Corporate Governance Rating (CGR)—A More Efficient Approach to Corporate Monitoring[1]

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1. Introduction

The term "corporate governance," which has become widely used in corporate management discussions, defies a simple definition. The concept of governance covers a broad range of fields from economics and management to law and accounting, and thus varies depending on the particular focus. Yet despite differences in context, a common theme running throughout these disciplines is that good governance is indispensable to good companies.

Following the collapse of the bubble economy, Japanese companies have performed dismally, while a series of improprieties has rocked the foundations of many. With the lack of management discipline brought into sharp relief, the lack of governance has is regarded as a major contributor to the present state of business affairs. From the late 1990s, various attempts have been made to address this problem, including the structural reform of management for companies to autonomously achieve good governance. Measures include the introduction of executive officers and independent outside directors (Figure 1).

But given the limited effect of such autonomous measures, good governance ultimately depends on the external monitoring of management. Indeed, information disclosure is important for governance precisely because it strengthens monitoring functions. However, despite disclosure improvements, external monitoring is still riddled with problems such as the considerable expense of learning how to gather and analyze massive amounts of information. We propose the corporate governance rating (CGR) approach as a way to reduce the cost of evaluating governance. While not yet ready for practical implementation, it promises to be an important new approach to improving the efficiency of corporate monitoring.

Since April 2001, NLI Research Institute has collaborated with the Waseda University Institute of Financial Studies[2] to research and develop the CGR approach.[3] This paper

[1] This paper is part of a joint research project on corporate governance rating between NLI Research Institute and the Waseda University Institute of Financial Studies (headed by Prof. Hideaki Miyajima).
[2] Waseda University Institute of Financial Studies web site: http://www.waseda.ac.jp/finance/index.html.

introduces the development background, and proposes the CGR approach as a means of improving monitoring efficiency.

Figure 1 Reform of the Board of Directors

Measures to Strengthen Board Functions

Response	No. of companies	Composition (%)
A. Already implemented	785	**59.9**
B. Not implemented	520	**39.7**
No response	5	**0.4**
Total	1,310	**100.0**

Specific Measures Already Implemented

Response	No. of companies	Composition (%)
A. Nominate outside board members	261	**33.2**
B. Reduce number of board members	363	**46.2**
C. Introduce executive officers	279	**35.5**
D. Revise compensation system	131	**16.7**
E. Other	219	**27.9**

Source: Tokyo Stock Exchange (2000), *Survey of Corporate Governance*.

2. Growing Expectations Toward Institutional Investors

The difficulty in defining governance stems from the diversity of values and measures regarding what constitutes "good governance." We must be aware that the values we adopt to assess governance will largely determine the nature of our ratings.

The CGR approach adopts the perspective of shareholders, and assumes that the primary users will be institutional investors. Behind this assumption are the growing expectations of the market regarding the role of institutional investors in governance. Several factors explain this focus on institutional investors.

First is the destruction of the main bank myth. Prior to the collapse of the asset bubble, the market believed that main banks effectively monitored the condition of their customers. Banks were often seen extending loans and dispatching directors to faltering businesses, and leading restructuring efforts at companies if failure was imminent.

[3] Governance ratings are also being developed by S&P and the Japan Corporate Governance Index Research Committee (headed by Prof. Takaaki Wakasugi of the University of Tokyo). However, unlike our quantitative approach, these approaches are qualitative.

Such activity by main banks seems to suggest that they may have had the ability to monitor companies. However, after the bubble collapsed, banks themselves were in precarious condition—inappropriate loans and scandals surfaced, nonperforming loans swelled to massive proportions, and excessive shareholdings became a detriment. Moreover, delays in addressing these problems only aggravated their problems. Banks came to be seen as the source of the governance problem, and monitoring by main banks was no longer regarded as reliable. Thus the market turned elsewhere for monitoring functions.

