The construction of a corporate governance rating system for a small open capital market: Methodology and applications in the Greek market

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Abstract

The need of institutional investors to evaluate the corporate governance (CG) practices of the listed companies resulted in many attempts to construct CG rating methodologies. This paper, in response to this situation, presents an attemp to quantify the compliance of large capitalisation Greek companies with international best practices. The methodology consisted in the creation of a questionnaire reflecting the Greek CG code, which basically replicate the OECD Principles. Other, well-regarded CG codes were taken into account. Then, we contructed a rating system based on CG indicators and we applied it for the years 2001 and 2003. The total rating results for the years 2001 and 2003 demonstrated a relatively satisfactory improvement. The highest compliance is in the category of shareholder rights, while weak compliance appears in the last category, which incorporates committment to CG, CSR and the relations with shareholders. The exercise, using practically all agreed principles of the OECD, could demonstrate a reasonable degree of compliance of the average company rated. Its limitation in that respect is that it could not satisfy investigations on convergence. The indicators used were highly pertinent to measure compliance, but not convergence, which was not within the initial targets and would need a longer time series analysis. Our methodology applies in a small open economy and may have significant implications in other similar capital markets. Methodologically, the merit of the exercise lies in its approach toward the creation of "collectively subjective" weightings, and is valuable to institutional investors, policymakers, regulators and academics.

Keywords: *corporate governance; rating; Greece*
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Introduction

The upgrading of the Greek capital market to mature market status and the global competition for capital has boosted the CG debate in Greece. In addition, the recent corporate failures and financial scandals around the world have increase awareness that proper corporate governance (CG) is fundamental to the efficient operation of capital markets. The need of institutional investors to evaluate the CG practices of the listed companies, resulted in many attempts to construct CG rating methodologies. This paper, in response to this situation, presents an attemp to quantify the compliance of large capitalisation Greek companies with international best practices. Firstly, we review the literature on CG ratings. Secondly, we present a brief history of the CG in Greece. Then, we present the structure of our CG rating methodology and the results. Finally, we summarize the findings and procced with some critical points.

Literature on corporate governance ratings

Corporate governance (CG) has been a widely discussed issue among academics, capital markets' regulators, international organizations and the business world. Shleifer and Vishny (1997), define CG as the way in which the suppliers of finance to corporation assure adequate returns on their investments. Agency theory is the fundamental reference in CG. The agency problems vary, depending on the ownership characteristics of each country. In countries with dispersed ownership structure (mainly the US and the UK) the separation of ownership and control, as posed by Berle and Means (1932), refers to the inherent conflicting interests of opportunistic managers and owners (Fama and Jensen, 1983; Grossman and Hart, 1986; Williamson 1985). Investors usually use their exit options if they disagree with the management or if they are disappointed by the company's performance, signalling - through share prices reduction - the necessity for managers to improve firm performance (Hirschman, 1970). On the other hand, in countries with concentrated ownership structure (continental Europe, Japan and other OECD countries), large dominant shareholders usually control managers and expropriate minority shareholders, in order to extract private control benefits. The agency problem of CG is therefore posed as how to align the interests of strong blockholders and weak minority shareholders (Becht, 1997).

In a period of volatile and uncertain markets, as shown by the recent corporate failures and poor governance structures, demanding institutional investors seek to place their funds in well-governed companies. Mainstream investors tend to examine and include in their overall investment strategy whether companies comply with specific internationally accepted CG standards. At the same time, as more investors evaluate CG when purchasing stocks and mutual funds, an increasing number of listed companies feel the pressure to take actions in order to adopt efficient CG policies and practices. As a response to the increase in demand for CG evaluations, some investment research firms and academic institutions are now developing CG rating services. A corporate governance score is derived mainly by analyzing to what extent a company adopts codes and guidelines of generally accepted CG best practices, and the extent to which local laws, regulations, and market conditions encourage or discourage corporate governance

practices (Spanos, 2005; Xanthakis et al., 2003).

