

The Emergence of Non-Financial Rating Agencies for the Promotion of Global Standards: An Assessment and Empirical Analysis of Two Proprietary Databases

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Abstract. There has been an emergence and exceptional growth in the number of agencies that rate firms based on their corporate governance, social, and environmental performance standards. The growing presence of these non-financial rating services presents a new opportunity for institutional investors to promote global standards beyond regulatory compliance via corporate engagement. Corporate engagement is the use of ownership position to influence change in management's decision-making strategy for a firm through a variety of private and public mechanisms. In corporate engagement, non-financial ratings can be used as a weapon, as well as, a lens through which to target underperforming firms. In this paper, we provide evidence that suggests that institutional investors will increasingly embrace and utilize non-financial ratings and that this will result in both higher global standards and protection of firm value. We do this via an extensive literature review, supported by interview responses from founders and executives of non-financial rating agencies to develop our understanding of the factors that promoted the emergence of non-financial rating agencies. Further, we assess the robustness of our argument that non-financial ratings *can* be harnessed to improve global standards by cross-analyzing two dissimilar proprietary non-financial rating agencies' data in shared research areas for agreement. Our bivariate analysis finds a strong positive correlation, providing evidence that the databases support each other despite their large differences in research orientations, levels of sophistication, methodologies, and historical geographic focuses.

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1. Introduction

This paper scrutinizes non-financial ratings and their role in promoting increased governance, social, and environmental standards in firms. It seeks to develop a more complete picture of non-financial ratings by examining why they were developed, who they were developed for, and if they rate what they claim to rate. We will examine what is different in the market environment *now* to support the emergence of non-financial ratings. We will then assess if it is *possible* for non-financial ratings to be used to increase global standards. Through this examination, we will be better able to assess the potential of corporate non-financial ratings to support the promotion of global standards in the future.

Independent evaluation of firms has a long history. Agencies that comparatively rate businesses based on their financial securities and credit risks or assets have been in existence since the early 1900s.¹ These ratings developed in response to the interest of portfolio managers in valuing corporations in a comparative and cost-effective manner. Suddenly, in the last five years, new initiatives, like corporate governance ratings, have become very important in the aftermath of the TMT economic bubble bust, the corporate governance scandals of 2001 and 2002, and the re-emergence of value investing. These new rating services evaluate firms on non-traditional value indicators, providing investors with information on areas of firm performance that may not easily be valued on the balance sheet of the company's accountant, but that do have significant implications for firm competitiveness and long-term share value. For example, ratings could be used to evaluate how a firm's management strategy, governance structure and market positioning is coping with the risk exposure that climate change poses to firm value (for a comprehensive look at the importance of climate change business strategy and governance practices to firm value see CERES (2002) and CERES (2003)).

Hebb and Wójcik (2004) argued that institutional investors use rating agencies as a *lens*, through which they see investment risk. The investment risk is then used to determine what firms they engage to improve their standards and then as a *weapon* to confront those firms. Therefore, Hebb and Wójcik argue, ratings can play a critical role

¹ In 1909, Moody's Ratings introduced the first rating system as part of Moody's Analyses of Railroad Investments. A rating scale of AAA-through-C was used to rate some 1,500 individual securities of over 200 US railroads.

in promoting global corporate, social and environmental standards. This paper furthers Hebb and Wójcik's research by broadening the understanding of the role of non-financial rating agencies. We use both quantitative and qualitative methods to advance our argument and understanding. An extensive literature review examining factors significant in the emergence of non-financial rating agencies is partnered with data from in-depth elite interviews (employing techniques developed by Clark (1998) and Clark (2005) of agency founders and/or executives to establish why and for who these agencies have been developed. To establish whether non-financial ratings rate what they claim to rate, a quantitative analysis is conducted on two proprietary non-financial rating databases. These databases examine two different non-financial areas using two very different methodologies, but have overlapping themes within them. If our research shows that ratings agree in these similar areas, it would suggest that they justify and support each other's results and would imply that it is *possible* for non-financial ratings to be used to increase global standards. The qualitative interviews and lengthy literature review combined with the quantitative bivariate analysis of the rating databases will provide the backbone of our theory that non-financial ratings will increasingly promote higher global standards as a result of being harnessed by institutional investors who use the ratings as both a lens of investment risk and a weapon of corporate engagement.

This research is particularly relevant to the field of economic geography as it contributes to two important themes within the discipline (as identified by Angel 2000 in the Oxford Handbook for Economic Geography). First it will help to determine whether the processes of economic globalization can be utilized to improve environmental performance. This by assessing whether non-financial ratings are likely to be utilized by the forces of economic globalization and if this utilization can lead to enhanced corporate environmental performance. Second it will contribute towards providing insight into whether political, economic, social, and cultural differences influence the transferability and effectiveness of global 'best practices' by assessing whether non-financial ratings rate what they promise to rate. If they do, it defends the future use of data from these rating agencies to examine and draw conclusions on international trends in environmental, social, and corporate governance performance. This research will, also, contribute to the emerging field of environmental finance. Environmental finance is a field of inquiry that examines environmental problems from the internal perspective of

business and identifies the factors that promote environmental performance in the self-interest of the firm (Labatt and White 2002). Environmental finance is framed on an acceptance of the idea that sound environmental management and sound economic management are positively correlated, and that environmental quality is justified by the bottom line. We contribute to these fields by identifying the market for non-financial ratings, determining the worth of non-financial ratings, and gleaning some insight into the potential future market for these ratings.

In the following sections of this paper, we first develop a historical perspective on financial/credit rating agencies, to better understand their significance and influence within the financial market. We then examine the rise in the significance of institutional investors and increased activist role being played by them in response to an increased long-term investment horizon. In the third section of this paper, we examine the growth of institutional investors' demand for corporate disclosure and non-financial ratings, following the burst of the TMT economic bubble and the recent corporate governance scandals of the 2000s. In the fourth section, we examine the body of research that assesses the relationship between non-financial performance and firm value. In the penultimate section of this paper, we assess if non-financial ratings rate what they claim to rate by conducting a bivariate analysis on data from two proprietary rating databases. In the final section we conclude and draw implications.

2. The Emergence of Non-Financial Rating Agencies

2.1 Historical Significance

There is a long history of independent evaluation of firms via financial credit ratings. In the early 1900s, industries began to require more financial capital than they could raise via the traditional "relational" method. Rating agency's rankings allowed industries to raise additional capital by allowing investors, who did not know the business venture managers, to appraise the risks and benefits of investing in the corporation. The most well known of these financial credit rating agencies are the Standard & Poor's Corporation, Moody's Investors Services, Inc. and Fitch Investors Services.² These three firms dominate the financial rating market with a combined market share of roughly 94%

² For a look at the history of these rating agencies, see Cantor and Packer (1995), Jewell and Livingston (2000), and Sylla (2002).

(Wiggins 2001). The traditional role of credit ratings, which these agencies produce, has been to evaluate the debt instruments of corporations. That is to say, whether company debts are likely to be repaid in a timely manner and what would be recovered if the debt were defaulted on.

