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Do Institutional Investors Drive Corporate Social Responsibility?

International evidence suggests they have a positive impact and, when based abroad, succeed in transplanting their environmental and social norms into the firms they own

by Hannes Wagner

Managers face increasing pressure to look beyond profits and to consider their firms' environmental and social (E&S) impacts.

Additionally, firm-level measurement of these impacts has evolved enormously, and investors and other outsiders can easily track firms' E&S performance on the main investment platforms. Yet, whether improved E&S performance is beneficial to the average shareholder remains controversial.

Background and methodology

Investments that improve E&S performance could be a signal of agency problems in firms. Outside pressure groups with no financial stake do not need to consider the associated costs of such commitments and will advocate for improvements. If a firm's managers care about these pressures, or obtain other private benefits from E&S investments, they will overinvest (1). Alternatively, E&S investment could be value-enhancing by providing a form of insurance against event risk and/or product market differentiation (2). Thus, the evidence detailing the financial costs and benefits of investment to increase E&S performance is mixed.

In recent work, we assess whether the environmental and social (E&S) performance of firms worldwide is driven by investors (3). We test for a relation between ownership and firms' E&S performance. It is hard to dismiss the hypothesis that E&S investments benefit shareholders if owners are a driving force behind firms' E&S choices. After all, it is their money that is being spent. Tests featuring institutional investor ownership should be the most compelling. These investors own and vote the bulk of the world's equity capital, are sophisticated, and face legal obligations to primarily consider firms' financial returns in their investment and voting decisions.

We examine whether institutional investors drive firms' E&S performance around the world. The majority of work to date has focused on E&S choices within US firms, yet pressure for improved E&S performance is truly a global phenomenon. We construct environmental and social performance measures for each firm and year by scoring firms based on detailed data items (e.g., covering areas such as CO_2 emissions, renewable energy use, human rights violations, and employment quality) from the database ASSET4. We also use ASSET4's proprietary weighted *z*-score. These data are combined with institutional ownership data from Factset and firm characteristic data from Worldscope to build a sample of 3,277 non-US firms from 41 countries over the period 2004 through 2013. We perform robustness tests using Bloomberg and Sustainalytics data, two alternative sources for E&S measurement that are popular with investors.

E&S and institutional investors

We first explore whether institutional investors in aggregate are a driving force behind firms' E&S performance around the world. We test whether lagged total institutional ownership is associated with firms' E&S performance, controlling for other factors. We find that when institutional ownership is higher, firm-level E&S scores are greater in the subsequent year. Not only is this result statistically significant, it is also economically meaningful. A move from the first to the third quartile in institutional ownership is associated with an increase in the equally weighted (proprietary weighted) environmental performance score of 5.7 per cent (8.6 per cent) and an increase in the social performance score of 2.6 per cent (10.5 per cent).

These surprising findings matter because they demonstrate that *mainstream* institutional investors care about E&S issues, and actively push firms to improve their E&S performance. While one might expect activist investors, such as environmental and social impact funds, to push for such changes, we instead find that a broad range of mainstream investors do this.

We next assess whether institutional investors are more impactful in situations where stronger effects are plausibly expected. Two settings that predict stronger impacts are when institutional owners are clearly committed to activism on E&S issues and when firms have greater scope to improve their E&S performance. We find that both of these investor and firm characteristics matter. Investors that are signatories to the *UN Principles on Responsible Investing* (UN PRI) have more than double the average investor impact on firms' E&S performance, and investors have a stronger effect in firms with low (below-median initial) E&S scores than in firms with high E&S scores.

It is of course possible that these results reflect institutional inves-

(1) R.W. Masulis, S.W. Reza, «Agency Problems of Corporate Philanthropy», *Review of Financial Studies*, 28(1), 2015, pp. 592-636; I.-H Cheng, H. Hong, K. Shue, *Do Managers Do Good with Other Peoples' Money?*, Working paper, Dartmouth College, 2016; H. Cronqvist, F. Yu, «Shaped by Their Daughters: Executives, Female Socialization, and Corporate Social Responsibility», *Journal of Financial Economics*, forthcoming, 2017.
(2) H. Servaes, A. Tamayo, «The Impact of Corporate Social Responsibility on the Value of the Firm: The Role of Customer Awareness», *Management Science*, 59(5), 2013, pp. 1045-61; H. Hong, I. Liskovich, *Crime, Punishment, and the Value of Corporate Social Responsibility*, NBER Working Paper, 2016; R. Albuquerque, A. Durnev, Y. Koskinen, *Social Responsibility and Firm Risk: Theory and Empirical Evidence*, Working paper, Boston College, 2016; K.V. Lins, H. Servaes, A. Tamayo, «Social Capital, Trust, and Firm Performance: The Value of Corporate Social Responsibility During the Financial Crisis», *Journal of Finance*, forthcoming.
(3) A. Dyck, K. Lins, L. Roth, H. Wagner, *Do Institutional Investors Drive Corporate Social Responsibility? International Evidence*, Rotman School of Management Working Paper No. 2708589, 2016.