There are a few firms and academic institutions offering domestic and/or cross-border CG ratings. Ratings are usually based on domestic and global CG codes and try to determine whether listed companies comply with those standards and best practice rules.

Deminor has developed a methodology based on more than 300 CG indicators and offers solicited CG ratings. Its services, which cover the main Western European markets, include also investment advice on corporate transaction, proxy voting recommendation and shareholder activism (Deminor, 2001). GovernanceMetrics International (GMI) has also developed a CG rating system based on both public data sources and private information (e.g. in-depth interviews with senior management and board members). GMI rating criteria are based on more than 600 data points per company that cut across seven categories: board accountability, financial disclosure, shareholder rights, compensation policies, market for control, shareholder base and corporate reputation. The structure of the rating system follows a number of internation codes, such as those developed by the OECD, the Commonwealth Association for Corporate Governance and the Business Roundtable. Companies are rated on a scale of 1-10 relative to one another (Sherman, 2004). Standard & Poor's (S&P's), the world-leading rating company, launch in 2001 a new service (Corporate Governance Scores). A company Corporate Governance Score (CGS) reflects S&P's assesement of a company's CG practices and policies and involves the analysis of public and non-public information. The S&P's evaluation system analyses four key componets: ownership structure and influence, shareholder rights and stakeholder relations, financial transparency and information disclosure and board stucture and process (Standard & Poor's, 2001; Bradley, 2004). The Corporate Governance Authority, a Brussels based company founded in 2000, offers corporate governance ratings worldwide. The rating system includes 225 questions which are integrated into ten broad categories. The indicators are based on the OECD Principles of Corporate Governance (1999) and incorporate both public and non-public information (Corporate Governance Authority, 2002). In 2000, the German Society of Financial Analysts (DVFA) developed a "Scorecard for German Corporate Governance" (DVFA, 2000), based on the German code of best practices. The scorecard is divided into seven criteria: corporate governance commitment, shareholders and the general meeting, cooperation between management board and supervisory board, management board, supervisory board, transparency and reporting and audit of the annual financial statements. In the German scorecard, each indicator is weighted by a suggested "standard weighting" but also allows the reflection of individual weighting differences. The German approach is applied in many countries in East Asian (e.g. Indonesia and Philippines) and in Latin America (Strenger, 2004).

Most of the empirical studies examine the correlation of specific CG aspects and firms' market value or performance. A relatrive limited number of studies use a CG index in order to examine whether governance practices affect firm's market value. Black (2001) examined the relationship between CG behavior and market value for a sample of 21 Russian firms by using CG rankings developed by the Brunswick Warburg investment bank. A worst to best CG improvement predicts a 700-fold increase in firm value. The author reported a powerful correlation between the market value and CG of Russian firms. Durnev and Kim (2003) found that higher scores on both the CLSA CG index and

the S&P disclosure and transparency index predict higher firm value for a sample of 859 large firms in 27 countries. Gompers et al. (2003) showed the existence of a striking relationship between CG and stock returns. The authors used the incidence of 24 different provisions (primarily takeover deafness) of 1500 US firms measured between 1990 and 1999 to build a "Governance Index" and then they studied the relationship between this index and firm performance. The "Governance Index" is highly correlated with firm value. The study also evidenced that "an investment strategy that bought firms with the strongest shareholder rights and sold those with the weakest would have earned abnormal returns of 8.5 per cent per year". Klapper and Love (2002) used data on firm-level CG rankings across 14 emerging markets and found a wide variation in firm-level governance across countries. Black et al. (2003) constructed a multifactor CG index based primarily on responses to a survey of all listed companies by the Korea Stock Exchange. They found a strong positive correlation between the overall CG index and firm market value, which is robust across OLS, 2SLS and 3SLS regressions, in subsamples, in alternate specifications of the CG index, and with alternate measures of firm value.