The importance of financial rating agencies varied throughout the early 1900s. However, in the 1970s, there was an increase in demand for financial ratings by both issuers and investors following a series of major debt defaults (Cantor and Packer 1995). Since that time, the significance and power of financial rating agencies has grown considerably. The power of rating agencies was highlighted in 1996 by New York Times columnist Thomas Friedman, who said that there were two superpowers in the world, the United States and Moody's (MacNeil/Lehrer Newshour 1996). Some consider this statement an exaggeration (for example Partnoy 2002), but there is truth in Friedman's statement about the enormously powerful presence that credit rating agencies have developed in financial markets. This power was noted by Senator Joseph Lieberman in the 2002 hearing before the Senate Commission on Governmental Affairs "Rating the Raters: Enron and the Credit Rating Agencies". Lieberman stated, "The credit raters hold the key to capital and liquidity, the lifeblood of corporate America and of our capitalist economy. The rating affects a company's ability to borrow money; it affects whether a pension fund or a money market fund can invest in a company's bonds; and it affects stock price" (Senate Hearing 2002).

Part of this growth in power came from the use of these private rating systems by regulatory agencies in the United States, who increasingly used ratings in supervisory settings to evaluate firm creditworthiness. Beginning in the 1930s, and continuing to the present, regulations have been enacted that either encourage or require institutional investors (pension funds, insurance companies, banks, etc), to favor investment grade debt, over debt that is less highly rated or unrated (Hill 2004).³ Another significant factor contributing to the growth in importance of rating agencies is the economic globalization that has been occurring since the 1970s. Economic globalization is the growth and intensification of economic interrelations worldwide. This is marked by enormous flows of capital and technology, increased international trade, extended market reach that

³ For a more detailed look at how United States' regulatory agencies have incorporated the use of ratings from credit rating agencies, see Rhodes (1996) and Partnoy (1999).

creates new connections between national economies, and the emergence of gigantic multinational firms, international economic institutions and trading systems (Steger 2003). This economic globalization has dramatically increased the complexity of the marketplace to investors who now have many more investment opportunities globally. The sheer number of firms today that have a multinational scope gives an indication of how significant the globalization of the market has been. The number of firms with subsidiaries in several countries has grown from 7,000 in 1970, to roughly 50,000 in 2000 (Steger 2003). The new global economic linkages and interrelations and resulting increases in complexity of the financial marketplace has bolstered demand for a means to evaluate firms in a comparable way. Financial rating agencies have historically provided that means.

2.2 The Role of Institutional Investors

The history of non-financial rating agencies is very new in comparison to financial credit rating agencies. They have emerged in the mid to late 1990s and are continuing to establish themselves. Why are they appearing in the corporate ratings market at this time, in an arena historically ruled by the financial credit rating goliaths? In order for non-financial ratings to be developed and maintained, there has to be a client who is interested and wealthy enough to pay for the services that they provide. We argue that institutional investors, and in particular pension funds, have developed into this pivotal client. This argument contributes to the growing literature examining the vital role that pension funds play within society in general, and to Anglo-American societies in particular (Clark 2000, Clark and Hebb 2004b).

Recently, institutional investors have come to dominate global financial markets (Clark 2000, Davis and Steil 2001, Monks 2001, Clark 2003). Institutional investors held only 16 percent of the corporate equity in the United States in the 1960s (Useem 1996) and more than 57 percent by 2000 (Securities-Industry-Association 2000). The total financial assets of institutional investors have grown from \$672.6 billion (US) in 1970, to over \$13 trillion (US) today, which represents approximately half of all investable assets in the global financial system (Hamilton 2000, Clark 2000, Davis 2001, Monks 2001, Pensions and Investments 2003). In this paper we follow the argument set forth by Clark and Hebb (2004b), that in the 21st century we are entering a 5th stage of capitalism, where

the power of ownership and corporate control is being returned indirectly to individuals from managers via institutional investors as collective sources of money acting on their behalf. In Berle and Means' seminal book *The Modern Corporation and Private Property* (1933), they concluded that the rise of 20th century public corporations meant a dispersal of ownership rights among the population and a separation of ownership and control (control shifting to the firm managers). The recent rise in power and influence of institutional investors and pension funds in today's capital markets around the world offers a new solution to this struggle for corporate control between owners and managers, where the result is not a pension fund 'socialism' as envisioned by Peter Drucker (1976), but rather a reconfigured capitalism (Clark 2000, Monks 2001).

Previously, institutional investors were content to do the "Wall Street Walk" by selling their stock shares when they were dissatisfied with firm performance or risk level. In Hirschman's terminology this is known as "exit".⁴ However, the ability of institutional investors today to sell shares has decreased significantly due to the sheer size of their equity holdings (Coffee 1991, 1997). An institutional investor would flood the market and decrease the share value if they just attempted to sell their holdings of a firm that they were dissatisfied with (Graves and Waddock 1990 and Labatt 2002). In addition, today, most institutional investors are shareholders in a particular firm because the firm is included within an index product (Clark and Hebb 2004a).⁵ As a result, institutional investors are increasingly finding themselves in the role of "reluctant" activists (Graves and Waddock 1990, Pound 1992, Pozen 1994, Smith 1996, Useem 1996). Using Hirschman's terminology institutional investors are being forced to use "voice" to react to institutional decline. The increased use of "voice" means that institutional investors will rely more on ratings as a means of evaluating performance and as a weapon to confront underperforming firms.

Corporate engagement can be conducted via a number of "loud" or "quiet" methods. The preferred forms of corporate engagement ("voice") are "quiet" behind-the-scenes influence and private negotiation with the firm (Silverstein 1994, Smith 1996, Pellet 1998, Byrne 1999). The less preferred "loud" methods of corporate engagement

⁴ For a discussion on the preconditions leading to "exit" and "voice", or alternatively "loyalty" see Hirschman (1970).

⁵ Institutional investors usually own both passive index-linked stock portfolios and active stock-selection portfolios that are based on comparative stock prices and market capitalization (Clark and Hebb 2004a).

are the public voicing of concerns through proxy voting (Davey 1991, Pound 1992), media campaigns (Rehfeld 1998), shareholder proposals (Fortune 1993, Smith 1996, Del Guercio and Hawkins 1999), or floor resolutions made at shareholder meetings (Schwab and Thomas 1998). These are usually considered a last resort, as they can have negative effects on firm value. However, both methods are utilized⁶. A study by Johnson and Greening (1999) found that 72 percent of firms targeted by institutional investor activism settle before a stakeholder amendment or contest proxy is put forward. This indicates that “quiet” private negotiations are not only utilized, but also effective. This is supported by another study that found that 32 of 45 firms engaged by TIAA-Cref addressed problems before a proxy vote was filed (Carleton, Nelson and Weisbach 1998). The “loud” options are also being employed, and increasingly so. In the 2003-proxy season, there were 862 shareholder proposals filed, up from 802 in 2002. Notably for our research, 27.5 percent of these resolutions were concerned with social and environmental issues and 72.5 percent were concerned with corporate governance issues (IRRC and ICCR 2003).