In choosing the level of firm E&S performance, institutional investors may be motivated both by financial returns and norms

tors selecting firms that have higher E&S performance as opposed to investors pushing for E&S changes in firms they already own. To support a causal interpretation, we take advantage of a quasi-natural experiment provided by the BP Deepwater Horizon oil spill in 2010. This costly environmental disaster represents an unexpected shock that increased the perceived importance of having in place robust environmental policies and procedures, particularly for firms in extractive industries. If institutional ownership drives changes in firms' environmental policies, then we expect that firms with greater institutional ownership at the time of the shock will be more reactive in the years following this shock. We find precisely this result.

Other robustness tests support this causal interpretation. These tests include: statistical Granger-causality-style tests and an instrumental variable specification that follows Aggarwal, Erel, Ferreira, and Matos (4) and Bena, Ferreira, Matos, and Pires (5). To address the possibility that the results are driven by omitted variables, we employ a firm fixed effect specification as suggested by Gormley and Matsa (6). We address the potential concern that our results could be influenced by firms' governance or transparency levels by controlling for these factors and our results are unaffected. Overall, our results show that, in aggregate, sophisticated owners with a fiduciary duty to focus primarily on financial returns are asking for, and getting, improvements in E&S performance at the firms they own – this constitutes *prima facie* evidence that supports the beneficial view of improved E&S performance.

The role of social norms

These initial tests, however, do not explore the possibility that in choosing the level of firm E&S performance, institutional investors may be motivated both by financial returns and by *norms* – views as to how investment managers and others should or should not behave. If an investment manager lives in a community that believes strongly that firms should have high levels of environmental and social performance, increasing E&S performance in the firms in her portfolio brings the investment manager social rewards and avoids social sanctions. In that setting, the investment manager can potentially drive firms to overinvest in E&S performance in the sense that the level she chooses can exceed the level that maximizes financial returns, which becomes acceptable because it moves firms' E&S performance closer to her community's E&S ideals.

To explore whether firms' E&S performance is affected by investors' social norms, we introduce proxies for community ideals for E&S performance and then test whether the ideals help to explain cross-sectional differences across investors in their E&S impact. We exploit our global sample and focus on country-level norms regarding environmental and social issues. We use several types of cross-country data, including observed E&S behavior at the country level, for example captured by scores on the Environmental Performance Index, and stated values regarding E&S issues captured by the World Values

(4) R. Aggarwal, I. Erel, M.A. Ferreira, P. Matos, «Does Governance Travel Around the World? Evidence from Institutional Investors», *Journal of Financial Economics*, 100, 2011, pp. 154-81.

(5) J. Bena, M.A. Ferreira, P. Matos, P. Pires, «Are Foreign Investors Locusts? The Long-term Effects of Foreign Institutional Ownership», *Journal of Financial Economics*, forthcoming.

(6) T.A. Gormley, D.A. Matsa, «Common Errors: How to (and not to) Control for Unobserved Heterogeneity», *Review of Financial Studies*, 27(2), 2014, pp. 617-61.

Survey. Social norms towards E&S differ significantly across countries and these differences are persistent.

To facilitate identification of the impact of norms on investors' E&S impact, we focus on institutional investors' foreign holdings. Foreign investors are unlikely to obtain private benefits other than through the social norm channel, given that there is a geographic separation between investors' domicile and firm headquarters. In our sample, foreign investors account for two-thirds of institutional ownership and there is significant heterogeneity in national social norms across foreign investors.

The geography of social norms

Consistent with investors being motivated in part by norms, foreign institutional investors impact firms' E&S performance only when these investors are from countries where measured norms reveal a greater demand (above-median) for E&S performance. Our analysis suggests firms' environmental and social performance levels would improve by 7.4 per cent and 2.2 per cent respectively, if a firm's foreign investors are from countries with strong instead of weak norms towards E&S performance. We obtain these results for various measures of national social norms and they hold when we control for other country characteristics, such as GDP per capita.

To see the effect we document, we compare a Dutch mutual fund investing in a US firm with a US mutual fund investing in a Dutch firm. We find that the Dutch fund, and others like it, will successfully push the US firm towards better environmental and social performance. The US fund instead will not exert any such pressure on the Dutch firm. The rationale for this is that institutional investors cater to the social norms of their constituents. US social norms towards environmental and social issues are relatively weak. When instead social norms towards E&S issues are strong, such as in the Netherlands and throughout Europe, the foreign investor transplants (Dutch) social norms into (US) firms.

Geography is also highly correlated with levels of social norms. European countries occupy the top 17 positions in E&S rankings of countries. As a group, only European institutional investors impact firms' E&S performance. Investors have no impact on firms' E&S performance if they come from any other geographic region, including the US.

To put these findings into perspective, if money were all the same, and institutional investors were interested only in financial returns, then the cultural origin and social norms of investors should not matter. Instead, we find that cultural origin matters – foreign institutional investors domiciled in countries with social norms supportive of strong E&S commitments are the ones that impact firms' E&S performance. This result suggests that a society's social norms flow through the channel of portfolio investment into firms and provides new evidence on the way in which culture makes its way into economic decision making.