A brief history of the evolution of corporate governance in Greece

Traditionally Greek companies were, and most of them still remain, family owned. Family members were also board members and the company's executives. This kind of structure did not give rise to thoughts on efficient corporate governance (CG), such as there existed no agency problems between the owners and the management. However, the significant use of IPO's as means for raising capital in the late 1990's turned these companies from private-family owned to public listed companies, offered the first sign that the long lasting operating methods had to be reconsidered. The speculative events in the Greek capital market during 1999 led the Hellenic Capital Market Commission (HCMC), the main independent regulatory decision-making body, and the state to take an active role, introducing rules, regulations and codes of conduct. All these measures were aiming at the protection of investors against market abuse, the improvement of the transparency of the market and the establishment of appropriate business ethics. The discussion on CG in Greece is focused mainly toward protecting individual and minority shareholders' interests that are practically cut off from the decision making process of the firm (Mertzanis, 2001; Spanos et al., 2004; Spanos, 2005).

Corporate governance appeared as an issue in Greece in the mid-1990s through an introductory paper published by the Stock Exchange. The first, however, major step toward the formation of a comprehensive framework on corporate governance has been the publication of the "Principles of Corporate Governance in Greece" on October 1999 by an ad hoc committee co-ordinated by the HCMC (Committee on Corporate Governance in Greece, 1999).

The Greek code contains 44 recommendations compiled on seven main categories:

- The rights and obligations of shareholders
- The equitable treatment of shareholders
- The role of stakeholders in corporate governance
- Transparency, disclosure of information and auditing

- The board of directors
- The non-executive members of the board of directors
- Executive management

The principles and best practice rules incorporated were closely modeled according to OECD Principles on Corporate Governance (OECD, 1999). This, combined with an announced intetion of the Ministry of the Economy to amend the corporate law to incorporate additional CG elements that would then become mandatory, triggered an open controversy between the representatives of the industrial federations and the state. The former confirmed their belief in CG principles and support that voluntarily complies is a sufficient incentive and thus firms should be self-regulated. The Federation promoted its own code of conduct for its members. In May 2002 the Ministry of the Economy amended the corporate law and incorporated fundamental CG obligations.

The legislative framework of the Greek capital market is now fully harmonised with the guidelines and directives of the EU. Although improvements in CG have occurred in Greece, they are mainly confined to a small number of large listed companies that are more in tune with the international corporate stage.

The corporate governance rating system methodology

The approach

As the CG debate became a hot issue in 2000, the Center of Financial Studies in the Department of Economics of the University of Athens launched a project financed by the Stock Exchange, aiming at a pilot CG rating. The target of the project was to develop a methodology on CG rating and apply it to a broad number of companies on a voluntary basis (Tsipouri and Xanthakis, 2004). Specific targets were:

- To provide an independent and reliable tool for all investors who believe that a thorough examination of CG practices will lead to increased long-term shareholder value. The importance of the tool increases in a framework of a small open capital market that aims to attract sophisticated international investors.

- To provide a comprehensive and specific rating regarding all CG criteria for each company, enabling firms to use their individual results in order to measure themselves against several benchmarks (high, average, sectoral average).

- To produce useful results of aggregated data for the relevant authorities (e.g. the Stock Exchange, the Hellenic Capital Market Commission) and create an aggregate score for the Greek listed companies participating, thus demonstrating strengths and weaknesses to be taken into account for policy making.

- Form a basis for comparison with future exercises and offer a tool that will allow correlation of the results with stock value and profitability to check the extent to which investors pay a premium for companies with high ratings.

One of the main contributions of the project was the consensus that resulted from a very close collaboration between the Stock Exchange (which financed the study and had a vivid interest in practical results), an academic research center (which could guarantee methodology and impartiality) and representatives of market participants (who provided thorough inputs and assured the practical value of the results). In order to achieve the highest possible consensus and obtain market-oriented outcomes, a Special Advisory Committee on Corporate Governance was convened consisting of members of all the relevant agents (the Hellenic Capital Market Commision, the Stock Exchange, the Athens Chamber of Commerce & Industry, the Federation of Greek Industries, the Union of Institutional Investors, the Hellenic Bank Association, the Brokers' Association) to advise the researchers on practical matters related to their work. The Committee met as relevant milestones were reached, and commented or recommended additional work.

