CORPORATE GOVERNANCE RATINGS: GENERAL CONCERNS AND SPECIFIC PROBLEMS IN THE EUROPEAN CONTEXT

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Abstract

Recent corporate scandals have led investors to monitor corporate governance more closely. Corporate governance ratings by independent agencies have become popular with investors seeking indicators of good market returns. We present empirical data showing that such CG ratings show no significant correlation with European firms' stock price appreciation. We conclude with a few thoughts concerning possible dangers associated with the use of CG ratings.

Keywords: corporate governance, ratings, rating agencies, stock price appreciation

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Introduction

The wave of accounting and corporate governance scandals at American, Canadian, and European companies—Enron, WorldCom, Hollinger, Nortel, Xerox, Cendant, Royal Ahold, to name but a few—has prompted investors to demand more information about how major companies are actually being run. Moody's, Fitch and Standard & Poor's, the three warhorse rating agencies, failed to flag most of these companies as problematic. Only after the press got wind of problems at Parmalat did S & P downgrade the company's debt from investment grade to junk status, an overnight drop of eight notches. The failures at the big three credit ratings agencies have prompted new groups to try their hands at rating firms. Institutional Investor Services (ISS), Governance Metrics International (GMI), Standard and Poor's (S&P), and the Corporate Library have moved to fill a perceived need, concentrating not on creditworthiness but on corporate governance.

It is not clear, however, whether these new governance metrics will be of much use to investors. These corporate governance ratings agencies have not agreed in their assessment of particular companies. In November 2002—before disclosures about the accounting problems at Freddie Mac and Fannie Mae—, Governance Metrics International had assigned both companies a "well below average rating." Then, in the spring of 2004, S& P gave Fannie Mae, its first publicized company, its top governance rating of 9.0, a move echoed by Moody's decision to grant AAA ratings to both Freddie Mac and Fannie Mae data. The Corporate Library also praised Fannie Mae, describing the company's "rigorous approach" to corporate governance. How did these agencies vault from floor to ceiling during the two intervening years? The performance is especially puzzling, given that little seems to have changed at either company. Other discrepancies abound. For example, the Corporate Library gives Citigroup's board an "F", while GMI ranks the company's governance above average; Honeywell also gets an "F" from Corporate Library, but snags an "above average" from GMI (Duffy, 2003). Whose ranking is correct?

The rated companies would like to know which rating agency, if any, is most credible. Firms have been besieged by ratings groups sending them questionnaires and then threatening public exposure if the firms fail to return the data sheets in a few days. And they have been overwhelmed by the recent investor radicalism of ISS and the California Public Employees' Retirement System (Calpers). Calpers, for example, withheld votes on one or more directors at almost 90% of the companies in its portfolio. The stridency of some of these governance watchdog agencies and groups has led the SEC to reconsider a proposal (an amendment to Exchange Act Rule 14a-8) that would have allowed institutional shareholders in some circumstances to nominate directors directly. Former SEC chairman William Donaldson leaned toward a watered down version of the proposal, but

for now the proposal seems to be in limbo (Solomon and Schroeder, 2004).

The time has clearly come to evaluate the corporate governance evaluators. Should investors be placing their trust in governance metrics that purport to be able to capture the effectiveness of a company's management and oversight? This paper considers whether corporate governance ratings have functioned as reliable indicators of a company' shareholder returns. This paper addresses this question of reliability using ISS governance metrics and market return data for European companies. We discuss not only the reliability of the metrics in the European context but also compare the corporate governance rating agencies (GRAs) with the well-established credit rating agencies (CRAs) to raise some more general concerns about the value and viability of corporate governance rating agencies.

2. Governance Ratings as Indicators of Firm Performance

We test whether ISS's corporate governance quotient ratings (CGQ) have functioned in the past as reliable indicators of how the rated company's stock will perform.

Hypothesis: Firms receiving a CGQ rating higher than the mean rating for the sample showed greater stock price appreciation than peer firms with CGQ ratings below the mean.