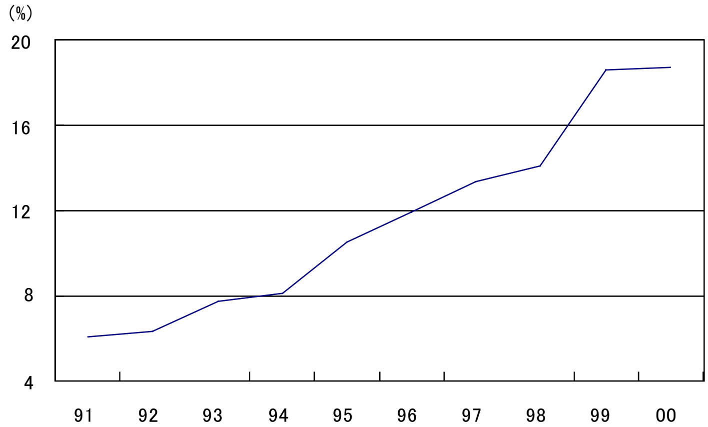
Second is the growing awareness of fiduciary duty mainly among pension fund managers. As experts in asset management, investment managers have the duty of care and loyalty to pursue the best interests of their customers. With regard to stock investment, this involves not only making buy and sell decisions, but exercising their *shareholders' voice* in corporate management. In the past, this voice was seldom exercised, and managers usually registered dissatisfaction in a company's management simply by selling off shareholdings. However, from the mid 1980s in the U.S., the view took hold that the shareholders' voice should not be summarily neglected, and shareholder voting in particular became a part of fiduciary duty.[4] This approach has been spreading among pension funds in Japan as well.

Third, governance is becoming globalized. The growing expectation toward institutional investors is not peculiar to Japan. In the U.S. and U.K., institutional investors already play the main role in governance, and this trend is spreading rapidly among other industrialized countries. Moreover, the concept of good governance is also converging globally. In 1999, the OECD formulated and released governance principles that emphasize shareholders' interests.[5] Proposed as minimum standards, the principles cannot be enforced but have considerable influence nonetheless. Meanwhile, due to the international investment diversification of foreign pension funds and capital participation by foreign companies, foreign shareholdings in Japan have grown rapidly, spurring the penetration of Anglo-American style governance (Figure 2). We predict that the role of institutional investors will continue to expand in the future.

[4] This trend began to gain momentum in the mid 1980s. In a formal opinion letter known as the *Avon Letter* of 1988, the Department of Labor set out its policy that the voting of proxies was a part of fiduciary duty. Furthermore, in 1994, the *Sherman Letter* applied this view to overseas stock investments. These interpretations are based on ERISA (Employee Retirement Income Act of 1974), and do not directly apply to investors other than pension funds. However, this understanding of fiduciary duty is widespread among institutional investors in the U.S.

[5] The governance principles are aimed at invigorating international capital markets. The broad ranging contents emphasize the protection of shareholder rights and equality, the priority of shareholder value (while also giving consideration to other interested parties), enhancement of disclosure, and responsibilities of the board of directors.

Figure 2　Growth of Foreign Shareholdings in Japan



Note: Shows foreign ownership ratio at market valuation at end of fiscal year.
Source: Tokyo Stock Exchange, *Shareownership Survey*.

3. Shareholder Voting—Present Status and Problems

The focus of management monitoring by institutional investors is on voting rights. While the shareholders' voice can be exercised by other means such as shareholder proposals and class action suits, these courses of action require expertise in areas other than stock investment, and also incur considerable cost. In contrast, voting represents a direct channel for shareholders to communicate with management, and does not require any special skills.

Pension fund managers have also focused on voting as part of their aggressive stance on governance in recent years. In particular, public pension funds, whose massive shareholdings give them considerable influence, have encouraged investment managers to aggressively use their votes to influence corporate management. The Pension Fund Association, a leader in improving governance since 1998, released its *Practical Guidelines for Shareholder Voting* in October 2001.[6] The guidelines propose formulating screening criteria and other efficient ways to exercise shareholder rights. As will be examined below, this is because voting procedures become complex due to the large number of companies involved. Moreover, public pension investment organizations such as the PFA, Government Pension Investment Fund and Pension Fund Association for Local Government Officials have collaborated to form a deliberation council. In addition to asset management methods, the council is also examining governance issues. Thus institutional shareholders are actively seeking to use their shareholder's voice more efficiently and effectively.

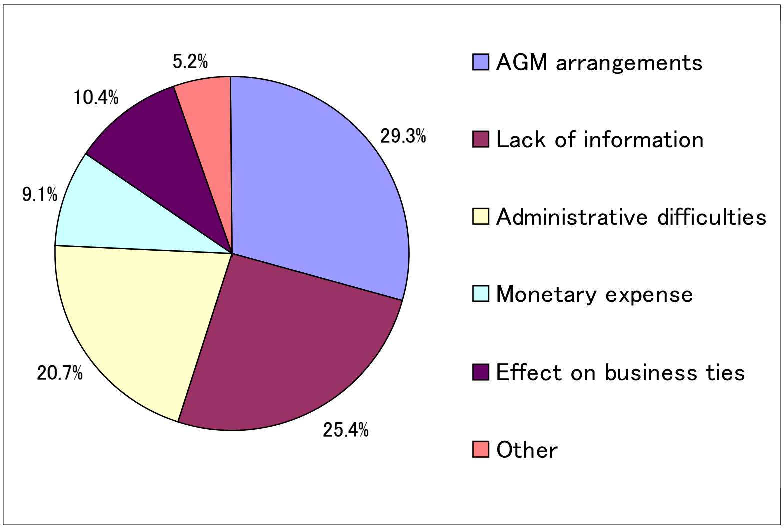
Let us now examine the present status of shareholder voting by institutional investors.

