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The Real Risks in Riskmetrics' GRIds

This week, Riskmetrics Group retires its signature governance ratings product, the Corporate Governance Quotient (or CGQ), and unveils its successor, Governance Risk Indicators (or GRIds). Many companies will be pleased to see the back of the CGQ, a blunt instrument used to pressure corporations into conforming to one-size-fits-all corporate governance "best practices". But GRIds will not give them much reason to cheer, being largely a sharpened version of the CGQ skillfully repackaged to take advantage of the elevated power of the word "RISK" (also the company's new ticker symbol). Predictably, in explaining the need for its new product Riskmetrics points to the financial crisis and the collapse of "storied financial houses," even though governance failures were not a primary cause of the crisis (many of those storied houses had boasted stellar CGQ scores) and even though, as we have previously noted, academic research does not support the value of governance ratings.

It does appear that GRIds will avoid some of the CGQ's more egregious flaws, like its mysterious "black-box" methodology and the conflict created by giving ratings credit for attending director education programs. Riskmetrics also says that GRIds will be more comprehensive and more granular than CGQ because, instead of providing a single relative governance "score" for each issuer, the take-away will be an absolute "level of concern" indicator (low, medium or high) in each of four dimensions: Board, Audit, Shareholder Rights and Compensation/ Remuneration. This change will provide more information than the unitary CGQ, but will likely also mean greater pressure on areas where a company fails to live up to the Riskmetrics ideal. Although the GRIds process will be more transparent, it is still just a mechanical formula-based application (using criteria and weightings established by Riskmetrics) that does not take into account a company's specific circumstances. Indeed, not only does GRIds not address serious real-world risks like the risk of failing to attract and retain top management talent, or the risk of being subject to a destabilizing hostile takeover bid at an opportunistic time, but blind adherence to its dictates could greatly exacerbate such risks.

Among the most serious risks to corporate effectiveness are the risk that managements and directors are distracted from the real threats and opportunities in their businesses by grading systems and "best practices" that are little more than "check-the-box" exercises, and the risk that the experienced business leaders needed to guide our corporations as directors decline to serve because the director's role is being downgraded by the "good governance" industry.

Given Riskmetrics' virtual monopoly in proxy advising, boards and their advisors will not be able to ignore GRIds and will likely have to spend considerable time understanding and responding to it. However, it should be seen for what it is, a data-point and an artfully marketed product, not a model to be embraced to earn governance "brownie points". We continue to recommend that corporations and boards consider their own unique circumstances and needs in establishing their governance and compensation policies, and their takeover defenses.

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