ISS-funded research purports to show that firms with better governance also produce better returns. The thinking runs as follows: boards of directors with more independent directors and separate committees for audit, compensation and governance will do a better job of holding management accountable, thereby forcing managers to think more strategically and to exercise more due diligence when making investments. If the audit committee is dominated by outside directors and meets without the CEO or CFO being present, then the board will more thoroughly question the accountants. In an environment of heightened accountability, fraud will be less likely to occur and the company won't have to restate earnings. Well-governed boards that require managers to enforce codes of ethics and develop ethics training programs will lead to more ethical companies. Ethical companies will operate more strategically, will treat their employees better, and will be less likely to get sued. As a result, they will report better earnings and show greater market price appreciation.

3. Methodology

We tested our hypothesis using a database with 180 large cap companies from Belgium, Britain, France, Germany, Ireland, Italy, Netherlands, Norway, Spain, Sweden and Switzerland. The companies were drawn from a variety of sectors. We used the 2003 annual stock price appreciation and the 2003 ISS rating for these companies. Stock price appreciation was modelled as the dependent variable; we regressed it against the ISS rating. We then compared the mean stock price appreciation for those firms with ISS ratings above the mean and below the mean.

4. Description of Variables and Discussion of Results

Table 1 presents the descriptive statistics for the variables in the study.

Insert Table 1

Market capitalization of European firms in the study ranges from $15 million to $118 billion, with an average size of $11 billion. ISS's CGQ ratings for sample firms range from 0.1 to 99.2 with an average score of 47. Stock appreciation over the one-year period ranged from -95% to 540%; the average was 42%. Descriptive statistics for variables of companies broken down by country location are provided in Table 2.

Insert Table 2

British companies received the highest mean ISS rating of 74.3; Irish firms showed the highest mean stock return at 93.7%; German firms had the largest mean value for firm size--$17.982 billion.

Table 3 shows the Pearson correlation coefficient matrix for variables in the study. According to the matrix, the CGQ rating is significantly (at the 1% level) positively correlated with the market size of the firm. The CGQ rating was positively correlated with stock price appreciation, but additional tests were needed to determine whether this correlation was significant (see discussion below of Tables 4 and 5).

Insert Table 3

To test whether there were significant differences, we stratified the sample based on the CGQ rating the firm received The mean value of the CGQ rating in our sample is 47. We stratified firms with ratings higher than the mean value into one group and assigned firms with ratings below the mean to a second group. Table 4A shows the mean values of stock price appreciation for the two groups.

Insert Table 4A

The mean stock price appreciation of group with higher CGQ ratings is 45.57%, while the mean stock price appreciation of group with lower CGQ ratings is only 37.85%. To test whether this difference in average stock price appreciation was significant, we performed an independent sample T test. Table 4B presents the results of this test.

Insert Table 4B

As Table 4B indicates, the stock price appreciation of group with higher CGQ ratings is 7.72% higher than that of the group that received a lower CGQ rating. This finding accords with the positive Pearson correlation for the relation between CGQ and stock appreciation. But this difference in price appreciation is not significant. Our analysis of the data, summarized in Tables 4A and 4B, does not, therefore, support the hypothesis. We also performed multiple regression analyses to analyze the relationship between stock price appreciation and CGQ ratings. Table 5A presents the results.

Insert Table 5A

Again, we found no significant positive correlation between the CGQ ratings of European firms and these same firms' market performance. As with the Pearson correlation test, the correlation coefficient was positive: firms receiving higher ISS CGQ scores showed great stock price appreciation (45.57% vs. 37.85% Table 4A) for the year 2003. However, the correlation (.346) was not significant. To test whether this non-significant, positive relationship held for firms in different European countries, we ran the model for companies by country location. Table 5B gives the results.

Insert Table 5B

Consistent with the results for the total sample, the individual country analyses generally revealed no significant relationship between stock performance and CGQ rating. The only exceptions are companies in France and Sweden. French companies showed a significant negative relation, while those in Sweden showed a significant positive relation between stock performance and CGQ rating. Given the small sample size for these two countries, caution needs to be exercised when interpreting this finding.

