

Current Challenges in Corporate Finance

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Exciting issues in the world of corporate finance

- Sub-prime loan defaults – Agency problem and corporate governance failure
- Investments flowing to the East
- Risk management: A scorecard for risk

Subprime loan defaults

- Rapid growth in subprime mortgages
 - Subprime mortgage: Borrower with
 - Weak credit history
 - High loan-to-value ratio
 - Facilitated by the steep yield curve after 9/11
 - Short-term rates were 1-2%
 - Medium-to-long-term rates 4-6%
 - Many qualified for adjustable rate mortgages with low current payment
 - Loan originators didn't care because mortgages sold in the secondary market
 - What about oversight and prudent lending?

Subprime loan defaults

- Rapid growth in subprime mortgages
 - Facilitated by the CDO market
 - Did the buyers check whether lenders applied appropriate (and stated) credit standards before lending?
 - Did lenders make false representation that they checked borrowers'
 - credit history or
 - net worth or
 - ability to pay should the interest rate rise as implied by the yield curve? Did buyers ask any of these questions?

Subprime loan defaults

- Banks are gradually reporting loan losses
 - Delay in recognizing bad loan losses
 - Illiquidity facilitates delay in recognition of losses
 - Loan portfolio value on a bank's balance sheet might be suspect

Investments flowing to the East

- China, India, Pakistan, Bangladesh, Philippines, and many other countries in the East
 - Population in excess of 3 billion
 - Per capita income less than US\$3000
 - Some of these countries are instituting market-oriented policies and the economies are growing rapidly
 - To sustain high growth, FDI is essential because they do now have domestic wealth to fund all the projects
 - West: Has a lot of wealth, and the investment opportunities in the East are quite attractive
 - Intermediation of all of this wealth to be invested wisely into foreign countries is challenging, but hugely attractive financially

Investments flowing to the East

- Challenges
 - Market for corporate control: Generally not as open as in the West
 - Liquidity and derivatives markets not as deep
 - Culture
 - Innovation, R&D: Tolerance for failure
 - Contract enforcement: Legal system on paper vs. in reality
 - Corporate governance
 - Professional, independent boards vs. control by family-owned business houses

Risk management: A scorecard for risk

- Everyone recognizes the importance of managing risk
- Managing risk with financial derivatives – works well for financial firms, but not always satisfactory for non-financial firms
- Non-financial firms: Qualitative measures of risk are known, but quantitative measures are not available
- Risk stems from operational issues in various parts of a company
- How do we aggregate the qualitative assessment of risk from various departments, divisions, and plants of a company?
- Proposal for a Scorecard for Risk

Two Fundamental Types of Risk

- 1) Business risks inherent in the industry that create uncertainty and volatility
 - Examples: product pipeline, competition, regulation
 - Risks carry both upside and downside potential
 - Less risk not necessarily better; more risk not necessarily worse
 - Management/Board selects risk tolerance and monitors/manages risk to that level

Two Fundamental Types of Risk

2) Risks that typically create only downside potential

- Examples: litigation, accounting irregularities, breakdown in supply chain
- Because risks carry only downside potential, less risk is better...but subject to costs of containing risk (i.e., risk reduction not free)
- Management/Board selects cost-effective risk tolerance and monitors/manages risk to that level

Three steps to RMS (Risk Monitoring Scorecard)

- 1) Identify key risks and tolerance
- 2) Identify key drivers of risk
- 3) Evaluate firm's development and performance on key risk drivers

Step 1: Identify key risks

- Identify key risks at all levels
 - Corporate, divisional, departmental, geographical, etc.
 - Map these in a tree form so that risks ultimately will aggregate to the corporate level
- Who identifies risks?
 - Board and executive management participation critical
- How to identify risks?
 - Key risks determined based on
 - Firm experience
 - Qualitative
 - Quantitative inputs

Step 1: Identify key risks

- Assign risk tolerance
 - A quantitative ranking (e.g., “1” on a scale of “0 to 5”) for risk tolerance
 - Ranking can be different for different types of risks at each level

Step 2: Identify key risk drivers

- Drivers of risk
 - Identify drivers of each type of risk at each level
 - Key risks may have drivers that are also risks (e.g., litigation risk driven by accounting risk and product risk)
- Who identifies risk drivers?
 - Executive management participation critical
 - Aggregate information from various levels of management – bottoms up approach to identifying the drivers of risks
- Example:
 - Key risk: Litigation
 - Drivers of litigation risk:
 - 1) Financial reporting risks; 2) Product risks
 - Subdrivers of financial reporting risk: 1) Internal control risk; 2) Balance in management incentives; 3) Opportunity for mis-reporting financials
 - Subdrivers of product risk: 1) internal controls in product development phase; 2) internal controls in product roll-out phase
- Drivers can be given “weights” if some more important than others
 - E.g., Driver 1 = 50% weight; Driver 2 = 50% weight

Step 3: Evaluate risk drivers

- Firm-wide management participation critical
- Risk driver given a quantitative score
 - E.g., “0 to 5”, where “0” means “no risk” and “5” means “high risk”
- Risk driver scores and weights aggregated to generate a “Risk Scorecard” for Key Risks
- See example on next page

Example of Risk Scorecard

Litigation Risk Assessment (assume 50% weights for all risk drivers)