There has been a limited amount of research into the effects of institutional investor activism and corporate engagement on firms⁷. The limited empirical research that has been conducted provides little evidence that shareholder proposals create firm value, although some private negotiations efforts may have (Karpoff 1998). Five studies found that institutional investor private negotiation had a positive effect on stock price (see Romano 2001). There is also some evidence that corporate engagement has affected the types of decisions made by the targeted firms, suggesting that intervention stops firms from continuing to make bad decisions (Hudson 1997).

There is a significant tension between short-term and long-term performance horizons that the investment managers of pension funds and other institutional investors must deal with when making decisions on future investment strategies. Investment managers must simultaneously be concerned with short-term returns, as part of an ongoing benchmarking process that is fundamental to upholding their fiduciary duty, and long-term firm value protection (Clark and Hebb 2004b). Past research has suggested

⁶ For an examination of two pension funds using loud vs. quiet engagement and the reason why they chose their method see Clark and Hebb (2004a).

⁷ For a thorough overview of empirical studies on shareholder activism see overviews by Karpoff 1998, Black 1998, Gillan and Starks 1998, and Romano 2001.

that, historically, Anglo-American pension funds have been dominated by an impatient, short-term, myopic investment management style that has eroded share value (Bushee 1998, Romano 2000, Shleifer and Vishny 1988). Other research has shown that European nations are not excluded from this myopic tendency (Becht and Mayer 2001). We argue that these studies only consider the short-term reaction of pension funds and do not adequately examine the long-term investment behavior because they are based on short-term event studies of the stochastic shocks following corporate announcements, rather than a thorough examination of long-term behavior (Bauer and Günster 2003).

Another area of research related to the long-term short-term debate examines how institutional investor ownership concentration (as a proxy for interest or activism) changes investment in long-term firm research and development (R&D) programs. The findings of these studies are mixed (compare (Jarrell 1985, Baysinger et al. 1991, Hansen and Hill 1991, Kochhar and David 1996, Zahra 1996, Wahal and McConnell 1999) and (Graves 1988, Shleifer and Vishny 1988, Chaganti and Damanpour 1991, Bushee 1998, Becht and Mayer 2001, Bushee 2001, Romano 2001). However, these studies do not consider the differences of specific types of institutional investors and of their objectives (Zahra 1996, Del Guercio and Hawkins 1999, Prevost and Rao 2000). Public pension funds are likely to have long-term horizons and to engage poorly performing firms (Blackburn 2003). However, investment banks and private funds have been the subject of concern because fund managers are evaluated on quarterly performance and are thus suspected of promoting short-term objectives in their own best interest. These differences in institutional investment style have been confirmed by an empirical study conducted by (Zahra 1996). Another reason for the inconsistent results of these studies is that the researchers have considered that ownership represents control. This notion is dispelled by Davis and Thompson (1994) who argue that firm engagement and activism is necessary for the institutional investor to realize true power over the firm. In addition, recent study by David et al (2001) supports this idea by showing that passive ownership alone does not give adequate power to change corporate behavior. Therefore, we suggest that institutional investor activism is required to have positive effects on investments that have long-term objectives.

This paper is based on the argument that institutional investors, in particular public pension funds, are increasingly interested in the long-term performance of the

firms included in their portfolio and that they actively engage poor performers as a result of that interest. The investment horizons of defined benefit public pension and retirement funds are the most likely to be long-term in nature, and to engage firms on their corporate, social and environmental performance, because of the large size and long duration of their investments (Clark and Hebb 2004a and Blackburn 2003). Since the long-term goals of different types institutional investors differ (public and private pension funds vs. banks, insurance agencies, mutual funds, etc), it is also likely that they will approach the potential impacts of environmental and social issues differently. Because of the longer-term investment horizons of defined benefit public pension funds, they have a stronger interest and potential for activism in response to social issues (including environmental issues) than other institutional investors (Smith 1996, Wahal and McConnell 1999). In fact, Johnson and Greening (1999) found that 91 percent of institutional investor activism involving social issues was initiated by pension funds (44 out of 48 shareholder amendments). Further, their study suggests that investment fund managers (mutual fund, etc) did not appear to have any interest in promoting corporate social performance, but that pension fund managers appeared to be interested in gaining an environmental responsible position.

Pension funds, and institutional investors more generally, have a fiduciary duty to their individual investors that should promote an interest in long-term firm value (for a full explanation of fiduciary duty see Hawley and Williams (2000)). In the past, “fiduciary duty” has been used as a shield to justify non-involvement in “environmental” or “social” investment, with the justification that “the business of business is business” (Friedman 1962) and that superior performance on environmental and social issues can only be achieved with higher cost and smaller financial returns to investors. However, with the growing amount of evidence supporting that there is a connection between long-term firm value/lower investment risk and the “non-financial” performance of firms (as is discussed in Section 4), it is increasingly clear that it is in the best economic interest of institutional investors to pay close attention to corporate governance, environmental, and social performance as part of their fiduciary duty. Matthew Kiernan and James Martin (1999) the founding director and chairman of Innovest Strategic Value Advisors respectively, said this about fiduciary duty in Investment & Pensions Europe “[I]t is now fair to say that to fail to consider available information about companies’ environmental

risk, performance and strategic positioning is to fail to discharge one's fiduciary responsibilities, not to honour them". Further, in the January issue of UNEP (2003), Kiernan states that there is "growing and incontrovertible evidence that superior environmental and social performance does in fact improve the risk level, profitability, and stock performance of publicly traded companies" and that "fiduciaries can now be seen to be derelict in their duties if they do not consider environmental and social performance and risk factors". Michael Jantzi, president of Toronto-based rating company Jantzi Research Inc. states that "the environment in which the prudent investor finds himself has changed dramatically since 1830, when the term originally was articulated by the Massachusetts Supreme Judicial Court. In the same way that financial indicators have evolved during the last 175 years, fiduciary standards today must include an examination of environmental, governance and human rights risks that increasingly face corporate management teams in their day-to-day operations."

While institutional investors hold the majority of corporate equity (Securities Industry Association 2000), this is cumulatively, and individual pension funds and other institutional investors do not usually hold large stakes in any one firm. Institutional investor 'ownership' of a particular company is therefore dispersed, although very significant in sum (Clark 2000). This makes institutional investor activism via coalitions and associations critical for effective corporate engagement to be conducted. Without the ability to join in a collaborative effort, individual institutional investors are likely to fall into a prisoners' dilemma, where each acting in their own best interest (selling the stock of the underperforming firm), has a far worse consequence than the outcome of acting collectively (using activism to demand corporate improvements to governance, environmental or social performance) (Davis and Steil 2001). As a result, corporate engagement is increasingly occurring via associations or coalitions of institutional investors (Clark and Hebb 2004b), such as the Council of Institutional Investors in the US and National Association of Pension Funds in the UK. An illustrative example of institutional investors growing willingness to work in collaboration is the 2002 Carbon Disclosure Initiative (CDI). The CDI, consisting of 35 institutional investors representing over \$4.5 trillion wrote to the chairmen of the world's 500 largest corporations expressing their concern about climate change and requesting the firms disclose what they were doing to identify and manage the business and investment risk

that it poses (Kiernan 2004). The tendency for institutional investors to work together is a relatively new phenomenon, as earlier they primarily worked alone (see Coffee 1991 for a thorough examination). With an enormous cumulative asset base and the willingness and ability to act with a single voice on behalf of their shareholders, institutional investors and their joint coalitions wield considerable power in the financial marketplace.