The only significant correlation across the board was between firm size CGQ rating (see the correlation analysis in Table 3). Larger European firms tended to get higher CGQ ratings. This finding is not surprising, for bigger companies typically are the trendsetters. Since corporate governance has been a very hot issue the last five years, these firms would be the ones most likely to have initiated reforms. Worldwide, the firms consistently identified as having the best corporate governance practices (e.g., Samsung, Pfizer) are large. Second, bigger firms usually have more money to devote to governance initiatives. So they are more likely to have hired consultants to help them revamp their CGQ ratings. We cannot tell from the data whether a particular firm received its high CGR rating after it had hired a governance consultant (ISS, GMI, or Standard and Poors) to evaluate its practices, procedures and structures. What we can say is that a high CGQ has not necessarily translated into better stock market appreciation in the past.

The lack of a correlation between governance ratings and stock returns may indicate that, while companies are paying lip service to corporate governance, they are continuing to do business as usual. If so, well-managed companies with good products and marketing may be prospering, despite being awarded a low CGQ by ISS. Conversely, poorly managed companies may be performing poorly and failing to impress investors despite efforts they've made to reform their governance.

Another possibility is that corporate governance reforms may have had a positive effect on stock performance, but any positive effects may have been offset, obscured, or overwhelmed by irrelevant factors incorporated by ISS into its CGQ score. ISS awards positive points for board independence and penalizes firms with inside directors. Although some studies have confirmed the value of independent directors (e.g., Shivdasani and Zenner, 2004), other studies have suggested that inside directors can be good for a company. Having some insiders on the board may help a board decide whether it needs to look for a new CEO outside the company (Hermalin et al, 1988). Inside directors on the board may even improve corporate financial performance. Bhagat and Black (2002) found that firms with supermajority-independent boards were less profitable than boards with a higher proportion of insiders.

ISS assigns positive points to companies with separate compensation and nominating committees, but again the research does not speak with a single voice. Uzun et al (2004) discovered evidence that US companies with compensation committees are more likely to engage in financial fraud. When this same group of researchers tested for the existence of a nominating committee, frequency of board meetings and frequency of meetings by audit, compensation, and nominating committees, they found little difference between the fraud and no-fraud groups. The only statistically significant governance factor seems to be the proportion of outside independent directors on the board. If so, the complicated scorecard of ISS with its emphasis on board structure is largely irrelevant. Mehran (1995), Agrawal and Knoeber (1996), and Hermalin and Weisbach (1991) could establish little or no correlation between board composition and corporate profits.

Since the ISS CGQ incorporates so many factors, only some of which appear to be significant, the rating likely contains too much statistical noise to be of much value to investors. Furthermore, much of the research ISS might cite to support its claim that good governance correlates with greater profitability is seriously flawed. As Sonnenfeld (2004) has noted, these profitability studies typically do not test board structure or composition directly. Instead, they use a proxy for good governance—e.g., a company is characterized as well-governed if it adheres to the General Motors guidelines for corporate governance or if it respects shareholder rights. Neither of these factors is a direct reflection of board structure or

processes. Therefore, such studies fail to establish a positive link between governance and financial returns. A thorough review of the literature reveals that research to date "*has not found any direct link between board composition and metrics of financial performance or shareholder value*" (emphasis ours) (Shivdesani and Zenner, 2002).

The fact that some countries in our sample show both significant and insignificant negative correlations between CGQ and firm performance (Belgium, France, Germany, Italy, Netherlands, Spain), while others show both significant and insignificant positive relations (Britain, Norway, Sweden, Switzerland) suggests that country–specific factors may be at play. For example, if a country's stock market is experiencing a bubble, almost all firms may be showing significant stock gains, regardless of their governance. Since our sub-samples are small, caution should be used when interpreting these results. Nevertheless, the variation we found in this study is a salutary reminder that differences among countries need to be taken into account.

