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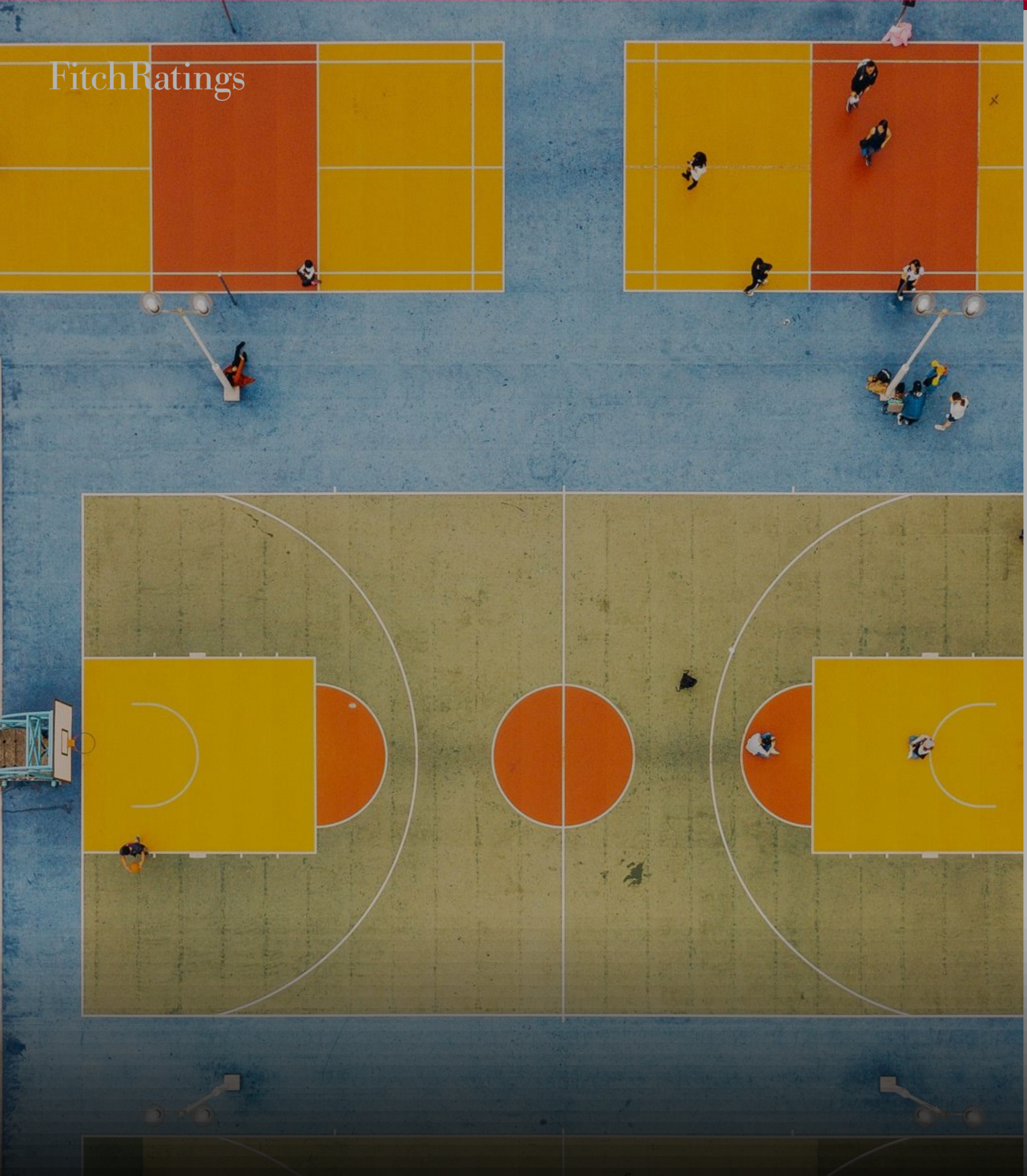

Governance and Credit Ratings

A Key Credit Consideration Grows in Prominence

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"The presence of structural governance weaknesses indicates a heightened risk of a negative event. Understanding risk control and decision-making frameworks are therefore essential elements in the assessment of corporate governance and its possible impact on credit ratings."

Sabine Bauer, Fitch Ratings

Scrutiny of Governance Quality Increases

Fitch Ratings expects idiosyncratic governance weaknesses to weigh on ratings more often than previously as the tolerance of governance failures from a wide range of stakeholders (e.g. authorities, investors, creditors, customers and employees) declines. It is likely that investors' growing focus on ESG topics and better ESG-related disclosure will mean that governance failures will have a more rapid impact on credit profiles, notably because of investors shying away from entities with perceived governance weaknesses.

We believe a combination of structural features and other qualitative elements, such as an entity's risk appetite, strategy, culture and control frameworks, are essential in spotting heightened vulnerability to governance events. A company's record of governance and ability to learn from a major governance event are similarly important elements in our assessments.

Higher Cost of Governance Failures

The cost of governance failures for entities in regulated industries, in particular in developed markets (DMs), has risen in the past decade. Following the financial crisis regulatory tightening led to higher fines and remediation, including for misconduct and mis-selling. There is also more focus on the impact on retail clients and consumers, and we expect this trend to continue. The hefty fines by the authorities for auto manufacturers is an example that the cost of governance weaknesses has also risen in the non-financial sector.

Poor Governance Lowers Credit Ratings

Governance has an asymmetric impact on ratings. While weak governance could lead to lower ratings, as it makes an entity more vulnerable to financial deterioration or loss of confidence, good governance only reduces the risk of a negative governance event. As a direct link with better business performance is more difficult to establish, Fitch would rarely consider governance a sufficient strength to result in ratings uplift.

The ways that governance can support ratings are more indirect. If sound governance and strong risk management lead to more stable performance, this would be reflected in our assessment of an issuer's business profile, financial metrics and ultimately ratings.

Governance has been more materially affected ratings of non-financial corporates compared to financial institutions as shown by the higher number of corporate issuers with Fitch's ESG Relevance Scores (ESG.RS) of '5' (36 compared with three at end-March-2021), and multiple observed cases of issuer downgrades and defaults (including investment-grade ones) due to governance factors. The impact on financial institutions has been more limited but it has been growing.

