

**ICGN Viewpoint****What is the role of the creditor in corporate governance and investor stewardship?****September 2019**

As investor stewardship extends beyond equities it can be challenging for investors to consider how to adopt their stewardship practices to include fixed income and other asset classes. In the case of corporate fixed income part of this challenge lies in creditors not having formal ownership rights—as well as sometimes competing agendas with shareholders. Yet in many areas of corporate governance there can be a significant alignment of interests that supports engagement on behalf of all financial stakeholders, both creditors and shareholders.

In ICGN's Global Stewardship Principles the role of the creditor is presented in the context of the “ecosystem” of stewardship.¹ In this context it is important to build understanding on the role of the creditor in corporate governance and to explore areas of commonality and difference with shareholders with regard to corporate governance matters. This can provide a framework for fixed income investors to factor governance related issues into investment analysis and stewardship activities.

As providers of risk capital, both creditors and shareholders are exposed to the residual risk of companies they invest in, and debt tends to be a permanent form of capital in most companies – even if individual debt issues are serviced and then reissued. Sustainable and healthy companies should seek to maintain positive relations with both creditors and shareholders to ensure cost effective access to both debt and equity capital. In turn, boards should ensure that company governance and capital allocation mechanisms reflect a fair and appropriate balancing of shareholder and creditor interests. Easier said than done?

Public debt is a critical source of corporate capital

In terms of size the public fixed income markets are substantial, with the global bond market's outstanding value measured at over \$100 trillion in 2017, as compared with global equity market capitalisation of \$85 trillion.² Most of this debt issuance comes from sovereign or public sector borrowers, but the corporate bond and money markets are an important source of finance for many global companies. Moreover, for many mature listed or controlled

¹ ICGN Global Stewardship Principles, 2016: Part 3: Ecosystem of Stewardship: <http://icgn.flpbks.com/icgn-global-stewardship-principles/#p=1>

² SIFMA Factbook, 2018, pages 51 and 54.

companies debt capital may represent the only “new” source of financing, if nothing else as existing debt issues mature and require reissuance. For example, in the world’s largest capital market, the United States (US) corporate debt issuance was over \$1.6 trillion in 2017, as compared with new public equity issuance of \$223 billion.³ In these situations the creditor can play an important strategic role in corporate financing as the main source of fresh capital

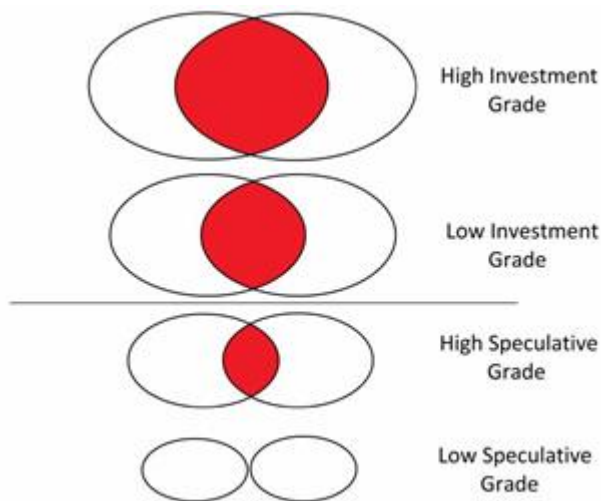
Irreconcilable risk preferences?

As creditors, holders of corporate bonds or other forms of debt, have an intrinsic preference for financial prudence and a company’s ability to not only repay its credit obligations on a timely basis, but also to maintain a stable and predictable credit risk profile. Creditor rights in the first instance are contractually defined in the terms of indenture agreements in individual debt issues vis-à-vis their seniority in the company’s capital structure, and the use of covenants in debt issues provides a basic, if sometimes crude, mechanism for the company to manage its finances within creditor preferences. However, most institutional investors expect, and strongly prefer, issuers to maintain their credit quality without having to make use of covenants or other formal creditor protections. Since they have no upside potential, they only face downside risks: hence the creditor’s tendency for risk aversion. It warrants noting that as securities, corporate debt can be less liquid than corporate equity, suggesting perhaps a longer-term commitment to a company than many shareholders, who often can easily trade in and out of an equity position.

Shareholders, on the other hand, have a focus on upside capital appreciation and total shareholder return, and tend to have a greater risk appetite for companies to generate desired returns on equity. They also have ownership rights to vote at company general meetings—to elect directors, approve the financial accounts, approve remuneration and capital transactions. These ownership rights can be used to encourage companies to take risks that may benefit shareholders at the expense of creditor interests.

³ Ibid, page 21.

Overlap of creditor and shareholder interests



The diagram above seeks to demonstrate the dynamic nature of how creditor and shareholder interests may vary with the financial strength of the company. Particularly for companies whose credit profile is mid to high investment grade, both creditors and shareholders will share a common interest in the company's ability to continue to function as a financially healthy going concern – to create sustainable value to satisfy the requirements of both providers of capital.