We would also note that, in some cases, financial factors have proven to be far more important than governance factors in determining how a company's stock fares. Kim and Lee (2002) reviewed the performance and governance of 590 non-financial firms listed on the Korea Stock Exchange. They tested for ownership variables (e.g., manager ownership vs. block-holder ownership), leverage, cash flow and degree of diversification and found that governance/ownership variables did not significantly affect stock performance. The degree of leverage, however, did correlate significantly with market performance. Firms with less leverage performed better as did companies with more free cash flow. The same might well be true with respect to European firms. Some of the studies purporting to find a strong positive correlation between governance factors and/or CGQ ratings and stock performance fail to control for these other possibly salient factors. Unless researchers have controlled for these other factors, their results should not be deemed conclusive. When these other factors are taken into account, studies to date do not support ISS's claim that its high CGQ scores strongly and positively correlate with better market returns.

5. More General Concerns Regarding Corporate Governance Ratings

At this point, we want to shift gears and call attention to two more general concerns we have regarding these corporate governance ratings.

Poor Quality of Information & Troublesome Conflicts of Interest

Corporate governance rating agencies (GRAs) often send questionnaires to companies asking about corporate governance and threaten to go public if the company does not provide this information in a few days. In one reported case, the firm was given only eight days to answer a 48-page questionnaire (Pagnamenta, 2004). The company may have to draw data from numerous locations—HR, corporate finance, investor relations, and the corporate secretary. The information thrown together in such a hurried fashion may be neither accurate nor especially revealing.

The governance ratings themselves are biased upward. ISS charges companies a $15,000 "open book" fee. After paying this fee, companies can access ISS's governance model to see how they will have to tweak their governance in order to improve their CGQ number. There is a real danger here that companies will start managing to the number, instead of stopping to think about their processes and business plan. Already we are seeing something akin to grade inflation: GMI reported in July 2003 that the average governance rating for US large cap companies had moved from 7.7 to 8.0 (Wei, 2004).

No wonder companies have started to question the value of governance rating agencies and their recommendations. Although ISS's governance rating system is rattling some cages—El Paso's low CGQ rating was a key factor in the 2003 battle at El Paso to restructure that company's board of directors—(Coffin, 2003), a 2004 survey of finance executives by CFO magazine found that only 11% of chief financial officers thought that the corporate governance recommendations they were being pressured to adopt would truly enhance shareholder value (Goff, 2004). Many polled thought that ratings and advisory firms were failing to consider the particular features of a company and relying instead upon a corporate governance checklist. But, until recently, few managers have been willing to criticize rating agencies or question their governance metrics for fear that they will be publicly labeled "unresponsive" or "anti-shareholder." This reluctance may be disappearing. Last year Reuters and BSkyB attacked a group called Business in the Community (BITC) for comparing the governance of companies in wholly different industries. Reuters was evaluated against a governance template, which included measures of the company's social responsibility with respect to global warming and health hazards. Reuters noted that such criteria are not applicable to an information company like itself (Pagnamenta, 2004).

American companies have also been troubled by the apparent conflict of interest at ISS and some of the other governance rating groups. ISS not only rates companies' governance but also makes money by consulting with companies to help them increase their CGQ. US investors have witnessed how the practice of combining of auditing with consulting undermined public trust in accounting firms. Consequently, many firms and investors are understandably skeptical about ancillary services becoming part of the governance rating world. ISS is not the only rating group to do consulting. Moody's and Standard & Poors offer both

governance rankings and consulting services. As Sonnenfeld (2004) has wryly observed, there is more than a little irony in the fact that Moody's is itself rated as a poor performer by GMI. As far as we can determine, ISS has not bothered to have its own governance rated by any of the other rating agencies.

It might be objected that a rating agency's concern for its reputation will prevent the agency from succumbing to client pressure or to the temptation to upgrade clients who have paid for governance consulting. After all, credit rating agencies (CRAs) also ask firms to pay for ratings. However, the CRAs historically have not earned a large percentage of their revenue from consulting; the credit rating business by itself has yielded robust profit margins as high as fifty percent (Hill, 2004). The GRAs, by contrast, apparently need consulting revenue to be viable. If the CRAs were to start providing many more ancillary services, then their perceived conflict of interest would become greater and companies would no doubt question the integrity of the rating agencies.

