Dueling Conflicts: Does Empowering Shareholders Always Increase Value? A Skeptical Perspective

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Corporate governance reformers advocating “shareholder democracy” seek to reform proxy voting rules and other governance practices in the interests of improving shareholder control over companies and lessening the agency problem between corporate management and stockholders. This view, however, ignores the conflict that exists between the institutional investors who manage large investments in corporate stock and their principals (e.g., pension holders who are the ultimate owners of the investments managed by pension funds).

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The experience thus far with corporate governance ratings – which have empowered institutional investors in their relationships with corporate managers – suggests that there is a real risk that governance reform could backfire in its effects on firm performance. Without appropriate regulatory interventions (which we explore in our paper, “Conflicts of Interest, Low-Quality Ratings, and Meaningful Reform of Credit and Corporate Governance Ratings,” available online at http://economics21.org) the perverse incentives that allow entrenched credit rating agencies and corporate governance rating agencies to dominate their respective industries will persist. Because of the market power in existing industry alliances, competitive pressures alone will not be sufficient to overturn these bad equilibria.

We first show why entrenched corporate governance rating agencies that earn large fees for providing low-quality ratings are able to take advantage of the fact that the users of ratings (institutional investors) are conflicted. Institutional investors investing on behalf of their clients face imperfect discipline from clients for failing to buy the most useful governance ratings, and may have reasons for preferring low-quality ratings.

Why would institutional investors demand low-quality corporate governance ratings? Institutional investors enjoy private benefits from doing so, which accrue to them rather than to their clients, the ultimate investors. Those private benefits 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 benefits that institutional investors gain at the expense of stockholders through their alliances with rating agencies.

When institutional investors are more concerned about these private gains that they are about the returns earned by their clients, they will form mutually advantageous implicit alliances with established corporate governance rating firms that pursue rent-seeking strategies and produce noisy (low-quality) governance ratings. Those alliances will undermine competition among governance rating agencies and give artificial market power to dominant rent-seeking rating agencies that produce low-quality ratings, effectively protecting those rating agencies from competition that they would otherwise face from new entrants with better governance rating models.

Given their protected status in such alliances, governance rating agencies will, in turn, be able to exact more rents from the firms they rate (e.g., in the form of requiring those firms to pay for superfluous consulting services about proper corporate governance practices). They also may use their market power to influence decision making at the behest of institutional investors (e.g., by encouraging corporations to meet the demands of institutional investors that are not value maximizing for stockholders; this is a particular concern in the case of pension funds that represent workers).

The results of this “bad equilibrium” are low-quality corporate governance ratings, rent extraction through rating agency “shakedowns” of public firms, reduced market discipline on public firms’ performance, and reduced market discipline on the behavior of institutional investors. This equilibrium serves the interests of institutional investors and governance rating agencies at the expense of ultimate investors.

Our research, therefore, suggests reasons for concern about reform enacted in the name of “shareholder activism” that is merely designed to bolster the position of institutional investors. For the market to reward high-quality ratings, the demand side of the market must care about ratings quality. Otherwise, competition will be muted and low-quality ratings will be tolerated or encouraged. In that case, conflicts of interest lead institutional investors to demand corporate governance ratings that benefit themselves at the expense of ultimate investors, which can sustain dominant but low-quality rating agencies and insulate them from competition from new entrants producing better ratings.