Fitch revised Credit Suisse's Outlook to Negative from Stable in April 2021, reflecting pressure on the bank's Long-Term Issuer Default Rating (IDR) of 'A-' from the consequences of loss events

Related Research

Governance and Investment-Grade Defaults (March 2021)

ESG Credit Trends 2021 (January 2021)

Governance Risk for Banks - Drawing on Experience and External Expertise to Assess Financial Crime Risk (October 2020)

Concentrated Ownership, Decision-Making Are Common Governance Risks for EMEA Corporates (October 2020)

Crisis Conditions to Expose Governance and Credit Risks (April 2020)

Concentrated Ownership and Related Party Dealings Are Common Indicators of Governance Risks in APAC (December 2019)

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linked to weaknesses in its risk governance. Other banking examples include Wells Fargo, which Fitch downgraded to 'A+' from 'AA-' in 2017, and Swedbank, which was downgraded to 'A+' from 'AA-' in 2020 due to material evidence of systematic flaws in its controls.

Instances in which Fitch has constrained issuer ratings prior to the actual unfolding of a governance-related credit event are mainly in emerging markets (EMs), where lower operating environment assessments often capture elevated governance risks.

Fitch has rarely used governance as a ratings constraint in high grade, often DM issuers prior to a governance-related event occurring. An example was Volkswagen AG. The emissions scandal in which the company was involved led to its downgrade to 'BBB+' from 'A' in 2015 and governance considerations have been a constraint on its rating, notably the lack of independence and diversity at the supervisory board level, and a complex shareholding structure. Recently, the re-establishment of a record of better corporate governance has allowed a change in the Outlook to Positive. We think the group's corporate governance practices will not fundamentally change in the medium term but believe they will be manageable at a higher rating level.

Governance Failures Not Exclusive to EMs

Governance-related defaults have occurred more often in EMs and in non-financial corporates. They are also more frequent among speculative-grade credits.

While investment-grade defaults have been extremely rare over the past 15 years, weakness in governance was a contributory factor to seven of the 15 non-financial corporate issuers defaulting within five years of having an investment-grade rating. Governance failures were the main driver in three of these defaults and a contributory factor in four others. Weak governance contributed to the defaults via efficacy of management controls, accountability, insufficient checks and balances, and risk management frameworks.

Weak governance in the case of the Brazilian construction companies Odebrecht Engenharia and Andrade Gutierrez translated into a culture in which corruption was enabled and in which parallel accounting, weak control over contracts and expenses created ineffective checks and balances. Another case in Brazil was Usiminas, which was primarily due to a sharp downturn in the industry but conflict among shareholders related to executive pay introduced governance failure aspects to the default.

Controladora Comercial Mexicana is an example of weak governance translating into risk management failures, weak controls and poor financial disclosure. The company was able to run large speculative derivative positions that ultimately trigged significant financial liabilities.

These examples are from EMs and it is indeed the case that governance characteristics often found in EMs (concentrated ownership, key-man risk, aggressive corporate culture, greater prevalence of corruption) are relevant to governance analysis. However, where these factors exist in other countries (notably Germany, Japan and South Korea), governance risks can also starkly affect corporate profiles.

DM cases of investment-grade defaults in less than five years related to governance include the commodity trader Noble Group in Singapore. This is an example of weak governance translating into undetected accounting irregularities, although the company had established what looked like a robust risk management and control framework.

In the US, PG&E's default was primarily due to wildfires in California in 2017 and 2018. After the wildfires, the company had "corporate governance therapeutics", which included changes in management and board membership and responsibilities, in an effort to refresh oversight to support a change in culture with a greater focus on safety and reporting issues. PG&E had previously overhauled its governance following the poor risk management, which partly led to the utility subsidiary's default in 2001.

In China, three defaults in late 2018 highlighted the risk of disclosure and governance problems among Chinese corporates. Shandong SNTON Group Co. (Snton, WD), Reward Science and Technology Industry Group Co. (Reward, WD) and Kangde Xin Composite Material Group Co. (KDX, WD) all defaulted on moderate amounts relative to their reported cash holdings. Corporate defaults are usually driven by insufficient liquidity, but these companies' stated cash balances could not explain the non-payments.

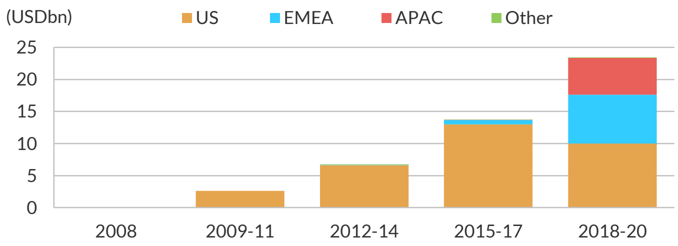
Reward's ratings have been constrained by its low transparency as a private unlisted company with concentrated share ownership. The company changed auditor and reissued its 2017 accounts due to disclosure and accounting problems flagged by the regulator. KDX was listed on the Shenzhen Stock Exchange (SSE), but an apparent problem with its disclosure of concerted party arrangements at shareholder level prompted an SSE investigation, which hampered access to funding and prompted our downgrade in December 2018. Snton's case demonstrates unpredictable financial management. It failed to repay domestic bank loans, but has continued to service onshore bonds.

Banca Privada d'Andorra is an example of a financial institution that very quickly suffered severe difficulties in its basic functioning after the US Department of the Treasury's Financial Crimes Enforcement Network named it a 'foreign financial institution of primary money laundering concern' in 2015. Fitch downgraded the bank's IDR from 'BB+' to Restricted Default eight days after the allegations.

Stricter Regulations, Enforcement Post GFC

The global financial crisis led to step change in the attitude towards governance failures. Since then, the cost of governance failures, primarily for regulated banks, has increased as regulators enforced fines and imposed minimum standards for remediation. Significant governance deficiencies were revealed at many of the largest and global banks. According to Fernego, monetary fines alone cost the affected banks USD47 billion between 2008 and 2020 for anti-money laundering breaches, non-compliance with know-your-customer requirements and sanctions violations. In addition, noteworthy changes to executive management and costly adaptations to risk and control systems were required. In some instances, credit ratings were affected.