The structure

The methodology consisted in the creation of a questionnaire reflecting the five chapters of the Greek CG voluntary code, which basically replicate the structure of the OECD Principles (1999). Other, well-regarded corporate governance codes were also taken into account. The answers to this questionnaire were integrated into a number of indicators, which did not have a 1 : 1 correspondence to the questions. The indicators were then assigned with weightings, depending on their priority, so that a composite final overall score could be obtained. More specifically the questionnaire consisted of five main category-indicators:

- The rights and obligations of shareholders.
- Transparency, disclosure of information and auditing.
- The board of directors.
- Executive management.
- Corporate governance commitment, the role of stakeholders and corporate social responsibility.

The total number of questions was 54, categorised into questions, which directly lead to indicators suitable for the CG rating (32 questions), questions combined into one indicator (16 questions leading to five indicators only) and questions used for clarification and control not leading to any indicator (six questions). Of the former 32, five questions received *ipso facto* the highest score because they refer to issues that are mandatory in the existing regulatory framework. The reason the latter were included was to show potential international investors that all listed firms in the Greek market comply with these minimum standards.

The questions were thus integrated into 37 indicators, of which six were for shareholder rights, nine for transparency, 12 for the Board, five for the CEO and the executives and five for general issues like corporate social responsibility.

In 2004, an updated version of the scorecard was issued to follow the Greek law on CG that had been published by the Ministry of Economy, as well as the recent trends of the capital market and the business world.

Content of the main criteria

The rights and obligations of shareholders: The criterion reviews all relevant issues related to the equal treatment of shareholders, like one-share one vote principle, confidential voting, voting procedures and absence of takeover defence.

Transparency, disclosure of information and auditing: This checks the extent to which all shareholders are equally and regulary informed, international accounting standards are in place, efficient risk management system exist etc. The criterion also focuses on sufficient disclosure of the board members' and executives' remuneration and deals with conficts of interests between external and internal auditors.

The board of directors: This criterion evaluates board structures and functions, like CEO duality, board independence, board size and meetings frequency, board committees, new board members' rotation and training, non-executive directors' remuneration, non-executive directors' election frequency etc.

Executive management: The emphasis is on the duties and responsibilities of the CEO, executive managements' and CEO compensation, full information on stock options etc.

Corporate governance commitment, the role of stakeholders and corporate social responsibility: The final criterion includes a mix of factors related to the external position of the firm. We were concerned that emphasis on issues like stakeholder rights or social responsibility might create a reluctance of companies to cooperate, as there has been a clear tension between managers and shareholders on the one side and government on the other in earlier years on such issues. While in the last decade this tension has diminished, it was decided to limit question of this type to a minimum and also to attribute very low weightings.

Calculation and weighting

Weighting was the greatest difficulty, as it inevitably had to include subjective judgements. The way we proceeded was to first have each of the senior members of the research team individually assign priorities amongst and within each category. Fortunately, their assigned priorities coincided to a large degree, and where they did not, agreement could be reached after discussion. Then, a score of 0 (inadequate), 1 (intermediate) and 2 (top performance) was assigned per indicator. These weightings were presented to the Advisory Committee and were confirmed or altered to reflect the priorities and the evaluation of the participants in the market.

The highest weighting was assigned in the category of transparency and disclosure, followed by the shareholder rights, the board of directors, the executive management and CSR.

Corporate governance rating for the large Greek listed companies

Sample and data

The dataset includes public information on 27 different corporate governance indicators for the 20 biggest companies (based on the capitalization) in 2001 and 2003, as they figure in the corresponding list of the Stock Excange (ASE/FTSE-20). The companies included in our sample represent more that 70% of the capitalisation of the market. The data is taken from the firms' annual reports as of year-end 2001 and 2003.