3. Growth in Demand for Disclosure and Firm Evaluation

Recent historic events have significantly contributed to institutional investors' increased demand for corporate disclosure and improved non-financial behavior standards. In the 1990s, investment in technology, media, and telecommunications (TMT) was booming. This boom was marked by an unprecedented market growth, together with significant job creation throughout many socioeconomic layers, increased growth in productivity, gains in both income and wealth were widespread, and there was a low inflation rate (CEA 2001). However, this overvalued market proved to be inherently unstable, and as a result, trillions of dollars in paper gains have disappeared since the burst of the TMT bubble in 2000 (Babcock-Lumish 2004).

In 1999-2000, overall investment in telecommunications grew at rate of approximately 10% per year, but then in 2001 it fell by more than 20% (Brenner 2002). Between the end of 2000 and the middle of 2002, more than sixty telecommunication companies went bankrupt and laid off over 500,000 workers, 50% more than the industry hired during its expansion between 1996 and 2000. The TMT bubble bursting cost investors monumental amounts when the stocks plummeted. For example, the annual performance of USS's investment asset base fell 16.7%, falling from £22 billion in 2000 to £15.5 billion by late 2003 (Clark and Hebb 2004a). Investors who had been lured into venture capital investments were awakened and are much more interested in identifying investment risk in corporate behavior and standards.

Investors were further disenchanted by the colossal loss of value associated with the corporate governance scandals of 2001 and 2002 that was commenced and epitomized by the fall of Enron. Enron's stock peaked in August of 2000 at close to \$90 a share, America's seventh largest firm by market capitalization (Bratton 2002). Fortune Magazine had named it America's most innovative firm five years in a row (Chatterjee

2001). Then, on December 2, 2001 Enron sent a shock through the investment world by becoming the largest bankruptcy in American history (Zellner and Forest 2001), the result of the largest financial fraud and audit failure in history. Enron's stock ultimately fell to around forty cents (\$0.40) per share (Coy 2001). Enron was the first of a number of corporate accounting scandals to rock financial markets. It was followed by WorldCom, Tyco, Adelphia, Parmalat and Royal Ahold. The evidence, today, makes clear that these corporate scandals were not unique, and that they were a result of problems that were pervasive in corporate governance at the time (Coffee 2003).

It is not surprising then, that post TMT and post Enron, there was a surge in the market for non-financial rating services. Marnie Bammert of Oekom Research stated, "After the burst many investors re-discovered the importance of a long-term perspective and a system of values based on responsibility and fairness. This led to a dramatic rise in demand for sustainability research." This was confirmed by Howard Sherman of GMI who said "Those events convinced a number of market participants that governance really does matter. The sheer size of the losses, and the clear failure on the part of many boards to exercise their oversight responsibilities, had a galvanizing impact on our target market." Matthew Kiernan, Innovest's Director explained it this way in IPE (2003). "These cases [specifically corporate governance scandals], and others like them, have fundamentally shaken both investors' and the general public's confidence in the reliability and even the relevance of audited financial statements, once among the most basic raw material of securities analysts everywhere. This is creating unprecedented opportunities for proponents of alternative (or at least supplementary) analytical approaches." Michael Jantzi, president of Jantzi Research Inc. stated that "the scandals that rocked corporate America fundamentally altered institutional money managers' once firm belief that non-financial indicators were inconsequential to shareholder value. Once the door opened a crack, it provided those of us who work in this industry the opportunity to push it open a little further and make the case that environmental and social risks matter."

In a recent academic study, Hebb (2004) demonstrates how institutional investors force firms to adopt higher transparency standards to ensure that the firm is serving the interest of firm shareholders. Hebb argues that transparency not only aligns the interests of managers and owners, but that it, also, raises issues of firm behavior that facilitates the

engagement of the firm by other stakeholder groups. This is supported by the findings of Wójcik (2004) that shows that disclosure was the category of corporate governance improving the most in a study of European firms between 2000 and 2003. Hebb (2004), also, reports that the corporate governance campaigns of institutional investors are shifting away from increased board oversight of management, and towards mechanisms that force increased transparency and disclosure. This is logical, as fifty percent of Enron's board of directors were independent members (Hebb 2004). Once the transparency being demanded by institutional investors is put in place⁸, and presented in a useable format by rating agencies, it can then be harnessed by institutional investors to demand action for higher performance standards in governance, social and environmental performance (Clark and Hebb 2004b, Hebb and Wójcik 2004, and Hebb 2004).

As previously noted, institutional investors are major suppliers of capital to the financial market and therefore, they have a significant interest in corporate disclosure and the underlying performance standards. However, with increased amounts of disclosure, and the resources required to accurately appraise it,⁹ comes a growing need for a way for institutional investors to access and evaluate the information that the disclosure includes. As a result, institutional investors rely on rating agencies for their expertise in judging firms based on non-financial metrics. For example, environmental reporting alone does not offer investors adequate information because it is not standardized and is therefore frequently not comparable across and between industry sectors (Prichard 2000 and SustainAbility 2000). For these reasons, institutional investors and pension funds in particular, are demanding independently assessed qualitative and quantitative ratings from agencies that are able to provide them with comparable, systematic and standardized measures of non-financial corporate performance (Bauer et al. 2002, Hoffman 1996, Rondenelli 1996, Reich 1998). These rating services are particularly important in judging investments in a complex international market with vastly different national regulatory standards and legal regimes. Rating agencies are needed because contrary to popular perception, institutional investors like pension funds have a limited internal ability to monitor the behavior of firms in their investment portfolio (Hebb and

⁸ For example see the case of Royal Ahold studied by Clark, Wójcik and Bauer (2004).

⁹ Like financial rating systems, non-financial rating systems require significant resources for development, due to the vast amount of information they assemble and analyze some of which requires considerable judgment in interpreting.

Wojcik 2004). According to Oekom Research's Marnie Bammert investors and financial service providers prefer to use ratings then develop their own ratings because "from a practical point of view, co-operating with specialized research providers is advantageous for different reasons: the costs are definitely lower, the research is independent and has a high quality." Michael Jantzi, president of Toronto-based rating company Jantzi Research Inc. argues that "using independent investment research is not a new phenomenon for institutional investors, in fact it's common practice. What has changed is their willingness to access social and environmental research alongside the more traditional sell side analysis they've always had from the street."

The role that rating agencies play in the promotion of global standards was highlighted in a recent paper by Hebb and Wojcik (2004) who developed a theoretical construct they coined "the global institutional investment value chain" (See Figure 1). This "value chain" concept is of central importance to our research, as it illustrates in a comprehensive way the mechanism of how institutional investors promote global standards through the use of non-financial ratings. In the model, the rating agencies must provide accurate information to institutional investors for higher global standards of corporate conduct to be achieved. We examine this in Section 5 of this paper.