Fines Levied on Financial Institutions



Fines related to AML, KYC and Sanctions
Source: Fitch Ratings, Fenergo

The increase has been most notable in jurisdictions with more developed regulatory frameworks. We expect the financial and reputational damage from governance weaknesses will grow, and the scrutiny over governance quality for regulated issuers to remain high with a broader investor and stakeholder base being more mindful of sustainable, fair and good conduct.

Criteria and ESG Relevance Scores

Governance is a central component of most of the risk factors issuers are facing, spanning strategy, management, execution, conduct, compliance, controls and operational vulnerabilities. It influences risk appetite, risk management and ultimately affects financial performance. Beyond the traditional core elements, including ownership and management, the analysis of an entity's risk and incentive frameworks is highly relevant in today's context as it can give early indications of which stakeholders' interests it prioritises.

Governance in Criteria

- Corporates: Navigator Factors for Management Strategy, Corporate Governance, Group Structure and Financial Transparency.
- Banks and Non-Bank Financial Institutions: Rating Navigator scores for Management & Strategy, with governance-related elements captured in the Company Profile, Risk Appetite and Operating Environment factors.
- Insurance: Score for Corporate Governance and Management, used as an overlay.

Governance risks are an integral observation within Fitch's ESG.RS assigned to more than 11,000 issuers, transactions and programmes.

Fitch's ESG Relevance Scores

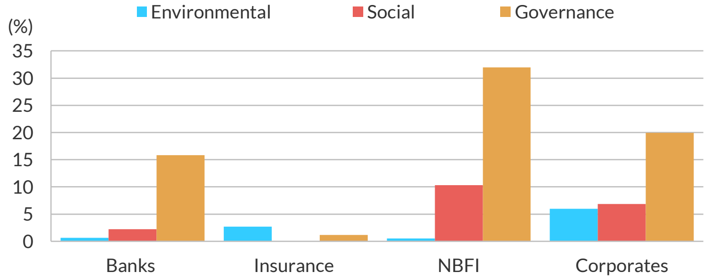
The governance related factors that analysts score are management strategy(GEX), governance structure (GGV), group structure (GST) and financial transparency (GTR).

The framework allows analysts to flag governance weaknesses and the impact they have on the rating.

A score of '5' indicates that the ESG issue highlighted is a key rating driver. A score of '4' signals that the issue has an impact on the rating in combination with other factors, but is not a key rating driver. A score of '3' signals a low impact, while scores of '1 'and '2' signal no credit relevance for the sector and the issuer, respectively.

Fitch's ESG.RS at the end of 2020 showed that governance factors remained the most relevant of all of the Environmental, Social and Governance factors for credit ratings across all analytical groups, with factors tied to the issuer and broader group structure most prominent for the Corporates and Financial Institutions sectors.

Issuers with ESG.RS '4' or '5'



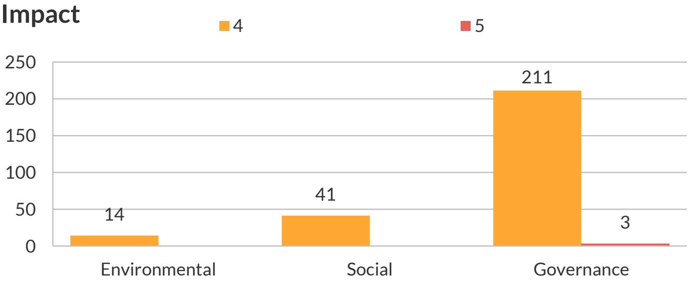
Source: Fitch Ratings

Financial Institutions

In assigning ratings to financial institutions, we assess corporate governance by considering both the jurisdiction and the issuer. Jurisdiction-specific considerations often overlap with the operating environment. Issuer-specific considerations include broader factors, such as the effectiveness and composition of the board of directors, transparency, related-party transactions and know-your-customer processes and enforcement. That said, most governance events for financial institutions have extended beyond these features. Broader risk control shortcomings, which often have a root cause governance failure, have significantly contributed to the most recent string of cases.

Governance was a key rating driver as measured by a governance-related ESG.RS of '5' for just three financial institutions at end-March 2021 (2020: six). The number of governance-related ESG-scores of '4' has remained much higher at 211 financial institutions at end-March 21 (end-2020: 219, see ESG dashboards).

ESG Elements Driving Financial Institutions' Credit Impact



Note: The chart shows the number of elements scoring '4' or '5' in each category
Source: Fitch Ratings

Observations from Case Reviews

For this report we looked into a wide range of cases with a focus on instances where Fitch commented on the incidents at the time. The list of examples is not meant to be exhaustive by no means complete but it helped to group governance-related events into themes. We also show selected issuer-specific cases.

This section illustrates the spectrum of governance-related themes that financial institutions have faced. Lessons learned include:

- An aggressive corporate culture can increase performance demand and pressure on sound board/control oversight;
- A culture of inappropriate behaviour, selling of risky, non-suitable or misrepresented products could but does not necessarily stem from governance weaknesses;
- Accounting and regulatory reporting irregularities often occur alongside broader governance weaknesses;
- Concentrated decision-making in combination with other elements can lead to a loss of confidence and business model challenges;
- Related-party lending often occurs in combination with weak controls and the dominance of a key interest;
- Increasing intolerance by external stakeholders will lead to higher rating relevance of corporate governance;
- Anti-money laundering, corruption and sanctions violations are very often only identified after the event, but sometimes they may be linked to broader governance weaknesses or aggressive culture; and
- Highly isolated governance-related lapses or fraud situations have not yet had rating impacts.

Aggressive Sales Culture – Pressure to Perform

Governance weaknesses tend to manifest themselves in periods of downturns or in environments of high performance pressure. Fitch expects pressure on profitability to build amid the fallout from Covid-19 and in the low interest rate environment. These are often a challenge for financial institutions in fragmented and highly competitive banking systems.

Japan's tough environment has affected the banking sector since more than a decade. Suruga Bank's aggressive corporate culture led to fraudulent activity as employees struggled to meet unrealistic growth targets. The regional bank specialised in niche consumer-finance areas where widespread falsifying of borrowers' finances was exposed.

Another example is Wells Fargo & Company (A+/Negative), which created customer accounts without their permission or knowledge to inflate its success at cross-selling banking products. Its superior profitability reported over a long period of time was also partly due to underinvestment in risk controls.