Results

The total rating results for the years 2001 and 2003, shown in Table I, demonstrated a relatively satisfactory improvement (77.8% and 81.1% respectivelly). The highest compliance in the Greek market is in the category of shareholder rights, followed by CEO/Executive management and transparency. The Board of Directors category had a medium compliance score, while weak compliance appears in the last category, which incorporates external factors like committment to CG, corporate social responsibility and the relations with shareholders. This ranking of the categories is also infuenced by the impact of mandatory provisions, which are concentrated in the categories with the highest compliance score.

----- take in Table I ----

As observed in the results of TableII, shareholders rights appear to be well protected in Greece. The one-share one-vote rule is legally imposed. During the course of time the CG ratings have been improved (94.3% in the 2001 survey and 100% in the 2003 survey). Transparency and disclosure practices are of a quite high quality (Table III), with in-time and undertsandable publication of the financial statements, and equal treatment of all investors and financial analysts regarding information dissemination for important corporate events.

----- take in Table II ----

----- take in Table III ----

Weaker compliance is observed in the disclosure of managerial remuneration (52.9% in the 2001 survey and 57.5% in the 2003 survey), the application of the IAS (firms employing the IAS or the US-GAAP are those listed in foreign stock exchanges – 58.8% in 2001 and 60.0% in 2003) and the disclosure of company's risk management policy (58.8% in 2001 and 60.0% in 2003). In the category "The board of directors", presented in Table IV, large capitalization companies performed better in the 2003 survey compared with the 2001 survey (70.5% and 67.9% respectivelly). A note-worthy feature

is that Greek firms seem to have a universal problem in the frequency of changing non-executive directors. The introduction of the new law on CG in July 2002 increased the number of non-executive and independent directors. Moreover, firms perform better in the establishment of board committees indicator (47.1% in 2001 and 62.5% in 2003). Table V, indicating ratings of the CEO and executive management, shows that the FTSE/ASE-20 firms perform very well (81.1% in 2001 and 84.7% in 2003). The weakenes lies in disclosure of share ownership information of the executive management.

----- take in Table IV ----

----- take in Table V ----

It came as no surprise that the degree of compliance is relatively low (Table VI) in the last category that incorporates CSR and stakeholders issues (56.3% in the 2001 survey and 63.1% in the 2003 survey).

----- take in Table VI ----

Conclusions and further research

The main conclusion drawn from this survey was that overall Greek companies demonstrate a fairly satisfactory degree of compliance with OECD CG principle. The introduction of the new CG law in July 2002 had a positive impact on the CG rating results. However, there is still quite weak compliance concerning the role of stakeholders and CSR, the non-executive directors' election frequency, disclosure of remuneration and CEO/Chair split.

The merits and the limitations of the work undertaken can be summarized around four main areas:

- Raising the issue: Following the increased interest on CG internationally and the upgrade of the Greek market, the work undertaken really raised the issue and helped shape a discussion on the potential merits of CG.
- Demonstrating market compliance: The exercise using practically all agreed principles of the OECD could demonstrate a reasonable degree of compliance of the average company rated. Its limitation in that respect is that it could not satisfy investigations on convergence. The indicators used were highly pertinent to measure compliance, but not convergence, which was not within the initial targets and would need a longer time series analysis.
- Using "collective subjectivity" for the attribution of weightings: The Greek methodology for the creation and valuation of weightings was different to those used by academic publication or credit rating exercises. The idea of an academic suggestion validated by all market participants was an effort to substitute for the impossibility of longer term econometric testing. In the absence of initial data, this method presents the advantage of passing the market test. It also contains a dynamic aspect of change overtime, as attitudes and trends change in the particular market. Weightings can be adapted accordingly. While inevitably subjective, these weightings

took a more objective character through their validation by representatives from the market. We believe that our innovative approach leading "collective subjectivity" may be a good methodology substituting for the absence of databases, in particular for smaller markets, where this exercise is easier to undertake.

- Identifying the potential to diversify tools based on the inputs used: As a first step one can undertake scoring based on public domain information and make comparative exercise that allow to rank firms or markets. If one wants to go deeper into the investigation of CG quality in a firm, then it is necessary to enrich the exercise with more indicators that are customized and result from in-depth research and interviews.