Rating providers are becoming a significant group of actors in the investment world and their foundation of clients is growing. Perceived market demand from institutional investors was the major cited reason by non-financial rating agency executives for the development of their specific firm. GovernanceMetrics International's (GMI) Chief Operations Officer Howard Sherman told us that on a scale of one to five, the importance of institutional investors was a "five". Further, he said, "The very premise of GMI is to provide institutional investors a systematic way of identifying governance risk, as well as governance leaders, in their investment portfolios." Marnie Bammert, head of Corporate Communications for Oekom Research AG, echoed this opinion, "Institutional Investors play a significant role for the development of our rating agency. They are the most important group of users of our research." According to Michael Jantzi, president of Toronto-based rating company Jantzi Research Inc., Canadian institutional investors make up the bulk of his firm's clientele.

Interestingly, the dominant financial credit rating firms are not leaders in the development of ratings for non-financial aspects of firm performance. Moody's has

added firm-level corporate governance ratings to its services post-Enron (Gompers 2003). Standard & Poor's offers an internal corporate governance consulting service to firms for a fee providing them with a final score that they can publicize if they want. (Only 20 scores have been made public to date.) Small rating agencies like Innovest, Deminor, GovernanceMetrics International (GMI), Kinder, Lydenberg and Domini (KLD), CoreRatings, Oekom, and Sustainable Asset Management (SAM) are currently the leaders in the non-financial rating market. These ratings are catching the attention of company executives as they help to determine what firms are included or excluded from the large socially responsible indices (for example FTSE4Good, Dow Jones Sustainability Index, and the KLD Domini 400 Social Index). Firms can see exclusion from these indexes as a reputational threat. This further encourages firms to raise disclosure and corporate, social and environmental standards (Hebb and Wójcik 2004). Therefore, these ratings are providing a type of global standard enforcement mechanism, where the pure existence of the rating is a sign of demand for higher standards.

The services provided by these rating agencies range widely, with some firms concentrating on very specific areas, like corporate governance structure, and others that have wide-sweeping aims, compiling data on hundreds of different governance, social, environmental and other strategic management metrics. The methodologies of these rating agencies are, also, diverse. Some agencies concentrate on individual sources of information, while others utilize many qualitative and quantitative data sources. Some firms focus fully on qualitative data sources and others strictly on quantitative sources. Some ratings use only publicly available information, assuming that this helps to avoid subjectivity bias and that it is the information that is available to the market to evaluate and reflect in firm value, while others primarily assess private information in hopes of gleaning hints to risks or value unvalued by the market. While the various services and methodologies of these firms are widespread, they share the common aim of providing shareholders with insight into intangible risks and value, not readily available via financial reports or ratings.

4. Growing connection between “non-financial indicators” and firm value

The relationship between non-financial performance standards and firm shareholder value is critical for developing a complete understanding of the potential that institutional

investors and financial markets have for promoting higher global standards. The stronger the relationship is shown to be, the greater the interest institutional investors will have to engage firms to increase their performance. The following is a summary of the most recent and appropriate studies in this growing area of academic research.

The connection between corporate governance and financial performance has been explored by relatively few studies¹⁰. Generally, these have found a positive relationship between well-governed firms and financial out-performance (See Gompers et al 2003, Drobetz et al 2003, and Derwall et al 2004, La Porta et al 2002, De Jong et al 2002, Black 2001). This positive correlation seems to be stronger in countries that have less developed standards of regulations (Derwall et al 2004). Another group of studies dealing with the connection between non-financial performance and firm shareholder value examines corporate environmental performance. In this area of research, a number of recent studies have shown that there is a positive connection between corporate environmental and corporate financial performance (Edwards 1998, Kiernan and Lievinson 1998, EPA 2000), particularly the connection between environmental awards or disasters and financial performance (See Piesse 1992, Blacconiere and Patten 1994, Klassen and McLaughlin 1996, Blacconiere and Northcutt 1997, Dasgupta et al 1997, Patten and Nance 1998).

The research into the connection between environmental disclosure and financial performance is limited. Early studies had mixed findings (compare Belkaoui 1976, Freedman and Jaggi 1982 and Stevens 1984). More recently, studies have made findings that support a positive connection between environmental disclosure and financial performance (Stanwick and Stanwick 2000 and Al-Tuwaijri et al 2004), a negative connection (Richardson and Welker 2001), and no relationship at all (Murray et al 2001). These studies into the connection between environmental disclosure and financial performance do not suggest a correlation. However, the inconsistency found in these studies could be explained by the use of different indicators for both financial performance and environmental disclosure.

Overall, the evidence provided by all of these studies show a slightly positive relationship between non-financial performance indicators and financial performance. This is corroborated by a 2001 review of 80 empirical studies by Margolis and Walsh.

¹⁰ For a more thorough overview of corporate governance literature specifically see Becht et al 2003.

Their review found that when treated as an independent variable, non-financial corporate performance (social, environmental, and/or ethical) is positively correlated to financial performance in a small majority of the studies (42 or 53%), unrelated in 19 (24%), negatively in 4 (5%), and with a mixed relationship in 15 (19%). These results are over simplistic of course, both in that they combine so many different areas of non-financial performance, some of which are sure to have greater direct effect on financial performance, and in that they do not account for the strengths and limitations of each study. However, it is useful to note from this that there is a significant amount of research that shows a positive relationship, and very limited evidence showing a negative relationship. This suggests, that higher corporate performance in non-financial areas will not hurt firm share value, and may even improve it. These performance improvements may be seen in greater firm profits, reduced costs, improved employee satisfaction and retention, consumer loyalty, and brand reputation both in domestic and broadly international markets (Gompers 2003, Porter 1995, Dowell 2000, EPA 2000).

Institutional investors increasingly are appearing to believe there is a connection between non-financial performance and firm value as many are adopting SRI approaches in their portfolios, and thereby are assuming a correlation (Thompson and Wheeler 2004). This is not to say that causality is assumed, but that there is an indication of a superior management capability to manage complex issues, which is increasingly important in today's turbulent business environment (Wheeler 2004). Non-financial rating agency executives definitely believe in this connection. For example Howard Sherman of GovernanceMetrics International told us "There is a growing body of empirical research that finds a link between corporate governance and shareholder returns, especially when measured across a number of years using multivariate analysis. My hunch is that the common thread is cost of capital - companies with weak governance are viewed as representing additional risk and therefore face a higher cost of capital. I have also seen research linking environmental performance and return...Companies in an environmentally sensitive industry, like oil and gas exploration, have very specific risks and potential liability. A failure to manage those risks represents not just an environmental hazard but a governance failure as well." Michael Jantzi, president of Toronto-based rating company Jantzi Research Inc., says "my belief that there is a positive correlation between non-financial indicators and financial performance not only

is supported by a growing body of research, but by the continuing success of my company and other rating agencies around the world. If our clients didn't see value in Jantzi's analysis we would have been out of business long ago. And in this arena value is measured in only one way...helping your client achieve competitive financial returns."

5. Do they rate what they claim to rate?

In order for non-financial ratings to promote improved global corporate standards, they need to justifiably rate what they claim to rate. In this section, we assess whether the results of non-financial ratings are legitimate and justifiable by conducting a quantitative cross-analysis to determine if their results support each other in analogous areas.

