclude, the corporate-bond market in the five countries studied is still small, but growing vigorously. The current situation could provide an opportunity for further expansion, thereby generating an alternative source of financing for the region’s smaller firms, given the countries’ inefficient banking systems. The active role of institutional investors is crucial for expanding this market, and for supporting better corporate governance schemes

In terms of corporate governance, the changes made to regulatory frameworks in the countries studied have had positive results, although the improvements are not fully reflected in practice or in the indicator proposed to measure corporate governance performance in terms of debt issuance. The results obtained show that generally there are areas of opportunity for alignment with the proposed standards to improve corporate governance.

An analysis of these results on the basis of the six categories identified as crucial (the role of the board of directors, the role and selection of the directors, the audit committee, the corporate financing committee, the risks committee and the investments committee), shows that the highest scores are obtained in the first category. In other words, over half of the firms analysed are above average. This can be interpreted as meaning that in over 50% of the firms the board of directors has information on the investment and financing activities undertaken by the firm.

Unlike boards of directors, the categories that fall most short of the defined benchmark values are the risks and corporate financing committees; these require special attention by the firms. Although the scores corresponding to the audit committee are better, they are still low: only half of the firms

met the established standards. A critical point in corporate governance is the role and selection of the directors. According to the data revealed in the study, fewer than 50% of firms fulfil the standards proposed for this category.

Although this is an unrepresentative sample (22 firms), the results obtained when applying this qualitative indicator to them could shed light on what happens in other firms in the countries studied. It could also constitute an indicator of possible shortcomings, which should be optimized to improve corporate governance performance in terms of debt issuance, as the indicator categories become disseminated and the number of firms using it as a self-evaluation benchmark increases.

Moreover, the information generated here could also be relevant for rating agencies in respect of the debt securities they work with. Information on the degree of fulfilment of the proposed corporate governance standards could be incorporated into their rating methodology, under the “governance risk” heading.

The role of the stakeholders is crucial. The regulators consider the indicator a good benchmark for evaluating the firm’s performance in terms of debt issuance. The rating agencies consider it a tool for mitigating agency risks, by monitoring the actions and decisions of the board of directors, and according a greater weight to corporate governance when evaluating the risk of debt issues. The indicator can also help to improve the disclosure of information on the firm, its ownership structure, and the growing role of institutional investors on the boards. A better credit rating, supported by the reputation of the investment bank, will doubtless lead to lower underwriting fees.

Lastly, it is important that the regulatory authorities are involved in practice in all corporate governance improvement processes, because the latter often depend on them and on the type of information supplied by the firm to the market on its real corporate governance performance.

A public policy recommendation that can be drawn from this project is to improve the quality of enforcement and prudential controls on best practices, including the standards applicable to corporate governance.



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