Collusion and market manipulation, including of the LIBOR benchmark interest rate, by multiple global trading and universal banks (GTUBs) leading up to the global financial crisis (GFC) resulted in substantial fines for these banks. Banks did not have adequate controls over their trading desks and it appears that they had a culture that did not discourage such behaviour. The fines and remediation work slowed certain banks' financial profile recovery and therefore affected their ratings post-GFC.

Risky, Misrepresented and Inappropriate Products

The financial sector will always be exposed to conduct risk given the complexity and uncertainty inherent in many products, and the scope for financial institutions, regulators and customers to have conflicting views on whether a product was sold appropriately. Lending to less credit-worthy customers and adequate disclosure on charges and fees are recent areas of strong regulatory focus. Consequently, offering high-return products could require sound risk management practices, as illustrated by the last example in this section.

Fraud related to the underwriting of residential mortgages and sale of mortgage-backed securities were key elements of the global financial crisis. Countrywide Financial Corporation (acquired by Bank of America Corporation (A+/Stable)) and Washington Mutual (acquired by JPMorgan Chase & Co. (AA-/Stable)) were the most prominent in aggressive mortgage lending in the run-up to the GFC, which ultimately led to the acquiring banks to incur billions in regulatory fines and legal settlement,

The UK banks' remediation for mis-sold payment protection insurance (PPI) has been significant and we believe that tighter regulation has led banks to strengthen their risk management frameworks. Cumulative refunds and compensation paid during 2011-2019 reached GBP38 billion, equivalent to about 8% of the sector's common equity Tier 1 (CET1) capital. PPI claims did not trigger any rating downgrades as the UK banks' capitalisation remained in line with their ratings during the period, helped by sound underlying operating profitability.

Experiences in Taiwan and Hong Kong provide examples of how attempts to move into more complex products can give rise to conduct and reputational risks. Ten Taiwanese banks were found guilty in 2014 for inappropriately selling yuan derivative products – target redemption forwards. In the 2000s, Hong Kong banks sold Lehman Bank-related products to retail investors that led to losses. Banks agreed with the regulator to compensate clients or buy back the products and absorb most of the losses.

Recent defaults by several prominent unrated life insurers in Indonesia due to products that offered very high investment returns highlight governance weaknesses linked to shortcomings in investment-risk management. A state-owned life insurer failed to pay its customers whose policies matured in 2018-2019, while a private insurer also failed to make payments on products in 2019. The cases eroded customer trust and spilled over to other insurance entities.

Ineffective Risk Controls Leading to Reporting Issues

Accounting and regulatory reporting restatements can easily trigger uncertainty and a new reality, both of which could be negative for ratings and often occur alongside broader governance weaknesses.

American International Group, Inc. (A-/RWN) had difficulty establishing adequate risk controls and processes around its loss reserves, which contributed to prior-year loss reserves being inadequate for nine consecutive years to 2016. Additionally, in 2007 AIG's auditors cited a material weakness in internal controls related to the valuation of super senior credit derivatives, an issue that later contributed to the group's severe financial distress and a US government-backed bail-out.

In April 2021, Fitch downgraded Mexican finance company Alpha Holding, S.A. de C.V. to 'CC' from 'B' following accounting errors that made its financial statements not reliable since 2018. A default appears probable due to a heightened likelihood of an early call on a bond and concerns on the ability of the entity to rebuild its capital metrics due to the possible size of the error (about 1.5x the company's equity). Consequently, we have revised the ESG.RS for Financial Transparency and Governance Structure to '5' from '4' and '3', respectively. Fitch expects investor concern regarding the financial disclosures and transparency of other Latin American finance and leasing companies to constrain their funding access in 2021.

Concentrated Decision-Making

The risk that a strong individual, often the founder of a company, drives decisions, circumvents control mechanisms or renders them ineffective is often exacerbated through high stakeholder trust in that person.

UK-based Metro Bank Plc's (B+/Negative) governance weaknesses showed through the undue influence of the chairman, who was the founder of the bank, and the long tenure of directors, which pointed to weaknesses in board independence and control oversight. In combination with misclassified loans for risk-weighted asset calculations in 2019, this contributed to a lack of credibility with investors as to whether the bank had a profitable business model.

Direct and Indirect Related-Party Exposure

Lending to related parties can signal governance weaknesses, often in combination with other features, such as weak controls and the dominance of a key interest. The identification of what constitutes a risky related exposure is often tricky and compliance with regulatory limits may not always tell the whole story of a key interest resulting in a misalignment of incentives relative to creditor interests.

Related-party lending to businesses associated with owners and management with no purpose was a major cause in several Russian banking failures. Before CJSC Peresvet Bank's default in October 2016, Fitch highlighted funding and liquidity pressure and uncertainty related to a change of chief executive. Another Russian entity, OJSC JSCB Probusinessbank lost its banking licence in 2015 amid insolvency caused by investing in high-risk, low-quality assets.

In other markets, such as the Philippines, prudential supervision requirements in relation to related-party exposures have capped reported transactions to fairly low levels, however, high corporate lending concentration and the prevalence of local conglomerates in the economy means the two categories of exposures may be interlinked.

Another example are Mexican banks, which commonly have high related-party transactions given the ample regulatory limit (35% Tier1 equity). This risk has had mildly negative effects on selected bank credit ratings, although it has not materialised, except in a few instances in smaller banks, which have not had material implications from a systemic perspective

Regulatory Weaknesses and Initiatives

A string of non-bank financial institution defaults in Indonesia point towards a weaker regulatory framework than its banking sector, despite some strengthening of regulation and supervision in recent years. Local media reported that governance-related defaults affected six companies (all unrated by Fitch) and resulted in losses of up to USD3.5 billion to investors since 2018. Indonesia's banking sector has not suffered any recent defaults through corporate governance failings, although Fitch believes governance in the sector continues to lag more developed markets.

The momentum for regulatory inquiries related to Australian banks increased at end-2017, when the Australian regulator focused on tighter supervision of non-financial risks and included misconduct to a range of different areas. These included bank bill swap rate manipulation, claims payment problems in life insurance operations and poor financial advice in wealth-management businesses. Fitch said in early 2016 that the regulatory push should ultimately result in a stronger compliance culture within Australia's banking system, but that this was likely to take some time to filter through all levels of the institutions.