For this analysis, we used two proprietary non-financial rating databases that examine two different non-financial areas using two very different methodologies. However, the databases have overlapping themes within them. The rating databases used were the Deminor Corporate Governance Rating Database provided by Deminor Corporate Ratings SA of Brussels, Belgium, which rates the Corporate Governance of companies included in the FTSE EUROTOP 300 stock index. The EcoValue'21 Rating Database provided by Innovest Strategic Value Advisors of Toronto, Canada, quantitatively rates the environmental performance of the majority of the companies listed on the primary world indices including the S&P 500, FTSE 350, FTSE Eurotop, Nikkei, and MSCI World. From the Deminor Corporate Governance Rating Database, we used the Environmental Information Score as a rough indicator of corporate environmental performance. The Environmental Information Score consists of four (4) indicators that are assessed based on publicly disclosed information. This is a miniscule part of the Deminor Rating system, accounting for roughly one percent of all the indicators included in the metric. From the Innovest EcoValue'21 Rating Database, we used the overall rating score as an indicator of corporate environmental performance. This single score includes roughly 60 indicators of environmental risk, management and strategic profit opportunities.

The sample we will use includes only those firms for which we have both Innovest and Deminor ratings. Therefore, our sample is limited to the firms listed on the FTSE Eurotop 300 index. The FTSE Eurotop 300 is made up of the largest 300

European firms according to their market capitalization (the stock market price of the firm multiplied by the total number of outstanding shares). Seventeen (17) European Nations are represented in our sample. The most recent data available will be examined in this paper. We will use the Deminor Ratings from 2003 that was released after the year's end and the Innovest scores from December 2003. The Deminor Environmental Rating Scores are compared one to one with the Innovest Overall Scores for each of the two hundred and eighty two (282) firms that are present in both databases in 2003 in order to assess the bivariate relationship of the two scores. Table 1 shows the number of firms represented by each country and industry (Industries were assigned in conformity with the Industry Classification Benchmark (ICB) that was developed by the Dow Jones Indexes and FTSE in 2004). A Spearman Rank test for nonparametric correlations was conducted in order to assess the significance of our results. Further, we checked our results for a country or sector bias (i.e. that the relationship between the scores is strictly the result of a firm's home nation or sector, such that particular nations/sectors score all the high scores and other nations/sectors makeup all the low scores.).

(Insert Table 1)

Table 2 shows the mean and median Deminor Environmental Scores sorted by the Innovest Score that they received (Seven (7) Classes from AAA to CCC). Table 2 is graphically presented in Figure 2 (Mean Scores) and Figure 3 (Median Scores).

(Insert Table 2)

(Insert Figure 2)

(Insert Figure 3)

The Spearman Rank test resulted in a value of 0.502.¹¹ Figure 4 shows the distribution of scores within each of the seven (7) largest countries (those with a significant number of firms (more than ten (10))). Figure 5 shows the distribution of scores for each of the ten (10) industries (As defined by the ICB).

¹¹ The correlation is significant at the 0.01 level.

(Insert Figures 4 and 5)

The relationship between Deminor's Environmental Information Score and Innovest's Overall Score that is depicted in Table 2, Figure 2 (Mean Scores) and Figure 3 (Median Scores) shows a visibly positive trend. Firms that scored high on Deminor's Environmental Information Score also were ranked well on Innovest's Overall Score. This relationship is shown to be significant by the Spearman Rank Coefficient value of 0.502.

We observe a strong performance for the firms located in the United Kingdom, but still with some variability. Strong United Kingdom firm performance is expected, as this finding is consistent with the existing research into the performance differences between Anglo-American and continental European corporate governance (of which disclosure is a part). Previous research using the Deminor database has found that firms located in the United Kingdom score higher than other nations do in Deminor's Ratings, including the Disclosure Category (Wojcik 2004). However, we are interested in assessing whether the United Kingdom (or particular industries) account for all of the high scores in both rating schemes. As is clear from the previous figures, (4 and 5) there is no evidence of country or industry bias. There is not a clearly defined linear relationship within the scores either, but this is expected due to the non-continuous nature of the variables.

The statistically significant relationship between Deminor's Environmental Information Score and Innovest's Overall Score is noteworthy for a number of reasons. First, the focuses of the two rating databases analyzed here are very different. Deminor Rating's Focus is on corporate governance including the main themes of "Rights and Duties of Shareholders", "Range of Takeover Defenses", "Disclosure on Corporate Governance", and "Board Structure and Functioning". In contrast, Innovest's research and ratings are centered on the environmental factors that contribute the greatest amount to financial out-performance. Second, the methodologies used to determine the ratings are vastly different. The Deminor system relies solely on publicly available information to apply its rating. Innovest uses over 20 quantitative and qualitative information sources to compile data for its ratings including extensive interviews with senior management executives. Third, the two scores used in our analysis have very different levels of

sophistication. The Deminor Environmental Score is made up of four (4) scored factors and is of minimal importance to the total score a firm receives. Whereas, the Innovest overall score is based on multifactor metric approach that includes 60 scored indicators of environmental risk, management and strategic profit opportunities. This is the final rating that a firm receives from Innovest. Finally, the nations where the databases were developed and the regions they were originally developed for are very different. Deminor Ratings were developed by Deminor, an independent consulting firm whose home market was Belgium, the Netherlands and Luxembourg. The Deminor ratings were and are focused strictly on Europe, while Innovest's EcoValue'21 Rating system was developed in North America and was originally applied to only to American and Canadian firms. Innovest has since expanded its study scope to include Europe, Japan, and many other nation's large and mid-cap companies.

This analysis has shown that rankings with different levels of sophistication from two very different non-financial rating systems with different focuses, methodologies, and geographic backgrounds support each other in overlapping/analogous areas. One implication of this is that environmental information disclosure is a valuable proxy for predicting the strength of environmental performance in general. This is not to undermine the value of Innovest's score that provides significantly more information that may be important to investors. Further, our results are a rough indicator that supports the notion that non-financial rating agencies justifiably and effectively rate what they claim to rate. The results suggest that if these non-financial ratings are further embraced by institutional investors and firms they would provide an important instrument that could be utilized to promote higher standards of global corporate governance, social and environmental standards.

6. Conclusions

In this paper, we have focused on developing a greater understanding of why there has been a recent emergence in agencies that evaluate companies in various areas of non-financial performance. These non-financial rating agencies are in their infancy and have a great potential to become integrated player within the credit rating market. Regardless of their potential, non-financial rating agencies and the role they play, are understudied in the literature of finance, economics and economic geography. This paper contributes by expanding the work on this emerging player and their role in financial markets.

Two main arguments are made in this paper. First, that institutional investors, and pension funds in particular, have been the key driving force, which created a market to allow for the emergence of non-financial rating agencies. This argument was supported by the identification of a number of key factors compelling institutional investors to be increasingly concerned with long-term firm performance and investment risk minimization. The most significant of these factors is the recent lost ability of institutional investors to divest from under-performing firms. Without the ability to get rid of shares in laggard firms, institutional investors must look for alternative ways to protect their investments.

