

EXECUTIVE SUMMARY

Conflicts of Interest, Low-Quality Ratings, and Meaningful Reform of Credit and Corporate Governance Ratings

by

Charles W. Calomiris and Joseph R. Mason¹

October 31, 2009

The corporate governance rating industry – composed of governance advisers, governance rating firms, and proxy advisers, sometimes operating as business units of a single company – plays a major role in corporate governance policymaking, and, because of its influence with institutional investors, effectively acts as a de facto corporate governance regulator. Like its counterpart the credit ratings industry, the corporate governance ratings industry faces serious challenges in ensuring that incentives are properly aligned and that principal-agent problems are avoided. The solution to ridding the industry of incentive conflicts and principle agent problems lies, therefore, in preventing rating agencies from delivering low-quality ratings in the first place.

Not surprisingly, rating agencies argue that the desire to preserve reputation should discipline them to consistently produce high-quality ratings. Nonetheless, entrenched corporate governance rating agencies earn large fees from passing off low quality ratings, taking advantage of the fact that the users of ratings (institutional investors) are faced with incentive conflicts and principle-agent problems with the ultimate investors. These bad behaviors are the direct result of incentive conflicts and principal-agent problems that cost the ultimate investors dearly.

Insidious incentive conflicts and principle-agent problems arise because institutional investors enjoy private (self-serving) benefits from demanding low-quality ratings. The private benefits of demanding low quality ratings include (1) avoiding legal liability for their decision making processes when selecting portfolio firms, (2) avoiding accountability to their investors for poor firm performance, and (3) other potential private and regulatory benefits that institutional investors gain at the expense of stockholders through their alliances with rating agencies. The harmful principal-agent problems arise when a conflict of interest arises between an institutional investor and their clients, and the ultimate investor. Given the incentive conflicts and principle agent-problems that lead institutional investors to demand low quality ratings, dominant but low quality rating agencies are insulated from competition from new entrants producing superior ratings.

¹ Calomiris is the Henry Kaufman Professor of Financial Institutions at Columbia University and a Research Associate at the NBER. Mason is the Hermann Moyse, Jr./Louisiana Bankers Association Endowed Professor of Banking at Louisiana State University and Senior Fellow at The Wharton School. This paper benefitted from the support of the Wharton Financial Institutions Center and World Growth, and from the comments of Niels Holch, Paul Rose, Nick Schulz, and Steve Wallman. The authors alone are responsible for the opinions expressed here.

With their protected status and implicit alliances formed with institutional investors, governance rating agencies are able to exact higher payments from the firms they rate by requiring those firms to pay for wasteful and unnecessary consulting services about proper corporate governance practices. The problem becomes more acute when a ratings agency has already achieved monopoly or near monopoly in the industry, as is the case with RiskMetric's Institutional Shareholder Services division. Because of the market power in existing corporate governance industry alliances, competitive pressures alone will not be sufficient to overturn the "bad equilibria" of low quality corporate governance ratings. Payment for wasteful and unnecessary consulting services through "shakedowns" of public firms, reduced market discipline on public firm's performance, and reduced market discipline on the behavior of the institutional investors will persist without meaningful regulatory reform.

The corporate governance industry provides ample evidence to support such views. Corporate governance rating agencies are no longer merely "independent" experts evaluating corporate governance but are in fact shaping the behavior of the corporations they rate, even though their ratings are only as good as the models that produce them. Given the lack of accuracy in the models of the credit rating industry, this is a worrying trend with dire ramifications for U.S. businesses. Just as rating agencies helped shape structured financial products in the recent credit boom, corporate governance rating agency models are furtively shaping U.S. shareholder voting and corporate governance structures. In fact, the situation may actually be worse in the corporate governance rating industry than in the credit rating industry. Corporate governance structures are far more complex than even the most complicated financially-engineered security and will take considerably longer to restructure toward stability if the corporate governance rating models are wrong. This directly and predictably impacts not only pension fund and institutional investors but the employees of the rated firms themselves and the local and regional economies in which they operate.

Moreover, industry observers have already raised concerns over agencies' potential conflicts of interest, especially with respect to firms that exhibit per se evidence of conflicts of interest or those whose proxy advice and governance ratings have proved unreliable. Institutional Shareholder Services, for example, sells advice on proxy voting and sells corporate governance ratings but also provides advice to companies on how to improve their ratings. Indeed, firms are often pressured to obtain corporate governance ratings from high-profile firms such as ISS and GovernanceMetrics International. However, firms often find that the metrics championed by these firms simply do not reflect either the firm's financial performance or business ethics and may in fact be negatively correlated with annual stock appreciation and ethics scores. Recent independent research raises serious questions about both the reliability and utility of corporate governance ratings agencies' models and assumptions. Thus, low-quality corporate governance ratings harm both the institutional investors with incentives to obtain them and pension fund and individual investors who have no choice but to rely on them.

Several important conclusions emerge from this analysis. First, because of various incentive conflicts and principal-agent problems, entrenched rating agencies are able to pass off low quality ratings to institutional investors and extract high fees from the firms they rate. Second, as a result of the alliances between rating agencies and institutional investors, creating a near-monopoly situation, new rating agencies will be deterred from entering the market. Third, and perhaps most importantly, the central role of investor conflicts of interest to the tolerance for low quality ratings should not be misconstrued as suggesting that governance rating agencies are passive or unwitting participants in

the productions of low quality ratings. In fact, corporate governance rating agencies use their protected status to actively pursue excess profit seeking strategies that maximize the resources that they can extract from the firms they rate. In turn, the rating agencies can use those excess profits to further entrench their positions with the institutional investors by offering additional benefits to those who ally with them.

Ratings reform of all types must make it profitable for rating agencies to issue high quality, non-inflated ratings, notwithstanding the demand for low quality or inflated ratings by institutional investors. This can only be accomplished through the following two regulatory interventions, both at the level of the rating agencies: (1) the objectification of the meaning of ratings, and (2) linking the fees earned (or penalties paid) by the rating agencies to objective measures of their performance. Ideally, the Securities and Exchange Commission would take a more active role by, for instance, requiring the ratings agencies to fully disclose requirements or business practice standards regarding any and all conflicts of interest. Further, the SEC should immediately require disclosure of all potential conflicts of interest, and should develop standards that would prohibit egregious conflicts of interest between rating agencies and the firms they rate. In the interest of mitigating excess profit seeking behavior, institutional investors should have to disclose all of their points of contact with the rating agencies, and these conflicts of interest should also be the subject of SEC standards.

As the SEC relies more and more on corporate governance ratings as a means by which institutional investors can meet their fiduciary duties to vote shares in a manner reflecting the best interests of the ultimate investors, it should require the corporate governance rating agencies that sell information to meet a fiduciary duty that imposes a regulatory obligation that requires them to maintain some degree of accuracy. To the extent the industry's role as corporate governance regulator becomes formalized, appropriate penalty structures like objectively applied clawback provisions should be developed.

But, notably, even with more comprehensive action by the SEC, it will be incumbent on regulators more generally to ensure that the governance rating industry can demonstrate a convincing value relationship between corporate governance ratings and recommendations and firm performance.