The rating attempt started practically in one type of a market (emerging with spectacular rises in stock prices) and ended up in a totally different one: during the 18 months that it took to design the methodology, test it, validate it and apply it to the sample used, the Greek market was upgraded to a developed market and the Stock Exchange suffered higher losses than the average of all developed markets. In this context, needs, prospects and expectations from this exercise changed and led to different requests from the various participants involved. These requests led to new discussions on how the existing indicators could be valorized by alternative calculations or how they could be enriched in the future to cover the newly emerging requests.

Our sample contains large capitalization quoted companies. Moreover, some of the companies are internationally quoted. For them, the interest does not lie in their comparison with Greek companies or with basic OECD principles, but on their potential to compete for funds globally. Finally, our approach could be applied in many small open economies. This particularly applies to counties that still have to develop a comprehensive legal and transparent basis for corporate governance.

Tables

Table I: Total CG rating results based on public domain information for the FTSE/ASE-20 companies (maximun=100%)

Corporate governance indicator	2001	2003
The rights and the obligations of shareholders	94.3	100.0
Transparency, disclosure of information and auditing	80.1	81.4
The board of directors	67.9	70.5
CEO and executive management	81.1	84.7
Corporate governance commitment, the role of stakeholders and corporate social responsibility	56.3	63.1
Total CG index	**77.8**	**81.1**

Table II: The rights and the obligations of shareholders (maximun=100%)

Corporate governance indicator	2001	2003
The equal treatment of shareholders	100.0	100.0
Absence of takeover defense	94.1	100.0
Existence of organized and autonomous shareholder department	94.1	100.0
Voting procedures in the GMS	100.0	100.0
Mechanisms of sufficient and timely information about the dates, place and agenda of the GMS	86.8	100.0
Mechanisms through which shareholders are sufficiently and timely informed on the proposals submitted in the agenda of the GMS	91.2	100.0
Total index	**94.3**	**100.0**

Table III: Transparency, disclosure of information and auditing (maximun=100%)

Corporate governance indicator	2001	2003
Report of the annual and semi-annual financial statements with clear and understandable way	100.0	100.0
In time publish of the annual and semi-annual financial statement	100.0	100.0
Equal treatment of all investors and financial analysts regarding information dissemination (fair disclosure) for important corporate events	100.0	100.0
Detailed analysis of any deviation from previously announced earnings targets and strategic goal	88.2	90.0
Application of an internationally recognized accounting and auditing system for the balance sheet consistent with the IAS	58.8	60.0
Disclosure of board directors and executive staff members' remuneration	52.9	57.5
Specific discussion of the company's risk management system on the annual report	58.8	60.0
Total index	**80.1**	**81.4**

Table IV: The Board of directors (maximun=100%)

Corporate governance indicator	2001	2003
Division between the role of the chairman and the CEO	29.4	45.0
The composition of the board of directors	88.2	88.8
Non-executive board directors' independence	76.7	80.0
The size of the board of directors	88.0	60.0
Board meetings frequency	100.0	100.0
Establishment of board committees	47.1	62.5
Non-executive board directors' election frequency	0.0	0.0
Total index	**67.9**	**70.5**

Table V: CEO and executive management (maximun=100%)

Corporate governance indicator	2001	2003
The duties and responsibilities of the CEO	100.0	100.0
Disclosure of share ownership of the executive management staff members	52.9	60.0
Existence of position of Chief Financial Officer	88.2	90.0
Total index	**81.1**	**84.7**

Table VI: CG commitment, the role of stakeholders and CSR (maximun=100%)

Corporate governance indicator	2001	2003
Existence of written CG rules in the company	41.2	42.5
Existence of a Corporate Governance Committee or individual entrusted with CG compliance issues	29.4	55.0
Existence of an efficient CG framework taking account the interests of all stakeholders	64.7	62.5
Corporate social responsibility and environmental awareness	97.1	97.5
Total index	**56.3**	**63.1**

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