[6] The PFA also released *Corporate Governance of Pension Funds* in June 1998, and *Fiduciary Duty*

According to a July 2001 QUICK survey, 38% of institutional investors in that year voted against some or all company proposals at annual general meetings (including withheld votes), which amounts to a 10 percentage-point increase from the previous year.[7] Moreover, as many as 70% of investment managers have a voting policy. The survey was taken only four years after domestic institutional investors followed the lead of foreign investors in exercising their shareholders' voice. From these results, it would be no overstatement to say that pension funds have contributed greatly to the startling changes during this brief period.[8]

Nonetheless, conditions are still not amenable to voting. In July 2001, the Ministry of Finance Policy Research Institute released a survey on obstacles to shareholder voting (Figure 3). According to the survey, the main obstacles are the concentration of AGMs on certain dates, procedural issues, lack of information to make decisions on proposals, and heavy administrative burdens due to the short processing period for proposals. In short, the cost of information gathering, decision-making, and administrative procedures poses a major obstacle to voting, and needs to be addressed.

Figure 3 Obstacles to Shareholder Voting



Source: Policy Research Institute, Ministry of Finance, *Survey Report of Institutional Investors in Japan Regarding Corporate Governance (2001)*.

We next examine the content of the voting policy guidelines that 70% of institutional investors were found to have. In many cases, the guidelines call for a vote decision prior to

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Handbook (Investment Manager's Edition) in April 2000.

[7] The QUICK survey was conducted July 3-5, 2001, and covered investment trusts, trust banks, and insurance companies.

[8] At shareholders' meetings in June 1998, then Mitsui Trust Bank withheld its votes (the equivalent of voting against) on proposals of companies involved in securities scandals or *sokaiya* scandals.

the actual vote for typical proposals presented at AGMs. The purpose of formulating guidelines is to set the voting policy before the vote, and thereby remove arbitrariness and ensure consistency in voting criteria, as well as to improve the efficiency of decision making.

However, we question whether the guidelines actually make the voting process more efficient. First, since the shareholders' voice must be taken seriously in light of its potential impact on future management decisions, shareholders need a more appropriate decision making process. Second, since institutional investors often invest in over 1,000 companies, the cost of applying the guidelines to each proposal is enormous. The trustor, who must bear this cost, must keep costs below the expected value of benefits. And even for proposals with the same content, it would be inappropriate to make summary decisions without obtaining and analyzing background factors.

Considering the complexities of corporate management, prior decision making is tenable only in limited cases where proposals clearly run counter to (or coincide with) shareholders' interests. The logic of voting guidelines dictates that guidelines should either indicate a general direction or specify detailed instructions. However, the former case would require other supplementary provisions, while the latter case would incur enormous cost.[9]

The shareholders' voice is not limited to voting on proposals. Since voting is only one facet, and since proposals do not necessarily address important shareholders' concerns, it would be inefficient to examine all proposals in detail. As we explain below, to generate a high-quality shareholders' voice at reasonable cost, what is needed is a process for screening companies and conducting dialogues with management.

4. CGR as a Solution

Let us first summarize the obstacles to exercising voting rights. The first obstacle is the high cost of gathering and analyzing information. Institutional investors are being called on to perform monitoring expertly and generate a high-quality shareholders' voice. Since institutional investors normally invest in hundreds of companies, meeting these expectations is costly, and the cost is proportional to both the quality of shareholders' voice and the number of investments. If voice quality is not to be compromised, the only way to contain costs is to limit the number of companies being monitored.

[9] In the U.S., Institutional Shareholder Services (ISS) and the Investor Responsibility Research Center (IRRC) offer proxy voting services and consulting services for guideline formulation. However, few investment managers in Japan use investment advisory services.