The second argument made in this paper was that the ratings provided by these non-financial rating agencies are, in fact, rating what they claim to rate effectively. This argument was defended by the findings of a quantitative bivariate analysis that determined that the results of two databases support each other in analogous areas. This is particularly noteworthy as the ratings are very different in their levels of sophistication, and are from two very different non-financial rating systems with different focuses, methodologies, and geographic backgrounds. This is a rough indicator that supports the notion that non-financial rating agencies justifiably and effectively rate what they claim to rate.

One major implication that we draw from our findings is that institutional investors are becoming increasingly sensitive to the intangible risks that effect long-term firm value. This is particularly evident following the recent TMT economic bubble burst of the late 1990s and economically devastating corporate governance scandals of the early 2000s. We contend that these intangible and non-financial risks that have caused institutional investors to become more sensitive will only continue to expand in importance within the financial market. Thus, the market for and use of non-financial rating services will grow significantly in the future and will continue to catch the interest of greater numbers of investment managers. This is a transition away from the use of non-financial performance indicators solely by investment groups who are concerned about making “ethical” investments (Religious investment groups, etc) and towards a diversified customer base who are interested in lowering risk and adding value to their shareholdings. If the market continues to grow in this fashion, it is easy to foresee a time when some of these non-financial rating agencies will be assimilated by the financial

rating giants of Moody's, Standard & Poors, and Fitch. When this occurs, the credit rating agencies and the economic gatekeeping powers that they hold will effectively be enforcing non-financial performance standards. This will make non-financial performance critical in importance to investors and businesses alike. This enlarging of the types of metrics used to evaluate corporate performance would, in fact, be placing demands on firms to disclose more information and perform at higher standards. Ultimately acting to eliminate an information inefficiency that currently exists in the financial marketplace. The result would be the promotion of a more effective and efficient capital market.

Finally, we conclude that non-financial ratings are an instrument that currently is increasing global corporate, social and environmental standards via their use by institutional investors. The results of our bivariate analysis indicate that this is possible as the databases rate what they promise to rate (specific non-financial performance areas). We know that pension funds and institutional investors are in fact using non-financial rating data, as all the non-financial firm executives who were interviewed listed institutional investors as their primary and major client. This supports the argument of Hoffman (1996) and Rondenelli (1996) that when institutional investors utilize non-financial ratings, they pressure firms to adhere to global standards, regardless of nationality or industry. This upholds the thesis that global standards are being increased, with rating agencies as a critical tool, acting as a lens to aid investors in identifying investment risk, and then being utilized as a weapon to engage under-performing firms. Our findings support the argument that non-financial corporate ratings are a valuable resource and will increasingly in the future, help promote global standards, lower investment risk and help protect long-term firm value.

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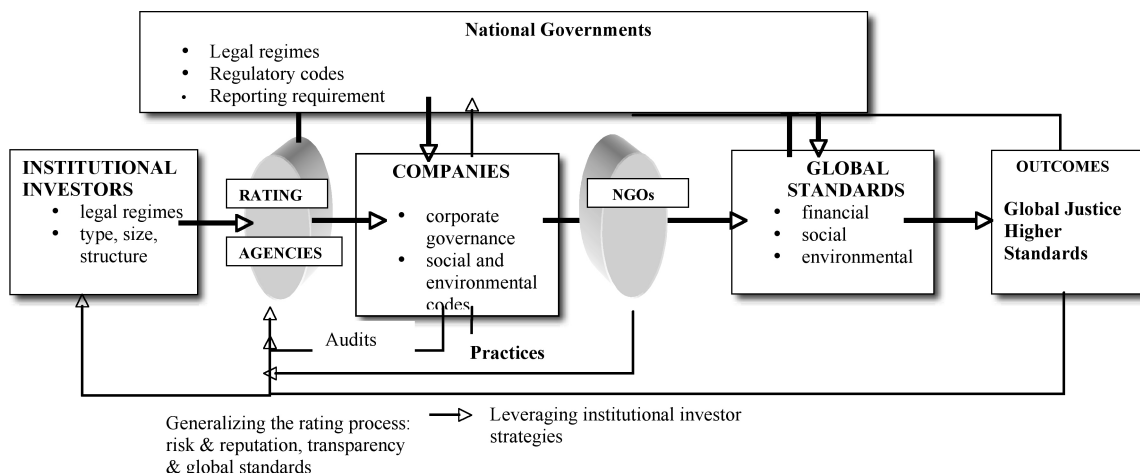
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Figure 1: Global Institutional Investors Value Chain



Source: Hebb and Wójcik 2004

Table 1: Number of Firms by Nation and Industry

Firms by Nation		Firms by industry	
United Kingdom	84	Financials	75
France	40	Consumer Goods	50
Germany	30	Industrials	35
Italy	22	Consumer Services	31
Netherlands	18	Basic Materials	22
Sweden	18	Telecommunications	19
Switzerland	18	Health Care	17
Spain	13	Utilities	16
Belgium	9	Oil & Gas	12
Denmark	5	Technology	5
Finland	5		
Ireland	5		
Norway	5		
Portugal	4		
Greece	3		
Austria	2		
Luxembourg	1		

Table 2: Score Relationship Averages

Summary	Number of firms in class	Mean Deminor Environmental information Score	Median Deminor Environmental information Score
AAA (6)	57	8.60	8.75
AA (5)	52	8.37	8.75
A (4)	51	7.57	7.5
BBB (3)	47	6.84	7.5
BB (2)	37	6.08	7.5
B (1)	19	3.95	5
CCC (0)	18	2.22	1.25

