Research projects for 2016-2018

As decided on September 10th, 2015, during the general assembly meeting of the Association FDIR, the researchers of the Chaire FDIR in conjunction with the sponsors have defined five high-priority research projects for the years 2016-2018. These projects are transversal to the main research topics listed in the document of February 2010. These projects are also related to the three priority topics that have been defined in the 2014 general assembly meeting and that deal with corporate governance, engagement, and the opportunities and risks in long-term investments. The precise research projects are presented below.

1. ***How governance affects firm value – Coordinated by Simone Sepe (IDEI-TSE)***

Over the past 20 years, empirical studies have gained tremendous importance in corporate governance discussions. These studies have largely supported the view that governance arrangements protecting directors and managers from removal increase the room for moral hazard by insulating insiders from beneficial disciplinary forces, reducing shareholder and firm value. On this view, "good" (i.e., value-increasing) corporate governance is largely understood today —in the legal academy as well as the real corporate world, both at the national and international level— as being about stronger shareholder rights. Instead, managerial protection from shareholder removal, commonly referred to as "entrenchment", epitomizes "bad" (i.e., value-decreasing) corporate governance.

This project plans to study this view in more depth by gathering new empirical evidence that enables to evaluate the results of prior studies and develop a novel theoretical account of what matters in corporate governance. We are gathering a unique dataset that covers thirty years of corporate governance in the US, from 1978 to 2008, and that enables to identify governance arrangements that grant directors and managers protection from removal with the agreement of shareholders (i.e., "bilateral protection arrangements") —such as staggered boards and supermajority requirements to modify the charter. The idea is then to test whether these bilateral arrangements increase firm value. The data also enables to identify protective arrangements that do not require shareholder approval (i.e., "unilateral protection arrangements") —such as poison pills and golden parachutes—. The idea would then be to test whether these arrangements reduce firm value.

The logic underlying these tests is that unilateral protection arrangements are indicative of bad governance because their "dictatorial" nature makes it more likely that moral hazard motivates their adoption, to the detriment of shareholders. On the other hand, bilateral protection arrangements appear as consistent with best governance practices because it may be in the shareholders' own interest to limit their rights, if such limits involve a beneficial bilateral commitment by boards and shareholders to corporate stability and longer-term investment strategies.

2. *Institutional Investors as Active Owner – Coordinated by Sébastien Pouget (IDEI-TSE)*

The objective of this project is to empirically study why and how institutional investors, asset owners and managers, vote during shareholder meetings. Separation between ownership and control is one of the fundamental characteristics of modern companies (Berle and Means, 1932). This separation opens the room for potential conflicts of interests between investors and corporate executives (Jensen and Meckling, 1976): managers may not always favor the strategies that are best for investors.

To mitigate the negative effects of these conflicts, investors can induce executives to follow their guidance by engaging companies, i.e., discussing with executive managers and board members, filing shareholder proposals and obviously voting during shareholder general meetings.

A priori, managers know best what is the right course of business for firms. But companies may generate externalities on society, and investors may care more about these externalities than managers. Two basic arguments then warrant investors to be active in engagement. The first argument rests on the universal owner logic (Mattison, Trevitt and Van Ast, 2011). Large institutional investors own a significant share in virtually all listed companies and have a long horizon. The situation is very different for corporate executives who, for the sake of incentives, in general own concentrated stakes in their companies. These different holding profiles generate conflicts of interests: executives are not going to internalize the effects that their companies have on the payoffs and value of other companies. For example, they may not take into account the negative economic impact that the polluting activities of their firm have on other companies. On the other hand, institutional investors that own very diversified portfolios would like the firm to take into account these negative effects to avoid deteriorating the overall value of their portfolios.

A second argument that calls for institutional investors to be active in engagement is related to the delegated philanthropy logic (Benabou and Tirole, 2010). Institutional investors such as pension funds, sovereign funds and mutual funds invest on behalf of clients who may have preferences regarding externalities that differ from the ones of executive managers. As a result, investors might want to promote their values and preferences towards executives so that they choose the appropriate course of action. One can for example think that the level of global risk induced by a firm (related to climate change, nuclear activities…) might not be valued in the same manner by managers and by the investors who represent clients. Investors may thus want to communicate corporate executives what is their preferred level of precaution. This can only be achieved via engagement.

This project plans to collect data on voting policies of various institutional investors in order to study how their engagement/voting policy is implemented in practice. Recent empirical evidence suggests that universal owners do have an impact on the firms in their portfolios (Dimson, Karakas, and Li, 2014, Azar, Schmalz, and Tecu, 2014, Kempf, Manconi, and Spalt, 2014, and He and Huang, 2014). However, the precise mechanism through which they exercise their influence has not yet been empirically identified. Our idea is thus to test whether institutional investors are more actively engaging firm in areas that are subject to externalities, and to test whether various investors have different preferences over these issues.

3. *ESG factors and the performance of small and mid cap companies – Coordinated by Sébastien Pouget (IDEI-TSE)*

This project proposes an empirical investigation of small and mid cap companies' strategic behavior regarding Environmental, Social and Governance (ESG) factors, and aims at testing how it affects their risk-return profile on the stock market. There are several reasons to believe that small and mid cap companies are very different from publicly traded large caps in terms of business strategies, in particular regarding ESG factors.

