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Institutional investors, corporate social responsibility, and stock price performance☆

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ABSTRACT

In 2006, the United Nations Global Compact launched Principles for Responsible Investment (PRI), and the Japanese Ministry of Environment advocated financial mechanisms for environmental protection. We find that institutional ownership in 2005 is positively related to the probability of subsequent improvements in environment ratings for Japanese firms. The result is especially evident for domestic institutional shareholders who signed up for the PRI. These results suggest that soft laws aimed at institutional investors can enhance responsible business practices and that national government initiatives play an effective role. Finally, improved ratings in the environment category do not harm shareholder wealth.

1. Introduction

This paper attempts to investigate the effects of soft law (non-legally binding guidelines) aimed at advancing corporate social performance (CSP) through increased monitoring and advising by institutional investors. Growing public awareness of environmental and social issues, such as climate change and human rights, has led to a heightened demand for financial mechanisms that enhance responsible business practice. Shareholders are the ultimate decision makers in corporations, and their attitude toward responsible behaviors should have a significant effect on CSP. Accordingly, recent corporate governance literature has argued that institutional shareholders effectively improve corporate governance structures (Aggarwal et al., 2011; Demiralp et al., 2011; Hartzell and Starks, 2003; Helwege et al., 2012; Shinozaki et al., 2016). This argument is supported by large institutional investors, such as CalPERS, that have demonstrated a commitment to corporate social responsibility (CSR) by investing in socially responsible companies (Guenster et al., 2011), and has given rise to the notion that institutional investors can be key financial players in promoting responsible business practices in investee companies. Indeed, the United Nations Global Compact officially launched the Principles for Responsible Investment (PRI) in April 2006, requiring institutional investors to introduce social and environmental issues into their ownership policies and decision making (see Appendix). Previous studies, however, do not find clear evidence that institutional ownership improves CSP (Barnea and Rubin, 2010). Little research has been devoted to examining whether soft law effectively influences institutional investors' attitudes and, in turn, investee firms' CSP. We attempt to fill this void and examine whether institutional ownership leads to improvements in CSP following the launch of the PRI. Such an analysis should contribute significantly to the literature on CSP.

Although numerous studies have examined the determinants of CSP (e.g., Barnea and Rubin, 2010; Ioannou and Serafeim, 2012; Henriques and Sadorsky, 1996; Nakamura et al., 2001; Stanwick and Stanwick, 1998; Surroca and Tribo, 2008), it is extremely difficult to address endogeneity problems inherent in this research. For instance, cross-sectional studies of CSP are susceptible to the risk of finding seeming correlations between CSP and a specific variable under investigation due to the existence of unobserved firm characteristics that are associated with both CSP and the variable. Given that the launch of the PRI is an exogenous shock for investee companies, however, we stress that our research can examine the relation between CSP and institutional

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ownership in a setting that suffers less from endogeneity problems.

In a similar vein, our research contributes to the long-held debate on the relation between CSP and corporate financial performance (CFP). Friedman's (1962) pragmatic assertion that "few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible," is frequently cited as the main theoretical argument against CSR (Schaefer, 2008; Teraji, 2009). In contrast, CSR proponents argue that socially responsible activities generate substantial advantages such as goodwill and new market opportunities (Guenster et al., 2011), and firms that ignore CSR destroy long-run shareholder value due to loss of reputation and litigation risk. Although numerous studies have examined the CSP-CFP relation (e.g., Al-Tuwaijri et al., 2004; Fisher-Vanden and Thorburn, 2011; Pava and Krausz, 1996; Ruf et al., 2001), it is difficult to avoid endogeneity and reverse causality concerns, and therefore those studies have not reached a definitive conclusion on the direction of a relation. We view the shift in CSR ratings after the launch of the PRI, an exogenous event for investee firms, as attributable to changes in institutional shareholder preference for CSR activities. By investigating the performance of companies that increased CSP following the PRI, we can reduce endogeneity and reverse causality concerns inherent in analyses of the CSP-CFP relation. We address this issue by examining Japanese companies.

There are several novel characteristics in Japanese data. Firstly, trust banks, a major domestic institutional investor in Japan, offered a CSR-conscious trust scheme around 2006 (e.g., the Emission Rights Trust and CSR-Conscious Receivables Collective Trusts scheme) and engaged in CSR consulting businesses. Those products are likely to serve as an effective channel through which Japanese trust banks foster responsible behaviors of their investee companies. Another important characteristic of Japanese data is that the Ministry of Environment takes measures to advocate the importance of financial mechanisms promoting environmental protection, as well as diffuse the PRI in the same year it was launched (year 2006). The Japanese Government also provided firms with economic incentives (e.g., subsidies) to adopt environment-friendly behaviors. These facts suggest that the Japanese Government pushes forward CSR issues with a specific emphasis on environmental protection, while the PRI covers all aspects of CSR including social engagement, corporate governance, and human rights.[1] Analyzing Japanese data allows us to determine whether national government measures can play an effective role in enhancing firms' responsible behaviors, or if the UN PRI, alone can improve the business practices of companies around the world.