The weight of financial returns

When investors are motivated by norms, the impact of high community E&S norms is greatest when an investment manager places a lower weight on financial returns relative to social conformity. This weight on financial returns depends on investment managers' financial incentive intensity and their expected fund-flow-financial-performance relationship – both of which vary significantly across investor type. Managers of pension plans, for example, have muted incentives and in the short term do not typically face the threat of outflows if firms in their portfolios underperform. Independent investment managers have stronger incentives than pension fund managers and more to fear from short-term underperformance, since they can experience outflows. Hedge fund managers have high incentives and can also experience outflows from short-term underperformance.

Consistent with this framework, we find that the weight an investment manager places on financial returns (as captured by investor type) influences its impact on firms' E&S performance. Pension funds have the most significant positive impact on firms' E&S performance, and their strong impact obtains when they come from both high- and low-E&S social norm countries. On the contrary, hedge funds (which represent only a small fraction of our total foreign institutional investor ownership) appear to lessen the E&S performance of firms they invest in, and this is generally true regardless

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of the E&S social norms where they are domiciled.

Most interestingly, we find that the impact of market-sensitive independent institutional investors (e.g., mutual funds) depends on the social norms they face. These independent investors account for the majority of foreign institutional investor capital and, thus, are more likely to play a pivotal role regarding E&S issues. They have a small and usually insignificant impact on firm E&S performance if they are from countries where E&S social norms are relatively weak – e.g., in the US. However, when independent institutional investors come from countries with strong social norms towards E&S issues – e.g., from the Netherlands – they have a significantly positive impact on firms' E&S performance. Strong enough social norms can overcome market pressures to solely focus on financial returns.

Managerial implications

From a CEO and firm management standpoint, the success of foreign investors transplanting their social norms into the firms they own adds an additional dimension to the importance of institutional investors. This «color of money» effect is unlikely to be without conflict – executives of firms from low-social-norm countries would have both social norm and fiduciary duty incentives to push back. Our results help inform the debate about increasing investor power by, for example, giving investors enhanced access to the proxy. To the extent that domestic social norms place less value on E&S performance, calls for enhanced investor power are likely to be challenged by management and domestic regulators. ■

In sintesi

- Negli ultimi anni, l'attenzione verso la performance sociale e ambientale delle aziende è cresciuta enormemente; **se una migliore performance sociale e ambientale si traduca però in un ritorno economico per gli investitori resta una questione aperta**. Da un lato, pressioni esterne da parte di soggetti non portatori di interessi finanziari nelle aziende potrebbero determinare un eccesso di investimenti sul versante sociale e ambientale; dall'altro, tali investimenti potrebbero rappresentare una forma di assicurazione contro il rischio e/o una forma di differenziazione di prodotto.
- La ricerca qui presentata (per una versione estesa si veda il paper di Dyck, Lins, Roth e Wagner, *Do Institutional Investors Drive Corporate Social Responsibility? International Evidence*) si occupa del **ruolo svolto dagli investitori istituzionali nell'indirizzare o meno la performance sociale e ambientale delle aziende di riferimento** a livello globale, prendendo in considerazione un campione di 3277 aziende di 41 diversi Paesi.
- Una prima evidenza della ricerca è **che una maggiore presenza di investitori istituzionali è associata a livelli più elevati di performance** sociale e ambientale. L'impatto degli investitori istituzionali è maggiore laddove questi abbiano preso impegni formalizzati su questo versante e quando i livelli di performance sociale e ambientale di partenza sono più bassi.
- L'impegno degli investitori istituzionali su questo versante potrebbe essere associato **al desiderio di scongiurare il rischio di catastrofi assai costose anche sul piano finanziario**; tuttavia, un ruolo significativo potrebbe essere giocato anche da considerazioni non finanziarie: in particolare, dalle norme sociali proprie delle comunità di appartenenza dei manager relative al comportamento che i manager stessi dovrebbero tenere.
- Una riprova del ruolo delle norme sociali arriva dal **comportamento degli investitori istituzionali che operano all'estero.** Quando gli investitori istituzionali provengono da Paesi con un'elevata attenzione per le questioni ambientali e sociali, l'impatto sulla performance delle aziende di riferimento in questi ambiti sarà significativamente maggiore. Una conseguenza è che le pressioni da parte di investitori istituzionali stranieri basati in Paesi con forti aspettative di performance sul piano sociale e ambientale su manager di aziende di riferimento di Paesi con livelli più bassi di attenzione a questi aspetti potrebbe portare a tensioni e conflitti riguardo alla gestione aziendale.
- L'impatto dipende anche **dalla tipologia di investitori istituzionali**. Laddove i manager dei fondi hanno livelli minori di incentivi e minor pressione rispetto alle performance finanziarie nel breve periodo, l'impatto sulla performance ambientale e sociale delle aziende in cui investiranno sarà maggiore; viceversa, laddove i manager hanno maggiori incentivi e maggior pressione rispetto alle performance finanziarie nel breve periodo, l'impatto sarà minore.