Chile

The Role of Institutional Investors in Promoting Good Corporate Governance Practices in Latin America: The Case of Chile

Chile's report was originally produced by Alvaro Clarke for the 2007 Latin American Roundtable Meeting.

The OECD Secretariat has updated graph 1 and 2 and added two sections entitled "Additional Information" and "Proposed Corporate Governance reforms being discussed in Congress", the rest of the document is the original paper.

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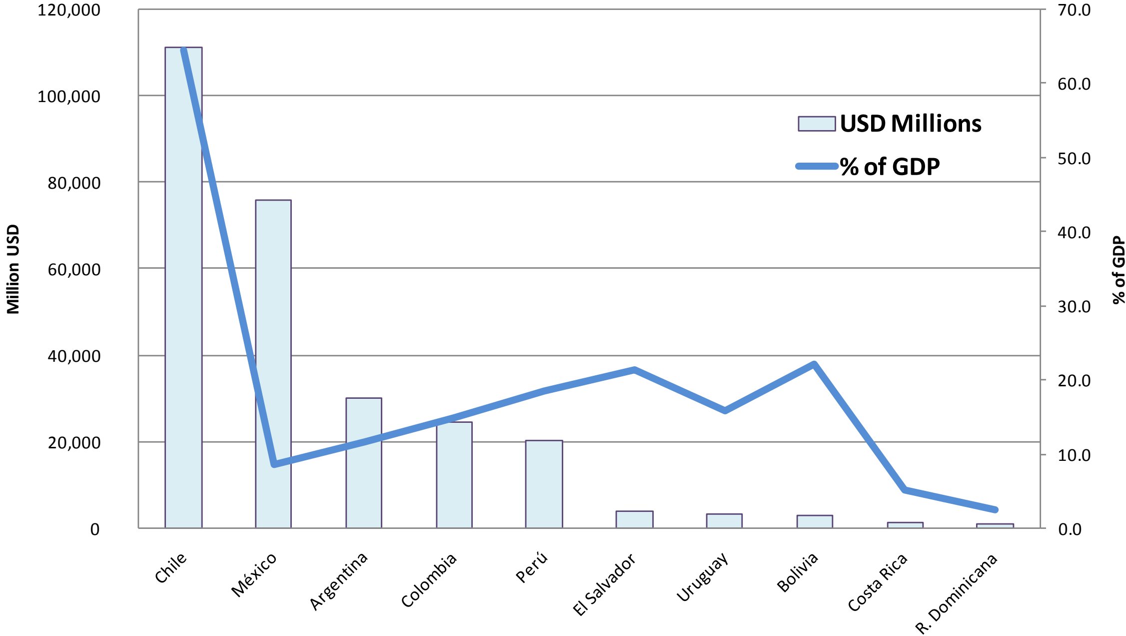
Introduction

Since the reforms of pension fund systems in the region, institutional investors, particularly pension funds managers, have played a growing role in the capital market. Chart 1 shows the total amount of pension funds invested in US dollars and its proportion of GDP.

Chart 1 Pension funds' investments (in million USD) as of December 2007



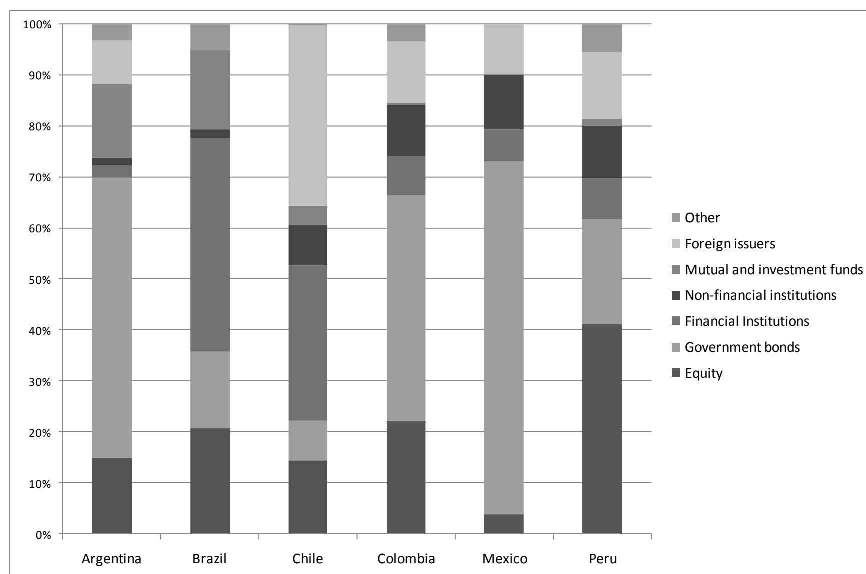
Source: AIOS

Among Latin American market agents and regulators, there is an increasing emphasis on the need for institutional shareholders to play an active role in the governance of companies. This view is based on the premise that because of their very size, they have the ability to influence the actions of companies. To adopt a proactive monitoring role, it is necessary that the institutions view themselves as an owner of corporations, rather than viewing equity shares as a short-term investment vehicle. From this viewpoint, institutional investors, in their role as major shareholders, are expected to take a long-term view of their shareholding position, and, where necessary, incur expenses in intervening to correct mismanagement.