Anti-Money Laundering and Corruption

Many banks, including some that are highly rated, have been fined for anti-money laundering breaches. Fitch has written on how external data providers could help us to identify financial crime risk, including through connecting it to governance-related weaknesses before the event (see *Governance Risk for Banks – Drawing on Experience and External Expertise to Assess Financial Crime Risk*).

The examples in this section concentrate on banks in jurisdictions where Fitch highlighted systemic risks that did not materialise, but also a case which led to a default.

Fitch highlighted ineffective anti-money laundering controls in some Central American banks in 2016. We commented that reputational risk could spread across the region, which brought another layer of risks to banks and exposed them to heightened event risk. In the following years, regulations and banks' practices have been strengthened, which is reflected in only two entities having ESG.RS for Governance of '4' and none at '5'.

Fitch had also identified reputational and conduct risks as key issues for Panamanian banks in 2017 owing to the interconnectedness of the regional financial system and high-profile corruption cases. Specific reputational and conduct risk events have had no meaningful system-wide impact on Panama's banking sector.

A Honduras-based entity, Banco Continental, was forced into liquidation in October 2015, when its main shareholder faced prosecution for money laundering in the US. In May 2016, Panama's regulators intervened in Balboa Bank & Trust Corp., which triggered a downgrade to reflect the bank's default.

Sanctions

Sanctions are a typical event risk that is potentially credit negative for the affected companies and the financial institutions that lend to them. Some direct sanctions and sanction breaches matter for an issuer's credit profile more than others if they cause funding stress or other material business disruption.

Russian companies and business people have been sanctioned at different times since 2014 and Fitch believes that Russian banks have managed sanctions risks so that they themselves did not breach sanctions. They reduced the share of external liabilities after sanctions were imposed against them in 2014, most of these liabilities amortised and were refinanced locally and that did not result in liquidity deterioration.

It is usually difficult for banks to sell or unwind their relevant exposures initiated before sanctions came into place without government support, as there is no active market for such assets. If they remain on banks' balance sheets, they may need to be restructured with extra provisioning. Most Russian banks' exposure to sanctioned individuals and companies have been modest relative to assets and equity, and as they remained performing they did not pressure their viability.

Isolated Cases of Fraud

Fitch viewed Goldman Sachs involvement with 1MDB as an isolated incidence of fraud, despite the large settlement Goldman entered into with various regulatory bodies. We did not view this as indicative of a systematic breakdown in the Goldman's risk management infrastructure or corporate governance frameworks. In combination with the view that financial impact did not affect our views of earnings or capital, this event did not affect the entity's ratings.

Issuer-Specific Case Studies

The cases below illustrate how we use our ESG.RS.

Credit Suisse Group AG (A-/Negative/a-)

- **Governance Structure:** ESG score of '4'

Governance issues contributed to the revision of the Outlook to Negative. This has a negative impact on the credit profile and is relevant to the rating in conjunction with other factors.

Fitch's revision of Credit Suisse Group AG's Outlook to Negative from Stable in April 2021 captures aspects of the bank's controls, its risk appetite, execution and earnings.

The group's ratings are at risk from the repercussions of a large prime brokerage loss. These include any restructuring charges as the group investigates and works to remediate the risk control shortcomings that allowed the loss to happen, reputational pressure that could slow pre-tax profit growth plans, instability arising from recent management changes and potential changes in priorities as a new chairman of the board takes over.

In addition, the fallout from the failed supply-chain finance company Greensill creates longer-term financial, reputational and regulatory risks for Credit Suisse.

The magnitude of the prime brokerage loss raises questions about the suitability of the risk controls employed in the prime brokerage business and potentially in other parts of the bank, which would likely take time to remediate and restore confidence in.

The potential for material losses arising from transactions linked to single clients also highlights the risk-reward dynamic that is symptomatic of the challenges faced by financial firms in a low interest rate environment.

Swedbank AB (A+/Stable/a+)

- **Governance Structure:** ESG.RS of '5'

Fitch has assigned an ESG.RS of '5' for the bank's governance structure due to anti-money laundering shortcomings as our assessment of the bank's risk appetite has a high influence on the bank's rating.

Fitch downgraded Swedbank AB (A+/Stable) in April 2020 following the bank's acknowledgement and confirmation by regulators of deficiencies in anti-money laundering controls.

The Swedish and Estonian financial regulators and Clifford Chance US LLP concluded in their separate investigations that Swedbank did not have adequate control over the money laundering and economic sanctions risks in its Baltic subsidiaries. The bank received a long list of recommendations from the Estonian regulator regarding its customer due diligence, risk identification, organisational structure and risk reporting.

Swedbank has already addressed the vast majority of the identified shortcomings and it received confirmation from the Estonian regulator in January 2021 that the actions taken were sufficient and that no further strictures are required.

Fitch expects that the bank will continue to seek to strengthen its controls to effectively combat and prevent money laundering in an effort to structurally embed these remedies in its corporate governance structure.

The Stable Outlook reflects our view that Swedbank has sufficient ratings headroom even under credible downside scenarios beyond our baseline economic forecast, which is underpinned by its robust asset quality, profitability and capitalisation.

Turkiye Halk Bankasi A.S. (B/RWN, b/RWN)

- **Governance Structure:** ESG.RS of '5'

Halk has been assigned an ESG.RS of '5' for Governance Structure, reflecting the elevated legal risk of a large fine, which drives the RWNs. It also reflects potential government influence over the board's strategy and effectiveness in the challenging Turkish operating environment.

Fitch has maintained Turkiye Halk Bankasi A.S.'s IDRs and Viability Rating on RWN since October 2019, when the US Department of Justice charged the bank with fraud, money laundering, and sanctions offences. The uncertainty surrounding the case and potential punitive measures remain.

US prosecutors accused the bank of using money service providers and front companies in Iran, Turkey and the UAE to evade sanctions on Tehran, enabling oil and gas revenue to be spent on gold and facilitating sham food and medicine purchases.

Corporates

Fitch's corporate criteria focus on governance concentrates on structure, group structure and financial transparency. The purpose of assessing governance and group structure is to see whether the way effective power within an issuer is distributed prevents (or makes more likely) potential problems. This could be, for example, management extracting value from the shareholders or debtholders for its own benefit or a majority shareholder extracting value from minority shareholders or debtholders. Elements to take into consideration include the presence of effective controls for ensuring sound policies, an effective and independent board of directors, management compensation, related-party transactions, integrity of the accounting and audit process, ownership concentration and key-person risk.