First, small and mid cap companies are more likely than larger firms to be owned and/or operated by their founder or by the founder's family members (Adams, Almeida, and Ferreira, 2005, and Fahlenbrach (2005)). This provides them with a long-term view and in turn a commitment power that can have valuable business consequences. For example, commitment power of executives and shareholders might enable small and mid cap companies to implement innovative human resources strategies, i.e. providing insurance to their employees in case of downturns or failures in order to increase their level of implication or creativity (Sraer and Thesmar, 2007). Also, a long-term horizon might enable the firm to develop innovative environmental strategies that necessitate efforts in the short run but are beneficial in the long run (Benabou and Tirole, 2010).

Second, even small and mid cap companies that are not owned and managed by founders or their families could enjoy a high level of economic performance: the relative illiquidity of small and mid cap equity markets provides stronger incentives for shareholders to monitor and engage with management (Maug, 1998).

This project aims at understanding what characteristics of small and mid cap companies may offer them the long-term view and commitment necessary to successfully implement innovative ESG strategies, and how these affect their performances. This project will rely on data on corporate governance, corporate behavior, accounting statements, financial ratios, and stock market performance for small and mid cap companies, as well as data on their ESG performance. These data will be obtained from public sources, for example Point.Risk of Altares, and from proprietary sources (after having signed appropriate confidentiality contracts).

4. *The measurement of ESG performance and risk: qualitative ratings or quantitative metrics? – Coordinated by Patricia Crifo (Polytechnique)*

In the CSR-financial performance literature, many scholars still consider that much research needs to be conducted before this relationship can be fully understood (see e.g. Delmas et al., 2011; Griffin and Mahon, 1997; Rowley and Berman, 2000; Surroca et al., 2010). From this perspective, this project proposes to examine how different combinations of Corporate Social Responsibility (CSR) dimensions affect corporate economic performance with data on

CSR performance, that is based on quantitative metrics of CSR related management practices rather than qualitative extra-financial evaluation through scores or ratings. As emphasized by Chatterji et al. (2009), extra-financial ratings are rarely evaluated and have been criticized for their own lack of transparency. In this project, the quantitative measures of CSR related management practices that are used offer a novel approach by relying on actual practices implemented by the firms, rather than evaluations (scores or ratings) based on past and/or expected future CSR behaviors. These CSR related practices are measured via the COI survey and the ENDD survey (from INSEE) two large scale databases including more than 10,000 French firms of more than 10 and 500 employees in 2006 and 2011.

The goal of this research is to analyze how different combinations of CSR dimensions affect firm performance measured by corporate profits. In particular we investigate the quality-quantity trade-off in the design of responsible ESG strategies. Preliminary results show that an aggregate measure of CSR, which counts quantitatively the number of practices adopted in terms of environmental, human resources, and customers & suppliers practices, affects positively and significantly firm performance. But on the other hand, the profitability of CSR investments seems to rely on a specific qualitative mix of different CSR dimensions. For instance combining responsible green and customer & supplier strategies improve firm performance more than combining responsible social and customer & supplier strategies. Hence the relationship between CSR and firm profitability is very complex. This first set of results will be further developed to analyze the links between CSR motivations (strategic/altruistic/defensive) and CSR commitment intensity, and their relationship with CSR actual practices. The interest is to determine which type of CSR metrics best correspond to declared versus implemented CSR practices and risks.

5. *Sovereign credit ratings and interest rates – Coordinated by Patricia Crifo (Polytechnique)*

The use of a large number of variables (quantitative and qualitative) as determinants of sovereign credit ratings reflects somehow the ambiguity surrounding the criteria underlying sovereign ratings. The objective of this project is to help better understand variables used in the determination of sovereign credit ratings. Our analysis builds on the previous literature by exploring the use of environmental, social and governance (ESG) factors as explanatory variables. The main question raised (and hypothesis tested) is the following: how much of an impact do ESG quantitative indicators have on sovereign credit ratings and interest rates?
Related to this, our principal challenge is how to quantify government ESG performance. The ESG performance of governments is difficult to assess for at least two reasons. According to many observers, it is often hard to know whether the government should be evaluated as a geographical entity (indicators based on its ESG factors, i.e. forest resources, access to water or CO2 emissions), as a demographic entity (indicators based on results that depend on the public authority's resources and therefore the nation's wealth and development, e.g. illiteracy rate, life expectancy) or as a political institution (this raises the question of how policy is judged based on level of development). In addition, there is no clear definition of the methodology and the value applied to assess the ESG performance of governments. The reality is that rating agencies and investment managers use a wide array of data from different official and recognized sources.

In that regard, in order to offer to the users of ESG analysis a more standardized method to, we will initially implement a Principal Component Analysis (PCA) to identify the number of quantitative criteria to be incorporated in ESG performance. This will also enable us to construct intermediate ESG indexes (including governance index, social index, population and labor status index, land and biodiversity index and environmental index) as well as a global ESG index. Then, we will examine the impact of ESG global index on the price of sovereign risk as well as the joint implementation of the five intermediate ESG indexes measured by the individual score (including governance quality score, social quality score, population and labor status score, land and biodiversity score and environmental pressure score) and interaction terms of the respective ESG indicators. The price of sovereign risk will be tested by using sovereign credit ratings from the two U.S. leading agencies, Standard and Poors, the oldest provider of sovereign ratings since 1961, and Moodys, providing sovereign ratings since 1974. The population of ratings used will be for the period from December 1996 to December 2010. Our analysis will be carried out across 35 advanced economies (AEs) and emerging market economies (EMEs).