Institutional investors, corporate social responsibility, and stock price performance

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A B S T R A C T

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 environmental 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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Analyzing Japanese data allows us to determine whether 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., Erhemjams et al., 2013; Henrques 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. Henrques 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

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