The Danger of Unsolicited Ratings

Does the fact that some rating agencies rate companies who have not sought to be rated lessen the appearance of a conflict of interest at GRAs? Much depends on the context in which these ratings occur. Standard and Poor's and Fitch offer unsolicited ratings; Moody's used to do so, but appears to have stopped the practice in many cases after coming under strong criticism. Unsolicited ratings can be used in a way that borders on extortion. There is always an implicit threat that companies who refuse to pay for a rating will not be able to provide input into the rating process and will have to suffer the consequences. Smith and Walter (2002, p. 312) tell of a case in which Moody's allegedly billed a bond issuer for an unsolicited rating and told the issuer to "reflect on the propriety of failing to pay for the substantial benefits that the issuer reaps from our efforts." The Justice department investigated Moody's for uncompetitive practices 2004). We have no evidence that the GRAs are throwing their weight around in inappropriate ways at the present. The point we want to make is that there will always be a temptation by GRAs to abuse the process of assigning unsolicited ratings. It is not clear what controls the GRAs have instituted to ensure that such abuse does not occur. Companies who want to contest an unsolicited rating that some GRA assigns to them have no regular forum in which to do so.

ISS's practice of advising both institutional investors and public companies has also raised a red flag in some quarters. ISS is telling corporate issuers how to get their proposals passed at the same time as it is advising institutional investors and proxy firm how to vote on management proposals. This dual role could be seen an ethically problematic, for as Agilent's CEO Nordlund has argued, "The two-way conversation between companies and investors ought to be accessible without a toll charge." (see endnote 1).

Conclusion

Credit rating agencies in America and Europe are powerful, but we doubt whether GRAs that focus exclusively on governance will be able to obtain the same degree of influence. Companies wishing to tap the equity markets suffer if they do not obtain a credit rating. But, at present, the market does not appear to impose any penalty on firms with low governance ratings. Moreover, some investment funds in America and Europe are prohibited by fund rules from investing in a company's debt or equity that does not bear a CRA rating of investment grade, regardless of how good that company's governance rating is. As far we have been able to determine, although some mutual funds and pensions funds are looking at governance ratings, they have not made their investment decisions contingent upon such ratings. Nor should they do so, given that stock appreciation of European firms shows no significant positive correlation with CGQ ratings and given the many other reasons to doubt the value and viability of governance rating systems.

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Endnotes

[1] John Goff, "Who's the Boss? Shareholder activists want more say in how American companies are run,"*CFO Magazine.com*, September 01, 2004, p.4.

Appendices

Table 1. Descriptive Statistics of Variables in the Study

	N	Minimum	Maximum	Mean	Std. Deviation
Market Cap($ mil.)	189	15	118032	11025.7	18323.2
CGQ rating	190	.1	99.2	47.398	37.0481
% Ch in Stock Price	190	-95	540	42.04	70.363
Valid N	189				

CGQ: ISS's corporate governance quotient ratings.
Market Cap: Market Capitalization of the firm.
% Change in Stock Price: Percentage change in stock price over one year period

Table 2. Descriptive Statistics of Variables in the Study for Individual European Countries
Table 2A. ISS Ratings for Individual European Countries

	Belgium	Britain	France	Germany	Ireland	Italy	Netherlands	Norway	Spain	Sweden
Minimum	.1	3.2	.2	4.2	5.9	2.7	6	2.8	.1	2.1
Maximum	76.8	99	95	79.9	99.2	92.4	95.6	74.3	90.2	98.7
Mean	28.79	74.3	45.36	41.21	69.57	31.94	42.3	36.38	41.74	49.23
Std. Deviation	27.09	30.88	45.14	30.85	32.07	31.62	41.16	27.88	39.99	40.31

Table 2B. % stock price for Individual European Countries

	Belgium	Britain	France	Germany	Ireland	Italy	Netherlands	Norway	Spain	Sweden
Minimum	-12	-22	-64	-58	-22	-95	-41	-64	3	-2
Maximum	72	69	156	189	540	148	155	122	63	257
Mean	29.9	26.25	35.85	49.65	93.7	10.55	37.35	48.7	25.2	43.2
Std. Deviation	23.746	21.42	45.173	53.265	176.33	49.726	50.983	55.61	12.19	71.25