Second, institutional investors who spend money generating their shareholders' voice may not necessarily reap corresponding benefits. Research indicates that the costs of exercising the shareholders' voice are not necessarily recovered in the form of higher share prices. In addition, there is the free rider problem. The shareholdings of institutional investors, while large, amount to only several percent of outstanding shares. Even if their shareholders' voice causes share prices to rise, gains are distributed among all other shareholders, including those who took no action. Thus since significant benefits cannot be expected, institutional investors need to limit the amount of money spent exercising their shareholders' voice.

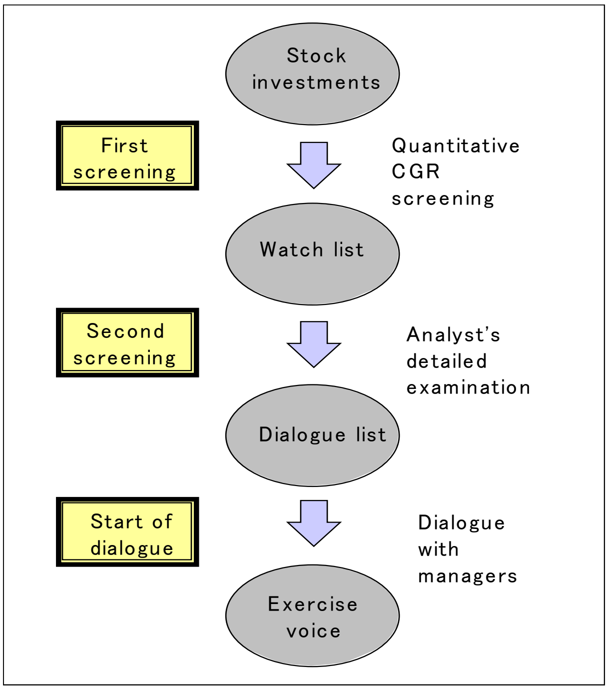
Third, in assessing the governance situation, there are difficulties in ensuring consistency of criteria and removing arbitrariness. Ensuring the consistency of criteria becomes more difficult as the number of issues increases. Removing arbitrariness requires a decision making process that focuses on specific management factors, adopts a particular perspective for governance assessment, and then makes informed voting decisions. At present, the preferred perspective for the shareholders' voice is that of management monitoring, and for this CGR is useful.

To achieve an efficient and effective shareholders' voice, we propose the following flow model (Figure 4). First, companies are screened using quantitative indicators. In this first screening, the screening sample can be limited based on cost considerations. Quantitative indicators should focus on data related to governance such as the CGR. The first screening generates a watch list, but at this point it would be premature to regard all companies on the list as problem companies. Due to the limitations of quantitative indicators, companies on the watch list then need to be scrutinized by analysts. In this second screening, governance problems are identified and companies that must be approached for dialogue are singled out. Analysts conduct dialogues based on these governance results. If explicit differences of opinion arise with management, shareholders can express their opinion through voting or other means.

This dialogue process is necessary because institutional investors are not management experts. As long as disparities in information and competence exist between management and investors, the coercive use of shareholders' voice is not likely to have a positive effect on corporate management. Indeed, a more realistic approach would be to deepen the relationship with management through constructive dialogue.

We believe that the process outlined here will enable institutional investors to exercise their shareholders' voice in an efficient and effective manner. CGR, which would be used in the first stage, is designed as a tool to enhance the shareholders' voice.

Figure 4 Flow Model for Institutional Investors



Source: NLI Research Institute

5. Development of the CGR Approach

The CGR approach, which is still in the trial phase of development, is based on the methodology of economics. Specifically, the development process involves formulating hypotheses from theoretical models and empirical research, performing an empirical analysis using the tools of economic analysis, and using the results to explain governance mechanisms and construct a quantitative model. The advantages of the model are its low cost, lack of arbitrariness, and consistency.

In formulating the CGR, which can be thought of as the corporate governance equivalent of credit ratings, we need to specify what constitutes a "good company." Since CGR is designed as a tool for institutional investors to exercise their shareholders' voice, the definition of a good company must contain the shareholders' perspective. And since the general aim of shareholders is to maximize shareholder value, the appropriate assessment measures should focus on management efficiency, which increases shareholder value. Thus we define good companies as those having good management performance.[10] Specifically, we assess

[10] Our aim is to construct a more diverse assessment model. We are also developing an assessment model that focuses on another factor of efficient management—mechanisms to return corporate management to good condition.

companies from the perspective of productivity, market valuation, and management stability.