Figure 2: Score Relationship Average – By Mean

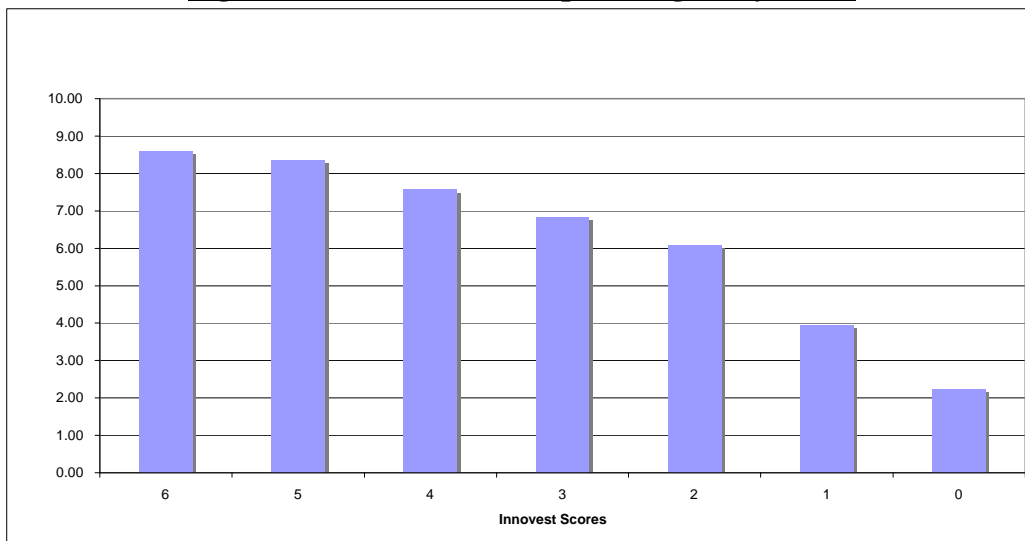


Figure 3: Score Relationship Average – By Median

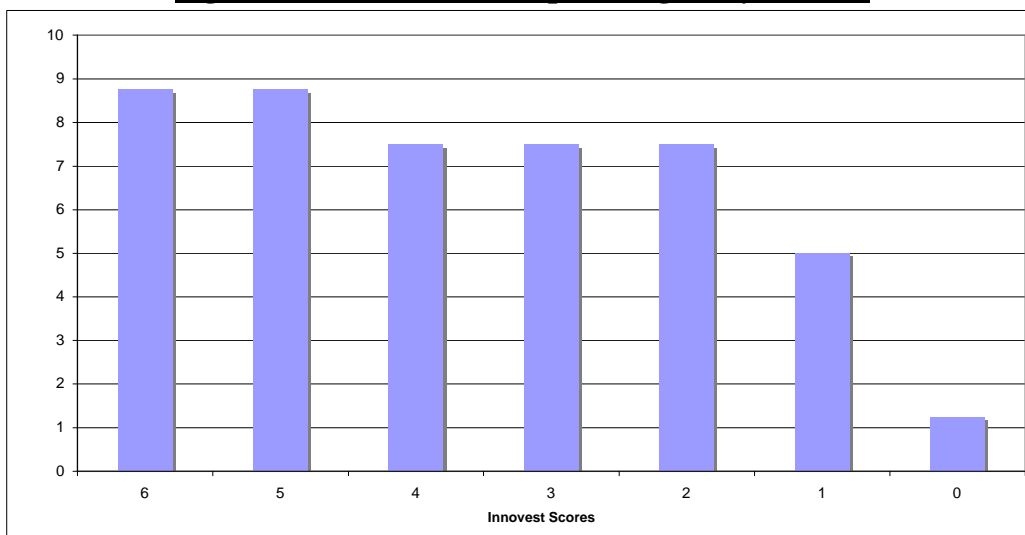


Figure 4: Score Distribution by Nation

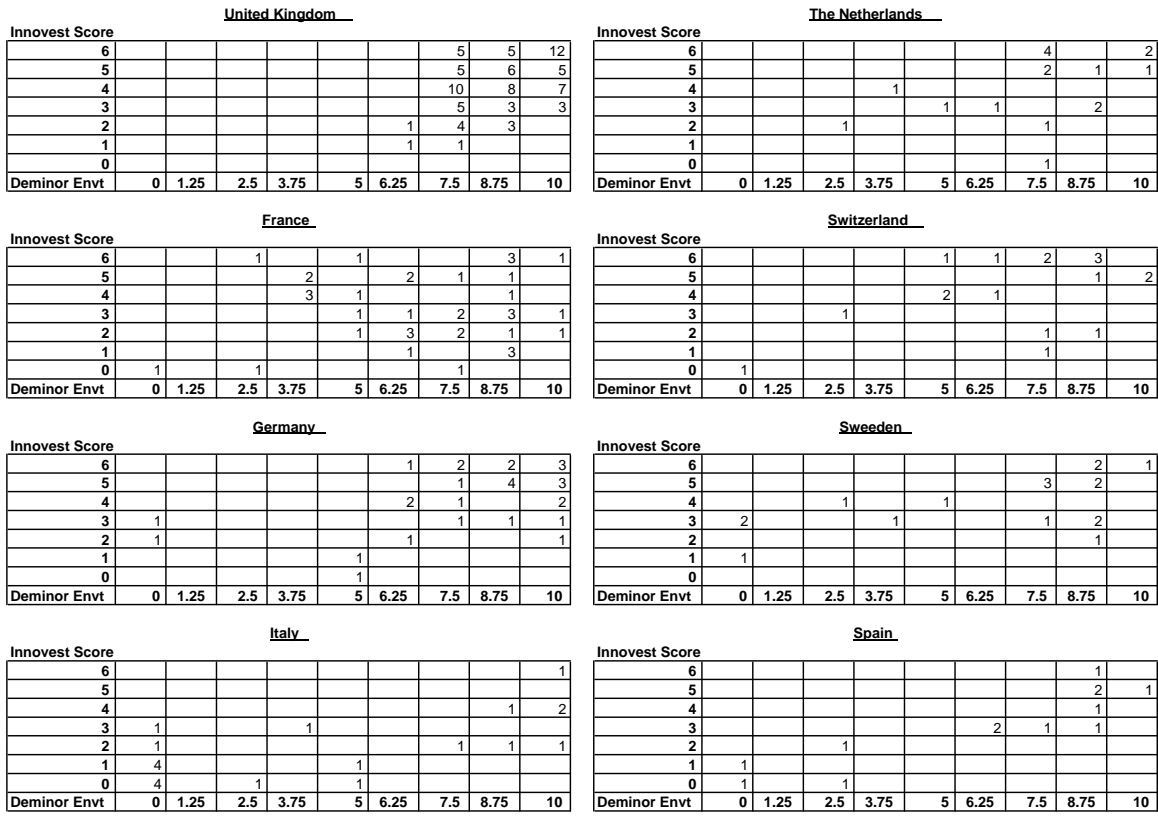


Figure 5: Score Distribution by Industry

Financials

Innovest Score	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10
6					1	4	5	3	
5						5	5	1	
4	1		1		3	6	3	1	
3	4		1			7			
2	3				1	1	3		
1	5		1		2		1		
0	4		2		1				
Deminor Evt	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10

Telecommunications

Innovest Score	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10
6									
5							1		
4						1	2	1	
3	1							4	
2			1		2			1	
1					1				
0			1				2		
Deminor Evt	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10

Consumer Goods

Innovest Score	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10
6					1		2	3	7
5				1		1	4	3	5
4							2	2	
3				1	1		1	5	3
2						1	2	2	
1								1	
0	1		1						
Deminor Evt	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10

Health Care

Innovest Score	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10
6							1	1	1
5								2	2
4				1				2	
3									1
2	1						1	1	
1					1			1	
0	1								
Deminor Evt	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10

Industrials

Innovest Score	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10
6						1	2	3	
5						1	1	2	1
4				2	1	1		1	4
3				1	1	1		2	
2			1			1	1	2	
1	1					1			
0	2								
Deminor Evt	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10

Utilities

Innovest Score	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10
6								3	1
5					1			1	1
4									1
3						1		1	
2					1			1	2
1									
0	1				1				
Deminor Evt	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10

Consumer Services

Innovest Score	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10
6			1		1		4	1	1
5							2	1	1
4						1	3	1	
3			1			1	3		1
2			4		1		1		1
1									
0					1				
Deminor Evt	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10

Oil & Gas

Innovest Score	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10
6									4
5								3	1
4								2	2
3									
2									
1									
0									
Deminor Evt	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10

Basic Materials

Innovest Score	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10
6									4
5				1			1	2	2
4								1	4
3						1		2	1
2							1	1	
1							1		
0									
Deminor Evt	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10

Technology

Innovest Score	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10
6									2
5									
4				1			1		
3									
2						1			
1									
0									
Deminor Evt	0	1.3	2.5	3.8	5	6.3	7.5	8.8	10