Financial transparency indicates how easy it is for investors to be in a position to assess an issuer's financial condition and fundamental risks. Publishing intentionally inaccurate or misleading accounting statements is symptomatic of deeper flaws in an issuer's governance framework. The public exposure of techniques that subvert the spirit of accepted accounting standards or, even worse, are designed to mask fraudulent activity can undermine investor confidence. at February 2021, representing about 1.5% of the publicly rated universe.

Corporate Portfolio Governance Analysis

Governance-related ESG.RS indicated that at least one of the Governance factors was a key rating driver that had a significant impact on the rating on an individual basis for 36 rated corporates as at April 2021.

The distribution of the Governance factors and their rating impact is shown opposite.

Governance

(%)	GEX	GGV	GST	GTR
1	0.1	0.0	0.0	0.0
2	0.1	0.1	0.3	0.3
3	96.6	91.9	93.8	96.9
4	2.6	6.8	5.3	2.6
4+	0.1	0.1	0.3	0.0
5	0.5	1.1	0.3	0.2
5+	0.0	0.0	0.0	0.0

Note: GEX – Management Strategy (Operational Execution); GGV – Governance Structure; GST – Group Structure; GTR – Financial Transparency
Source: Fitch Ratings

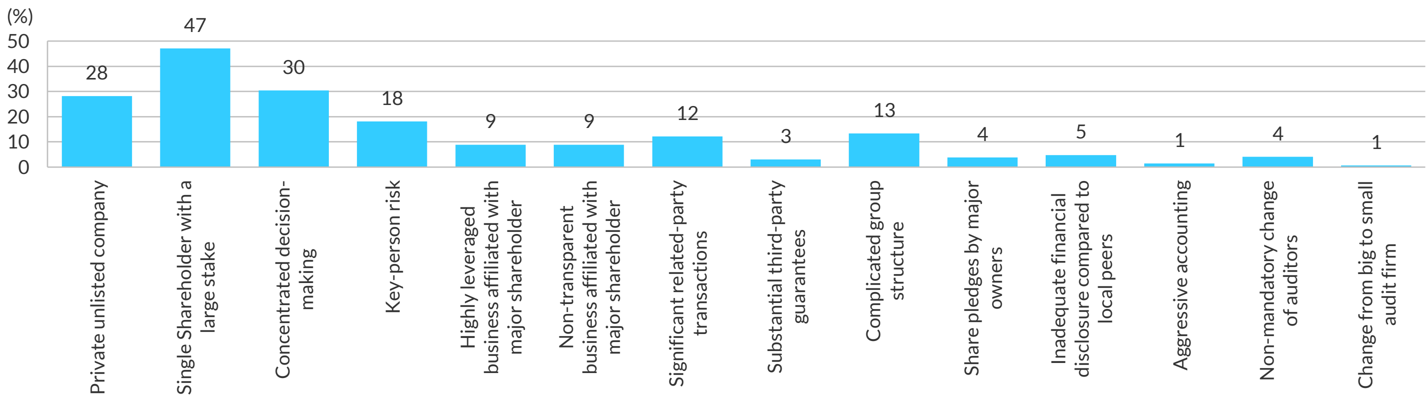
Fitch also examined 200 APAC, 245 Latin American and 350 EMEA corporate issuers in three separate reports. The analysis based on assigning weighted scores for 14 factors, covering risks related to ownership, decision-making, group structure and financial reporting. Higher scores, indicating a greater number of potential governance risks, do not imply that a governance-related event will materialise for a company, but the higher exposure requires close monitoring.

The most common risks relate to concentrated or private ownership and decision-making that is reliant on a single individual. Risks linked to financial reporting and auditing were by far the rarest. In assessing the risks associated with these weaknesses, we would typically examine them in combination with each other. Concentrated ownership, for example, is considered in conjunction with decision-making/key-person risks, as well as the existence of other significant businesses that belong to the same shareholder.

These potential corporate governance weaknesses were much more prevalent at the lower end of the rating scale in all three regions. Speculative-grade issuers are more likely to have decision-making controlled by one person, or a major shareholder controlling a highly leveraged business outside the rated group.

Latin American investment-grade issuers tended to have more potential weaknesses, by simple count, compared with the other regions. Of the sample, 81% have at least one, compared with 49% and 63% in EMEA and APAC, respectively. In the case of speculative-grade issuers, the three regions exhibit much closer figures with 87% of Latin American speculative-grade companies

Share of Corporates Identified for Each Factor



Source: Fitch Ratings

having at least one potential weakness compared with 88% in EMEA and 90% in APAC.

EMEA (%)	0	1 to 4	5 to 6	7 to 9	10 to 12	13 and Up	Score at 7 or above
AA	40	60	0	0	0	0	0
A	75	18	7	0	0	0	0
BBB	46	33	17	3	0	1	4
BB	19	34	11	21	6	9	36
B	7	21	36	15	11	9	35
CCC and below	13	20	33	0	0	33	33

Source: Fitch Ratings

APAC (%)	0	1 to 4	5 to 6	7 to 9	10 to 12	13 to 20	Score at 7 or above
A	36	41	23	0	0	0	0
BBB	37	41	16	0	4	2	6
BB	11	27	35	20	2	5	27
B	8	11	39	19	11	13	42
CCC	0	0	10	50	20	20	90

Source: Fitch Ratings

Share of Issuers by Rating Category

	Score range (%)					
Rating category	0	1 to 4	5 to 6	7 to 10	10 to 12	13+
A	17	25	58	0	0	0
BBB	20	55	19	4	0	1
BB	22	35	16	10	6	11
B	5	30	25	5	20	15
CCC and below	11	15	19	19	11	26
D/RD	0	25	0	25	25	25

Source: Fitch Ratings

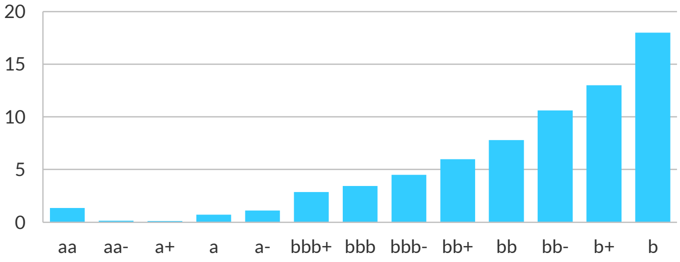
As part of the rating process, Fitch creates a Ratings Navigator, which helps assess strengths and weaknesses of the key elements of a company's financial and business profile. All navigators include an assessment of the strength of a company's management and corporate governance using a similar scale to that used for credit ratings.

