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Guess What? Governance does matter

The Renault case which hit the headlines this week is a strong reminder that governance plays a crucial role in assessing a company future risk profile. It's been our experience that governance may have either neutral, or negative impact on a company credit profile, because governance may simply induce management/ board behaviour, which in its turn may have a huge impact on a company risk taking discipline, its oversight, over its decision-making process, its effectiveness and rationale thereof.

Within Ostrum AM Credit Research we have always considered governance as a key pillar of our credit assessment process. We effectively believe the financial metrics are lagging indicators of what will happen to a company. The leading indicators include understanding the upcoming industry trends and dynamics, global trends and local differences, the details and coherence of the business model, management upcoming strategy and governance, the environmental and social considerations which may drive demand, shift business models, impact product mix... Putting the credit metrics together with these qualitative considerations allows us to project the credit risk profile of a company.

So, does the arrest of Carlos Ghosn, suspected of misconduct, have an impact on how we view the Renault credit risk? Not really. We can never predict the timing of it happening, nor even if it would happen or not. We are however able (and actually have been) to identify the key man risk that Carlos Ghosn represented for Renault and what his departure would mean for the company and its credit risk profile.

Simple fact: in our universe, a third of the companies we deem as unsuitable for bond investment are so for governance reasons. Poor governance may sometimes induce blow up risk and we are firmly convinced we should avoid putting our clients' money at that kind of risk. Governance shortfalls do happen. As an example, several Italian banks failed since 2015. We stayed away from them because we simply did not trust their management and their risk-taking disciplines. Among them, one had 6 CFOs over a 3-year period, while unable to provide us with valid rationale. That's red flag for credit!

So, governance does matter. It is like health. It has a neutral impact on credit as long as it is good. And potentially highly negative when the risk materialises.

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