Table 2C. Market Capitalization for Individual Companies by Country

	Belgium	Britain	France	Germany	Ireland	Italy	Netherlands	Norway	Spain	Sweden
Minimum	163	75	198	15	228	59	272	116	273	180
Maximum	19662	91249	59853	67381	10952	82396	47868	28864	76567	20798
Mean	5677	10243	12791	17982	3621	13182	10402	5555	13513	6548
Std. Deviation	6770	20255.4	19320	20115	3650	23442	13591	9187	21054	6492

Table 3. Pearson Correlation Coefficient Matrix
Relating CGQ Rating, Market Capitalization, and Stock Price Appreciation

		ISS rating	Market Cap($ mil.)	% Ch in Stk Price
ISS rating	Pearson Correlation	1.00		
Market Cap	Pearson Correlation	.266(***)	1.00	
% Ch in Stk Price	Pearson Correlation	.062	-.077	1.00

*** Correlation is significant at the 0.01 level (2-tailed).

Table 4 A. Means of Stock Price Appreciation of Two Groups: Firms that received a CGQ higher than the mean vs. firms that received a CGQ lower than the mean

	CGQ rating*	N	Mean	Std. Deviation	Std. Error Mean
% Ch in Stk Price	>= 47.0	103	45.57	84.187	8.295
% Ch in Stk Price	< 47.0	87	37.85	49.415	5.298

* : mean value of ISS rating = 47

Table 4B. Independent Samples T Test for Equality of Means of Stock Price Appreciation of Two Groups

	Mean Difference in STKPCE%[a]	F	Sig.	T	Df
STKPCE%	7.72	.892	.346	.753	188

a: Mean value of stock price appreciation of firms that received a CGQ score higher than the mean minus mean value of stock price appreciation of firms that received a CGQ score lower than the mean

*: Significance at .10 level

Table 5A. Results of Multiple Regression Analysis to Predict Stock Return

The Table presents the estimated regression coefficients for the model: $y^a = \alpha_0 + \beta_1 * CGQ + \beta_2 * MKTCAP + \varepsilon$
Estimated parameters are from ordinary least square

Model	Standardized Coefficients β	T	Sig.
Constant		4.547	.000
CGQ rating	.091	1.211	.227
Market Cap ($ mil.)	-.101	-1.342	.181
F Statstic	.576		.742

a Dependent Variable: % Change in Stock Price
CGQ: ISS's corporate governance quotient ratings. Market Cap: Market Capitalization of the firm.

Table 5B. Results of Multiple Regression Analysis to Predict Stock Return by Country

The Table presents the estimated regression coefficients for the model: $y^a = \alpha_0 + \beta_1 * CGQ + \beta_2 * MKTCAP + \varepsilon$
Estimated parameters are from ordinary least square and t-statistics are in parentheses.

	Belgium	Britain	France	Germany	Ireland	Italy	Netherlands	Norway	Spain	Sweden	Sw'land
Constant	(2.47)**	(1.98)**	(3.9)***	(3.6)***	(-.12)	(.114)	(2.14)**	(.66)	(6.64)***	(1.3)	(1.26)
CGQ	-.186 (-.451)	.038 (.160)	-.563 (2.411)**	-.357 (-1.585)	.137 (.369)	.131 (.391)	.052 (.186)	.338 (.952)	-.267 (-1.002)	.469 (2.386)**	.150 (.603)
Mkt Cap	.106 (.257)	-.212 (-.893)	.301 (1.288)	-.095 (-.424)	.360 (.970)	.073 (.217)	-.076 (-.273)	.052 (.147)	.148 (.556)	-.420 (-2.136)	-.310 (-1.25)
F Statstic	.105	.416	2.936	1.387	.375	.317	.04	.463	.507	4.59**	.79

a Dependent Variable: % Change in Stock Price
CGQ: ISS's corporate governance quotient rating. Market Cap: Market Capitalization of the firm.