There are strong public policy grounds for demanding that pension funds bear the private costs of monitoring and influencing corporate governance of the companies in which they invest, even though other, smaller investors will "free ride" on the actions that they take. Firstly, the system manages compulsory saving; therefore the social role of pension fund managers should be stronger. Secondly, to the extent good corporate governance renders positive benefits to shareholders, managers acting on behalf of their beneficial owners affiliated with the pension fund should be active in fostering good

corporate governance practices. Thirdly, once pension funds are invested in a corporation, due to their own size and the illiquidity of the secondary market[1], in fact they have little choice but to rest locked into companies, so that they have a longer-term interest to improve corporate governance. Fourthly, the regulation allows a limited (but growing) percentage of the portfolio to be allocated abroad[2], so most of the assets are invested locally, exacerbating the illiquidity problem described above. The next chart shows the portfolio composition of pension funds in the region.

Chart 2 Portfolio Composition of PFAs (2007)*[a]*



Source: AIOS

Insofar as pension funds cannot divest their investment from domestic corporations without high transaction costs, related to time and pricing, it would be clear that the long-term performance of local companies is of paramount importance to them. From this perspective the role of institutional investors to improve corporate governance in the region is very crucial.

In contrast, in more developed markets with higher liquidity, pension funds are indeed investors that are able to go in and come out the market without affecting prices and with lower transaction costs. Under these circumstances they may more easily allocate their money to the most profitable investments. If a corporation is mismanaged, institutional investors have the opportunity to sell their shares at market price.

A key question to address in promoting a more active role for shareholders is, what incentives should institutional investors have to bear a private cost of a public good? In practical terms, the system has

[1] Despite the high rate of market capitalisation in Chile, the equity turnover in one year is around 25%. This means that the liquidity of the market is relatively low. Therefore, big institutional investors like pension funds, are able to affect the assets prices.
[2] In Chile, this percentage is 45% as of 1 October 2008 and will be raised to 60% in 2009 %. In other Latin American countries it is still lower.

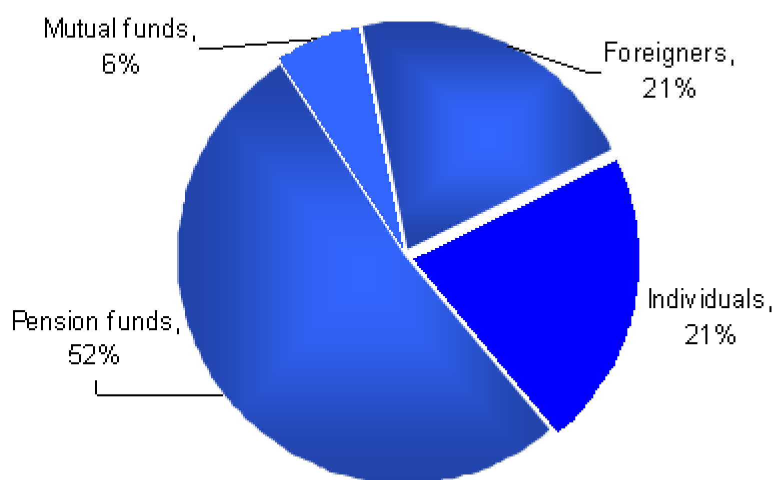
been thought to operate under a competitive market, in such a way that best performers should be able to attract more affiliates doing more profitable business. From this point of view, corporate governance should be another variable to compete. In addition, the political oversight of pension fund managers is very strict, to the extent that AFP's are in charge of managing compulsory long term savings they are under severe social control and they have to advocate on behalf on the interest of affiliates.

Additional Information (updated as of November 2008)

Institutional Investors

As mentioned in this paper, the Chilean capital market is characterised by the prominence of pension funds as the largest institutional investors followed by foreign investors and mutual funds.

