Going off the GRId

There are sound reasons why boards should not blindly follow the new RiskMetrics model.

BY DOUG RAYMOND

Many corporate boards have been working hard over the last few years to strike the right balance in their governance processes while facing significant economic challenges, increased public skepticism of business, and burgeoning government regulation. In addition, we have seen the increased importance of organizations like RiskMetrics Group. This spring, RiskMetrics upped the ante when it published its new Governance Risk Indicators™ (GRId), a new governance-related matrix comprising 59 to 95 weighted questions that define RiskMetrics' view of good governance.

While GRId incorporates a multifactor approach, it is not as nuanced as the analysis a board should undertake when developing its fully-integrated governance principles, which involves balancing the needs and objectives of the company's various constituencies as well as long-term and short-term perspectives on the issues confronting the company. However, given RiskMetrics' current influence with institutional investors, many boards may automatically fall into step with the new matrix, rather than pursuing a more thoughtful approach.

Methodology: GRId replaces RiskMetrics' Corporate Governance Quotient, which is being phased out. GRId will be aligned with RiskMetrics' proxy voting policies and regularly updated to reflect policy changes. Initially, RiskMetrics' GRId will cover approximately 8,000 global public companies, of which about 6,400 are U.S. companies.

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RiskMetrics uses GRId to evaluate each company's governance-related risk by comparing the company's practices to the RiskMetrics-defined best practices for the country in which the company is located. This departs from RiskMetrics' previous approach, which gave some weight to a company's peer group.

GRId's methodology comprises a set of questions addressing four categories of governance: Audit, Board Composition, Compensation, and Shareholder Rights (there are 63 questions for U.S. companies). Each category is divided into subsections, and subsections and questions are weighted differently based on the geographic market. Answers are based on the company's public filings and scored on a scale of "-5" to "5", with "0" representing a neutral score (suggesting that the company meets market standards). In many cases, scores are based on specific, prescribed criteria, and do not allow for much "leeway" if a particular company practice differs from the RiskMetrics-defined best practice. GRId results are reported as absolute "concern levels" of "low," "medium" or "high" for each category. This also departs from RiskMetrics' previous approach, which had provided a cumulative score and a ranking against peers.

GRId's 'One Size Fits All' Approach: In developing a company's governance policies and programs, the board should consider a broad spectrum of factors, including the business of the company, its industry and competitors, its geographic market, potential unfriendly acquirers, the regulatory environment, and the competing interests of its various constituencies, such as shareholders, employees, and short- and long-term investors. Because every company's circumstances are unique, a "one size fits all" approach often is inappropriate. Yet, a "one size fits all" approach is the Procrustean bed that RiskMetrics is seeking to impose with its new approach.

GRId evaluates each company's governance practices only against the RiskMetrics-defined best practices for the applicable geographic market. It does not consider industry practices. Nor does it consider a company's particular circumstances — which is precisely what directors should do when developing a governance program (or indeed when making any decision).

Further, because GRId expresses rankings in terms of absolute "concern levels" based on what largely amounts to a "check the box" scoring system, companies may be tempted to adopt RiskMetrics-defined best practices in order to increase GRId scores. A board that follows this path may fail to consider other measures that are equally or more important for that particular company.

Going Forward: RiskMetrics is the most influential voice today in setting governance standards for public companies, and has reached this position because of the confidence that many institutional investors place in its judgment. Boards, therefore, should give weight to RiskMetrics' views. However, boards should also recognize that GRId's "one size fits all" approach is based on one perspective — the institutional investors' perspective — and that boards should take a broader view when determining a fully-integrated approach to governance. And although GRId will now be a factor, boards should not blindly follow the RiskMetrics model; but, rather, continue to consider the full range of issues and interests when striking the right balance in their governance processes. ■

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