The Navigator assessment takes a different approach to this study and allows analysts more flexibility. In particular, it gives them the ability to put more emphasis on individual governance weaknesses where they believe there is a heightened risk of a negative governance-related event.

Nevertheless, we observe a strong overall correlation between higher scores in this review and lower Navigator assessments for management and corporate governance (the data for EMEA and Latin America are provided below).

Scores vs. Management & Governance Factor

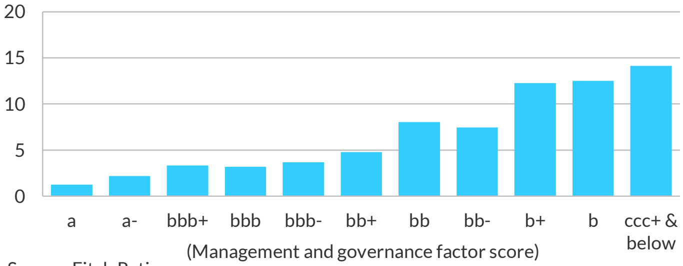
Factors with at least three occurences in sample
Average of weighted score



Source: Fitch Ratings

Final Weighted Score vs. Management and Governance Factor

(Simple average of final weighted score)



Source: Fitch Ratings

Corporate Case Studies

WeWork Companies LLC (CCC)

- **Management Strategy:** ESG score of '4'
- **Governance Structure:** ESG score of '4'
- **Group Structure:** ESG score of '4'

The scores of '4' reflect the company's challenges to implement a strategy to achieve sustainable profitability, SoftBank ownership concentration and to the complexity of its structure and related-party transactions with SoftBank.

Fitch initially rated WeWork Companies LLC, a flexible workspace provider, 'BB-' in April 2018. We downgraded this to 'B' in August 2019 due to the company's underperformance relative to our expectations at the time of the initial rating particularly as it relates to progress towards a normalised margin and, by extension, cash flow profile and credit protection metrics. At the time of the downgrade, Fitch noted that WeWork was largely controlled by its co-founder and chief executive Adam Neumann. The company was seeking to maintain the chief executives control through a dual-class voting structure such that the chief executive has greater than 50% voting control and as a result would not be bound to certain corporate governance requirements, such as having a majority independent board. This enshrined the key-man risk inherent in WeWork's framework. There were also related-party transactions as the company was leasing buildings controlled by Neumann.

Separately, the company has increased its overall complexity through various ventures to purchase and develop properties outright. These and other, numerous capital allocation decisions, including acquisitions, are likely to face less independent scrutiny under a controlled company structure.

WeWork was further downgraded to 'CCC+' in October 2019 following the company's formal withdrawal of its IPO registration statement and the consequent uncertain liquidity profile. Although concerns over Governance was not the only reason for the failure of the IPO, it did play a significant part. As a result, WeWork took steps to improve its governance structure, reducing the control of the founder and placing day-to-day management in the hands of experienced operators.

PT Delta Merlin Dunia Textile (RD)

- **Governance Structure:** ESG score of '5'
- **Financial transparency:** ESG score of '4'
- **Management and Corporate Governance:** 'ccc-', with Corporate Governance and Group Structure at 'ccc' and 'bb', respectively, with the other sub-factors at 'b'.

The ESG.RS of '5' for Governance Structure reflects the weaknesses highlighted by DMDT's concentrated ownership and lack of independent board of members. The ESG.RS of '4' for Financial Transparency reflects the lack of reliable timely information affected the rating in combination to other factors.

PT Delta Merlin Dunia Textile (DMDT) is part of the Duniatex group engaged in weaving business. Duniatex is one of the largest vertically integrated textile players in Indonesia with almost double the revenue as PT Sri Rejeki Isman Tbk (RD). Duniatex is the largest yarn producer and weaving company in Indonesia and DMDT is the group's key weaving company. It has contributed about a third of the group's overall revenue.

In February 2019, we assigned a 'BB-(EXP)' IDR with a Stable Outlook with a final IDR of 'BB-' on the issuance of its USD300 million bond in March, which were also rated 'BB-'. However, in July 2019, we downgraded the ratings to 'CCC-' as the company said it faced a severe cash drain on account of slower sales, which they attributed to increased supply of cheap fabric from China. The settlement of deeply out-of-the-money forward contracts drained cash and contagion when its sister company missed its interest and amortisation payments on its bank loans restricted DMDT's access to funding.

In August 2019, we downgraded the rating to 'CC', following our assessment that DMDT may have faced short-term liquidity issues and heightened risks that would mean the company would not be able to meet its upcoming debt servicing and forward contract settlement obligations. In September 2019, we downgraded to 'RD'. The company entered PKPU, locally known as a suspension of debt payment obligations, on 30 September 2019, and Chapter 15 petition at the US Bankruptcy Court followed to recognise the PKPU proceedings. Duniatex's PKPU vote was approved by the Indonesian court on 26 June and then ratified by the US court. Under the restructuring, the bonds will be exchanged into two notes: a secured, interesting bearing (1.5% in first year and 2.5% thereafter) USD150 million note A to be paid over eight years, and an unsecured zero coupon USD150 million note B to be paid over 12 years.

Crown Resorts Limited (BBB/RWN)

- **Management Strategy:** ESG score of '5'
- **Governance Structure:** ESG score of '5'
- **Management and Corporate Governance:** 'bb+', with Corporate Governance at 'bb' and Group Structure at 'aa', the other sub-factors at 'bbb'.

The ESG.RS of '5' for Management Strategy reflects the probity review of Crown Sydney's operations. The ESG.RS of '5' for Governance Structure reflects the weaknesses highlighted by the initiation of investigations by regulatory authorities and evidence given at investigations. The decision by the regulator not to approve the opening of Crown's Sydney casino prior to the commission's recommendations being handed down in February 2021 shows the escalation of regulatory risk for Crown.