On the other hand, when a company is in, or approaching, bankruptcy the interests of creditors and shareholders may have little alignment; in extremis they can be at odds with one another. These considerations suggest real or potential barriers for creditors and shareholders to be aligned, particularly with regard to stewardship and company engagement. The differing preferences of creditors and shareholders are explored in an empirical study by Keswani, Tran and Volpin of Cass Business School, University of London (2019), which also observes that the natural wedge between creditors and shareholders “is magnified close to financial distress”.⁴ Focusing on resolutions that shareholders routinely vote on in annual general meetings the paper cites potential conflict of interests in a number of practical areas, including:

- Dividends and share repurchases, which can reduce the company's financial assets and result in a riskier balance sheet and credit profile;
- Anti-takeover provisions – can reduce risky (and sometimes financially leveraged) takeovers

⁴ These barriers and differing preferences of creditors and shareholders are explored in an empirical study by Keswani, Tran and Volpin of Cass Business School, University of London: Institutional Debt Holdings and Governance, European Corporate Governance Institute Working Paper Series, June 2019.

https://ecgi.global/sites/default/files/working_papers/documents/finalkeswanitrانvolpin_0.pdf

- Executive compensation—providing equity-based incentives for risky behaviour
- Corporate restructuring, asset sales and spinoffs, liquidation.

Common ground: different asset classes, but one company

Yet while there is scope for conflict between shareholders and creditors there is also an overlap of interests, particularly for companies in a healthy “going concern” state. This is most obviously the case with so-called ‘universal owners’— institutional investors with holdings of both corporate bonds and corporate debt in the same company. At least at a broad level both creditors and shareholders will want companies using their risk capital to have good corporate governance and good management; even though they may have specific preferences there is much common ground.

A further premise is that creditors and shareholders with long-term horizons can unite around supporting the overall sustainability and long-term success of the company as issuer of both debt and equity. In many ways creditors and shareholders have a symbiotic relationship: they need one another. For an “enlightened shareholder” this suggests the imperative of managing the capital structure within appropriate risk tolerances, to respect the expectations of creditors—and to ensure access to debt capital at a cost-effective rate. An “enlightened creditor”, on the other hand must recognise the need for the company to take prudent levels of risk to generate sufficient risk-weighted returns on cost of capital. At least for companies comfortably in the mid/upper investment grade spectrum creditors and shareholders will both want companies to maintain sustainable financial performance to generate cash flows for debt service, as well as earnings growth, dividend payments, capital retention and capital appreciation.

It is ultimately the responsibility of boards to ensure that a company has a sustainable capital structure to satisfy the requirements of both creditors and shareholders. In many ways this is a matter of capital allocation – where corporate finance meets corporate governance.

ESG risks: a concern shared by both creditors and shareholders

Even though creditors are more protected than shareholders within a company’s capital structure, both share an aversion to environmental, social and governance (ESG) related risks that have the potential to threaten both credit quality and generation of returns for shareholders. As awareness of ESG risks builds, ESG factors are increasingly featured in fixed income analytics and credit analysis, linking levels of ESG risk to assessments of profitability, cash flow, balance sheet strength and ability to service debt capital. This in turn

links to credit quality and the cost of debt capital.⁵ After some urging from their institutional investor client base, the large credit rating agencies, such as S&P Global and Moody's, have introduced ESG assessments as supplements to the credit rating process. If this initiative is successful it stands to heighten awareness of ESG risks that threaten credit quality and credit ratings. It also provides creditors with an incentive to add their voice to the collective investor engagement with companies to promote better ESG performance and sustainable value creation.

A specific way in which creditors can influence better sustainability performance in investee companies is through negotiating covenant provisions in indenture agreements that establish performance parameters on specific ESG factors (environmental, social, ethical) that may be material to the company and its potential for sustainable value creation. The ability to achieve this level of influence may be greatest when the investors are "anchor" purchasers of new corporate debt issues.

Creditor expectations of companies

The conflicts between shareholders and creditors will never be completely eliminated, even for companies in a healthy financial position. But there are fundamental governance expectations that creditors can express that need not conflict with the interests of equity investors. These include:

1. **Statement on financial policy and capital allocation.** This should cover a company's own statement on the use of debt and financial leverage and address its overall approach to capital allocation. A risky financial strategy is not intrinsically flawed as long as it is appropriately communicated to creditors.
2. **Risk management, including ESG risks.** Shareholders and creditors both want companies to have robust risk management practices. This includes traditional financial and operational risks, but increasingly focuses on integrating ESG risks in an enterprise-wide context.
3. **Board effectiveness.** Shareholders and creditors want strong boards to provide independent support and constructive challenge to the company and its executive management. As part of the governance of sustainability, creditors expect boards to demonstrate appropriate understanding and oversight of ESG risks.
4. **Audit, accounting and reporting.** Creditors have a clear interest in a robust audit process and prudent accounting policies to ensure accurate reporting and guard

⁵ For example in the aftermath of Volkswagen AG's emissions scandal S&P Global downgraded Volkswagen's long-term and short-term credit ratings from A/A-1 to A-/A-2, reflecting its corporate governance deficiencies in risk management and internal control, as well as its ownership structure. The lower A-2 rating for its short-term debt has the effect of impacting its access to the commercial paper market, where many institutional investors do not purchase commercial paper rated A-2 or lower.

against financial risks. Creditors should encourage integrated reporting to ensure consideration of so-called “non-financial” (or pre-financial) issues.