The next issue is to analyze the relationship between "good company" and "good governance." The direct observation of internal governance at companies is difficult at best, since it relies on fragmented bits of information. Thus we focus on objective and observable corporate characteristics that are closely related to governance such as shareholder composition, capital composition, employee characteristics, and board structure. These factors, which we call governance characteristics, can affect management in a variety of ways. For example, if there is an increase in foreign investors—who are known to have an aggressive voice—management may feel threatened enough to shift to a more conciliatory stance. Or if executives own a substantial number of shares, management's stance will naturally lean toward creating shareholder value.

Particularly important are the differences in governance characteristics between companies. Our research suggests several possible models for the mechanism by which such differences affect corporate behavior, which in turn generates disparities in management efficiency. While good governance is difficult to observe directly, we can grasp its elements through their contribution to management efficiency. We are working to elaborate on the mechanisms based on empirical research.

Figure 5 presents a schematic diagram of the CGR approach. Governance characteristics and management performance are linked together by the assessment model, which quantitatively expresses the contribution of governance characteristics to management performance. This assessment model is used to calculate CGR based on the governance characteristics.

To better grasp how actual assessments would look, we conducted a trial simulation of CGR. We constructed an assessment model for shares listed on the First Section of the Tokyo Stock Exchange as of the end of March 2000 (excluding banks, securities firms, and insurance companies), and calculated ratings.[11] Because the IT bubble was in full swing in March 2000, the top 60 issues contain many new companies, while the bottom 60 issues contain many traditional companies. Since the model expresses the probability of good governance, the important point is not the specific ranking of companies, but whether they belong to the top or bottom ranking. Overall, the empirical research suggests that companies in the top ranking have a high probability of good governance, and vice versa. However, we must note that we found a few companies in the top half that clearly do not belong.

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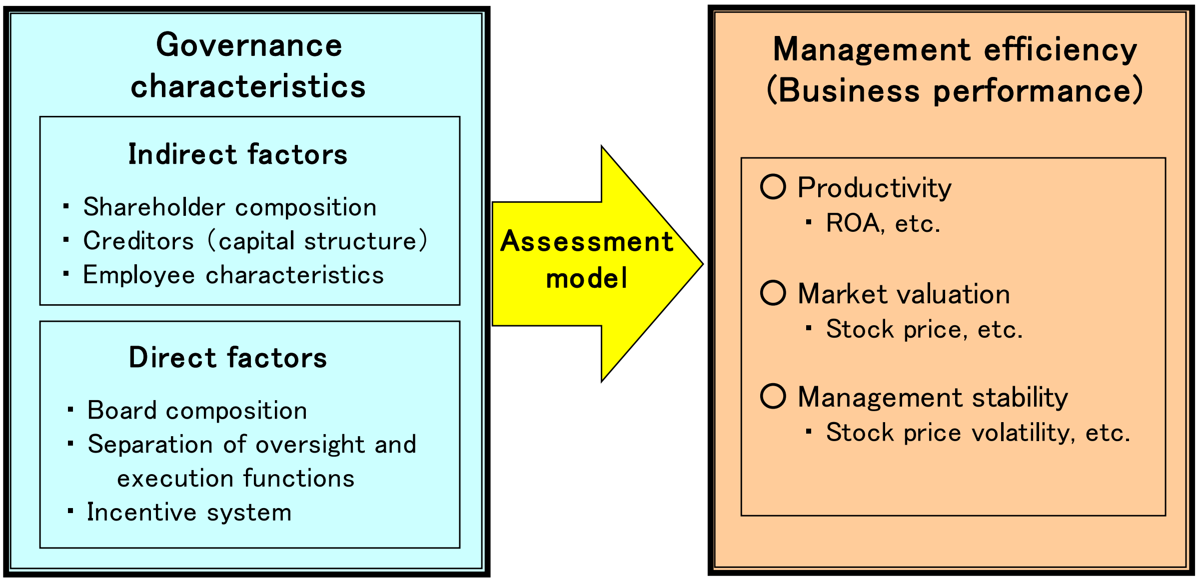
[11] The assessment model was constructed using data for the ten periods from fiscal 1990 to 1999.

Figure 5　Composition of CGR



Source: NLI Research Institute

6.　Conclusion

Five years have passed since Japan's institutional investors first began exercising their shareholders' voice. Meanwhile, the databases, tools, and other components of the infrastructure supporting the shareholders' voice still need to be developed further. For effective monitoring activity under these conditions, the greatest obstacle is the enormous cost involved in information gathering and decision making. Further development of the infrastructure will help reduce these costs and improve monitoring efficiency immensely. While development of the CGR has not reached the practical implementation stage, we believe it will become an important part of this infrastructure.