Crown Resorts Limited is an Australia-based gaming operator. It owns and operates two of Australia's leading integrated resorts, Crown Melbourne and Crown Perth. Crown also owns and operates Crown Aspinalls in London, and has an equity stake in Nobu restaurants worldwide. Crown was set to open a casino in Sydney in December 2019, but the opening was delayed as a regulatory inquiry found it unfit to hold a gaming licence.

In October 2020, we revised the 'BBB' Outlook to Negative following weaknesses in governance structure that were revealed during an inquiry by New South Wales' (NSW) Independent Liquor & Gaming Authority (ILGA). In addition, the Victorian regulator ordered Crown to provide more information about Crown Melbourne's compliance with its Internal Control Statement for junket operations and Australia's financial crime agency identified potential non-compliance with anti-money laundering legislation and started a formal enforcement investigation.

In November 2020, we placed the rating on RWN after NSW ILGA found Crown unfit to hold the Sydney casino and that it would have to implement significant changes to its governance structure to retain its Sydney casino.

JSC Holding Company United Confectioners (B/Stable)

- **Governance Structure:** ESG score of '5'
- **Management and Corporate Governance:** Navigator Governance Structure and Group Structure both assessed as 'b'
- **Financial Flexibility:** The Financial Discipline navigator sub-factor is assessed as 'b'

UC's rating continues to be constrained by weak corporate governance practices, while reflecting a strong business profile and moderate leverage consistent with higher-rated peers.

The ESG.RS of '5' for Governance Structure due to the concentrated ownership, lack of board independence and complex group structure, which has a negative impact on the credit profile, and is highly relevant to the rating, resulting in a change to the rating to of a one-notch downgrade.

JSC Holding Company United Confectioners (UC) is Russia's second-largest confectionery producer by volume (10.8% as of end-9M20) and value (12.0%). In 2020, UC lost market leadership by value to Mondelez (12.9%) but it still UC has a strong portfolio of recognised local brands that perform particularly well.

UC is owned by Guta Group, a private conglomerate without consolidated IFRS accounts. Historically, UC supported the group's other activities through loans to related parties or dividends. The lack of information on Guta makes it difficult to assess general financial standing or risks of Guta. According to UC's management, Guta has interests in several industries (e.g. banking, real estate, healthcare, hotels), but only healthcare is consolidated within UC.

Weak corporate governance, which could affect unsecured creditors, remains a core consideration for UC's rating. Major rating constraints include a record of large loans to related parties, lack of management and board independence, and material portion of UC cash held in the related Guta-Bank. In 2017-2019, UC started to show a net cash inflow under related-party transactions. Continuing this practice along with a further reduction in value of such transactions, improving transparency of financial policy, may result in a positive reassessment of the UC's corporate governance quality. This issue remains a drag on UC's credit profile, although the company's credit metrics and business profile are still commensurate with a higher rating.

Volkswagen AG (BBB+/Positive)

- **Emissions:** ESG score of '4'
- **Governance Structure:** ESG score of '4'
- **Management and Corporate Governance:** Governance Structure assessed as 'bb' and the remaining sub-factors assessed at 'bbb'

Volkswagen has an ESG.RS of '4' for GHG Emissions & Air Quality. The group is facing stringent emission regulation, notably in its main markets of Europe and China, so investments in lower emissions are a key driver of the group's strategy and cash generation.

Volkswagen has an ESG.RS of '4' for Governance Structure. Key areas of corporate governance weakness include a lack of independence and diversity at the supervisory board level, potential conflicts of interest with board members and a 20% blocking minority in voting resolutions.

Weak corporate governance has been a rating constraint for Volkswagen following its downgrade to 'BBB+'. The ratings are supported by the group's solid business profile and resilient financial profile. Volkswagen is the largest car manufacturers by deliveries in Europe and is vying globally for the top spot with Toyota, General Motors and the global alliance between Renault, Nissan and Mitsubishi.

In May 2021, we revised the Outlook to Positive and the ESG.RS for Governance structure reduced from '5' to '4' to reflect the re-establishment of better corporate governance. We do not expect the group's corporate governance practices, in particular limited board independence and complex shareholding structure, to fundamentally change but believe they will be manageable at a higher rating level.

The ESG.RS for GHG Emissions & Air Quality was also moved from '5' to '4' as the substantial fines and penalties paid since 2015 as a result of various global investigation ruling that its vehicles did not meet all legal requirements are coming to an end. The group faces stringent emission regulation, notably in Europe and China, which are its main markets. As a result, investments in lower emissions are a key driver of the group's strategy and cash generation.

Grupo Elektra, S. A. B. de C. V. (BB/Stable)

- **Governance Structure:** ESG score of '5'
- **Management and Corporate Governance:** All Navigator sub-factors are assessed at 'bb+', with the Governance Structure sub-factor assessed at 'bb'. Group Structure is at assessed 'b', given the highly complex group with large and opaque related-party transactions.

Grupo Elektra has an ESG.RS of '5' for Governance Structure resulting from ownership concentration and its related party's aggressive treatment towards different stakeholders and arrangements with related companies that benefit shareholders but affect creditor's interests. This has a negative impact on the credit profile and is highly relevant to the rating in conjunction with other factors, resulting in a change to the rating to 'BB'.

Grupo Elektra is one of Mexico's main department stores chains with operational and financial links with Banco Azteca. Both entities are owned by the Salinas family.

In March, Fitch downgraded Grupo Elektra to 'BB' from 'BB+' reflecting Elektra's weaker corporate governance structure after a default of a related entity (TV Azteca). Elektra indirectly owns 22.5% of TV Azteca and is controlled by the same shareholder group, Grupo Salinas. TV Azteca's decision to selectively default on its USD400 million bonds by missing a USD16.5 million coupon payment while using a portion of its USD160 million cash balance to repurchase MXN1,211 million (about USD60 million) of the outstanding Certificados Bursatiles through a market transaction, and to keep current on a related-party loan from Banco Azteca highlights potential conflicts of interest and different treatment to creditors. These underscore corporate governance concerns.

The perception of elevated corporate governance concerns also hold the potential to reduce external funding availability and are incorporated into the downgrade.