- 5. Remuneration.** Incentive structures should discourage executive management to take disproportionate risks to receive bonus awards. This is relevant to all corporate issuers, but of particular relevance to financial institutions given their high gearing and systemic significance.

Special cases: banks and sovereigns

For purposes of risk assessment and engagement relating to fixed income issuers, banks and sovereign bond issuers differ in some important ways from other issuers of public debt.

Banks are typically corporates themselves with their own obligations to deliver returns to shareholders. But they are distinct issuers for two main reasons. First, they are typically highly leveraged, with equity sometimes accounting for as little as 5% of a bank’s total funding. The overwhelmingly predominant source of funding is from creditors—savers, intrabank lenders and holders of bank public debt instruments. Secondly, as was recently demonstrated in the Financial Crisis of 2008 the health banking system as a whole is critical to the functioning of the global economy; some banks remain so systemically important that they represent a contingent liability to the host sovereign government.

These systemic considerations and the need to protect retail banking customers results in considerable regulatory oversight and controls in banks relating to capital adequacy, asset quality, liquidity and funding. Yet it is important for creditors and shareholders in banks not to rely on regulatory oversight and to seek alignment as providers of risk capital. Given the multiple tiers of debt in many financial institutions, holders of corporate debt (even senior debt) will rank in hierarchy below retail savers. In many ways the interests of creditors and shareholders in banks can be very similar. For example, bank debt instruments subject to “bail in” (forced conversion to equity) are in some ways another form of preferred stock.

From an engagement perspective both the creditor and the shareholder will wish to see the bank financially successful in terms of maintaining credit quality and the ability to generate shareholder returns.

Given the systemic risks and the confidence sensitive nature of banking, both creditors long-term shareholders should also discourage aggressive or risky funding strategies as a way to generate returns on equity (RoE) to boost share price. While RoE is a metric often focused upon by shareholders, it can be problematic to emphasise RoE for highly leveraged and systemically significant financial institutions, particularly as a performance metric in

executive incentive schemes. Risk-adjusted economic profitability, addressing returns on total assets, offers a more balanced basis of executive incentive from a creditor's perspective.

Sovereign borrowers and other public sector entities constitute a substantial portion of the global debt markets. For example, as of 2017 public sector debt represented roughly 80% of the debt outstanding in the US fixed income markets.⁶ Unlike corporate borrowers, sovereigns do not have shareholders, so creditors constitute the only financial stakeholder. In spite of this important role, sovereign creditors do not have ownership rights, such as the right to elect directors, approve capital issuance or other key transactions.

This suggests limits to what creditors might achieve in practical terms from engagement with sovereign or other public sector borrowers. Engagement which might challenge a sovereign issuer's own public policy is problematic, and the probability of success may not be high. However, particularly with the growing focus on integrating ESG factors into investment decision making, sovereign borrowers are also scrutinised for environmental and social risk factors that may pose long-term risks for credit quality and debt service. This has the potential to pressure credit ratings and cost of debt capital, and government debt investors should find ways of making their ESG and other financial concerns known to the sovereign borrower and its intermediaries.

Particularly in the area of fossil fuel emissions and climate change, companies account only for around 30% of global oil and gas production; the vast remainder is produced by sovereign governments, many of whom are issuers of public debt.⁷ This represents a specific area in which institutional investors that purchase sovereign debt may seek to engage sovereign borrowers on the issue of climate change and significantly reduced dependence on fossil fuels.

Conclusion: taking the long-term perspective

A sustainable company should seek to satisfy the legitimate needs of both creditors and shareholders; they both play a critical role in financing long-term growth and sustainable value creation. Investors should build sensitivity towards reconciling the different, but legitimate, perspectives of corporate creditors and shareholders, and seek to identify common areas of alignment as an aspect of stewardship and engagement. Taking a long-term view, a constructive tension between protecting creditors' interests while generating fair returns for shareholders can hopefully steer companies from the extremes of unwarranted financial risk or conservatism to enable a company to achieve its overall mission-- including satisfying the

⁶ SIFMA Factbook, 2018, page 29.

⁷ Global Proxy Watch, Vol. 23 No. 28, 19 July 2019

requirements of all its financial stakeholders. As a matter of stewardship and engagement, creditors and shareholders should aspire to find common ground to engage with companies to adopt business models, corporate strategies and financial policies that are positioned to stand the test of time.

Resources

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- Principles for Responsible Investment, Shifting Perceptions: ESG, Credit Risk and Ratings, 2017.
- S&P Global Ratings, The ESG Advantage: Exploring Links to Corporate Financial Performance, 8 April 2019.

About ICGN Viewpoints

This ICGN Viewpoint was drafted by George Dallas, ICGN Policy Director. While not defining a formal ICGN position on the subject, ICGN Viewpoints provide opinion on emerging corporate governance issues and are intended to generate debate.

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Contact: George Dallas, ICGN Policy Director: george.dallas@icgn.org