The results of our analysis indicate a positive relationship between institutional ownership in 2005 and the probability of subsequent rating improvements in the environmental protection category. The result is especially evident for ownership by domestic institutional investors who signed up for the PRI in 2006, suggesting that institutional shareholder preference is an important determinant of CSP, and that soft law can improve firms' business practices through increased monitoring and advice by institutional shareholders. Meanwhile, we do not find robust evidence that firms with high foreign ownership tend to experience improvements in environment ratings. A plausible interpretation is that CSR-related business relationships serve as an effective channel through which institutional investors promote responsible behaviors of investee companies. Institutional ownership has no significant effect on the likelihood of improved ratings in the social engagement, corporate governance, or employee relations categories. Overall, the results suggest that national government measures play an effective role in diffusing the PRI and promoting good business practices. Finally, we find no significant excess stock returns for firms that improve their ratings for environmental protection. The PRI and national government measures improve business practices without harming shareholder wealth. This result is also consistent with previous findings for the performance of socially responsible investments (Bauer et al., 2005, 2006; Galema et al., 2008; Renneboog et al., 2008).

We contribute to the literature by providing novel evidence that soft law can improve responsible corporate activities through monitoring and advice by institutional investors. To the best of our knowledge, this is the first research to show that institutional ownership positively affects CSP. Although many previous studies have examined the determinants of CSP, we show the evidence in a research setting less subject to endogeneity and reverse causality concerns. We also contribute to long-held debates on the CSP-CFP relation with analyses that examine stock returns during the period following the launch of new soft law to mitigate methodological problems.

This paper proceeds as follows: The next section reviews related research in the field of CSR. Section 3 provides an overview of the exogenous event used in this study and presents the main hypothesis. Section 4 provides an overview of the sample period, data sources, and detailed descriptions of the variables used in the analyses. Section 5 provides empirical results. Section 6 presents additional analyses. The last section offers concluding remarks.

2. Literature review

2.1. Determinants of corporate social behavior and performance

Previous studies have shown firm characteristics (e.g., firm size, intangible assets, and financial performance) and country-level institutional characteristics (e.g., political, labor, and education systems) are determinants of CSP and socially responsible behaviors (e.g., Erhemjamts et al., 2013; Henriques and Sadorsky, 1996; Ioannou and Serafeim, 2012; Nakamura et al., 2001; Stanwick and Stanwick, 1998). Recent studies also highlight the role of non-shareholder stakeholders such as employees, customers, and local communities in CSR activities. Since socially friendly activities are generally beneficial to non-shareholder stakeholders, less responsible firms are subject to threats of costly boycotts and media campaigns (Cespa and Cestone, 2007). Managers direct responsible activities as long as the expected costs of boycotts and media campaigns outweigh the direct costs of those activities. Henriques and Sadorsky (1996) show evidence that a firm's formulation of an environmental plan is positively associated with consumer pressure, government regulatory pressure, and neighborhood or community group pressure as well as shareholder pressure. Socially responsible behaviors also enable managers to obtain support from non-shareholder stakeholders that substantially reduces the risk of forced turnovers (entrenchment strategy). Cespa and Cestone (2007) present a theoretical model in which non-shareholder stakeholders affect the likelihood of CEO replacement, and incumbent CEOs adopt stakeholder-friendly behaviors. Consistent with this idea, Surroca and Tribo (2008) find positive effects of entrenchment on CSP, especially for firms with efficient internal corporate governance mechanisms.

Mitchell et al. (1997) indicate that shareholders possess the power to make urgent and legitimate claims, and therefore have the greatest influence over firm actions and decision-making processes. Institutional investors especially have large shareholdings (less subject to free-riding problems) and the ability to influence firms' decision making. Recent studies show evidence that institutional shareholders influence the governance structures of investee firms (Aggarwal et al., 2011; Hartzell and Starks, 2003; Helwege et al., 2012; Shinozaki et al., 2016), and, importantly, that institutional investors prefer to invest in firms with high CSP. For S&P 500 companies, Graves and Waddock (1994) find that the number of institutional investors holding shares in a company is positively associated with KLD ratings. Coffey and Fryxell (1991) find a positive relation between the percentage of institutional ownership and CSP of 110 Fortune 500 companies when CSP is measured by the representation of women on a board of directors. By investigating large

[1] See UN Global Compact PRI website: http://www.unpri.org/.