Chart3 Santiago Stock Exchange trading volume breakdown by participants
2007 (total 200 million USD)



Source: Deutsche Bank, SVS, Chilean Central Bank and Bloomberg

Chile has a mandatory contribution scheme. Pension fund managers (AFPs under their Spanish acronym) have been allowed to invest in equities since 1985. As of April 2008, Chile's five AFPs hold more than USD 121 billion in assets, approximately 74% of 2007 GDP.[3] AFPs currently have USD 18.2 billion in local equity, representing 8.5% of the total Santiago Stock Exchange capitalisation. While this percentage may appear relatively small, pension funds' influence is enhanced by the existence of cumulative voting provisions applying to minority shareholders, and the practice among pension funds and other institutional investors to co-ordinate their votes to elect "independent directors" (defined as directors elected by minority shareholder votes). These directors play an important role within Chile's

[3] Chilean Ministry of Finance.

"Directors' Committees," with responsibilities similar to an audit committee in making recommendations to the Board on related party transactions, appointment of auditors, etc.

Mutual funds and insurance companies had about USD29 billion each in assets under management, but almost entirely invested in fixed income instruments. In other words, among the key institutional investor groups involved in the market, pension funds are clearly the dominant players. However, as indicated above, pension funds face limited liquidity in the Chilean domestic market, constraining the choice of actively traded stocks in which they can invest. Thus, they have an interest in exercising voice rather than exit, and tend to invest in and hold stocks.

This problem has started to ease with pension law reforms that have relaxed limits on how much these pension funds can invest in equities overseas. Restrictions of investment by AFPs outside Chile have been gradually lifted, from 6-12% in 1999 to 45% in October 2008. With the new pension law reform enacted in 2007, this proportion is due to reach 60% in August 2009. Recent reforms also gave contributors a wider spectrum of choices, each fund corresponding to a different degree of risk (there are currently 5 risk-differentiated funds with proportions devoted to foreign equity ranging from up to 10 percent to as high as 80 percent).

This has had implications for corporate governance, as higher concentrations of equity investments allow for greater voting power. AFPs are allowed to invest up to 37% of their overall portfolios in shares and have a ceiling of 7% of any individual issuer's equity. While such limits significantly constrain pension funds' potential impact on governance by eliminating the possibility of becoming controlling shareholders, pension funds are permitted to co-ordinate their votes and to use cumulative voting in order to attain the 12.5% of votes necessary to elect a director.

Many commentators have highlighted the benefits of pension fund administrators on local corporate governance. These pension funds have significant shares in most of the most actively traded Chilean companies, holding equity in 113 companies in early 2007, with their votes serving to appoint 42 "independent directors," or 13% of directors overall. AFPs are now self-regulating their votes for directors in firms where they hold equity. Pension fund administrators are prohibited from voting for a candidate related to the controlling shareholder, and must disclose their voting intentions and proposed candidate(s).

With the Pension Fund Reform of 2007, AFPs can only vote for independent directors and must propose directors from a register held at the Superintendency of Pensions. The 2007 reforms also instituted a number of governance reforms for the pension funds themselves, an important step in view of the potential for conflicts of interest involving banks and other economic groups who are listed among Chile's main shareholders of pension funds. Thus, Chile's five pension funds are now required to report on how they address conflicts of interest related to their private ownership and administration. Further reforms require the appointment of a minimum number of two independent directors to pension fund boards, and the establishment of a Directors' Committee to review investments and conflicts of interest that must include among its members all of its independent directors, similar to the Directors' Committee structure in place for large, listed companies.

Proposed Corporate Governance reforms being discussed in Congress:

Chile's Congress is currently giving serious consideration to a significant series of corporate governance reforms.

These are aimed at improving:

- disclosure of information to the market and combating the use of insider information;
- the conditions and qualifications that independent directors must possess, to be related mainly to economic criteria rather than the current definition which depends on who elects the director;
- the composition and responsibilities of directors' (audit) committees, to ensure that independent directors maintain voting control at director committee level;
- regulation of related-party transactions, and conflicts of interest;
- stricter requirements for external auditors according to international standards.

Participants in the Roundtable

Alberto Etchegaray, (former) Chairman Securities and Insurances Commission[4]
Solange Bernstein, Chairman Pension Fund Superintendence.
José Antonio Martínez, CEO Santiago Stock Exchange.
Jaime De la Barra, President Investment Fund Association
Jorge Claude, CEO Insurance Association.
Valentín Carril, CEO Principal Mutual Funds.
Alberto Alcalde, Mutual Funds Association Representative.
Rodrigo Ravilet, Banchile Investment Funds.
Cristian Rodríguez Allendes, CFO Habitat Pension Fund Manager
Eric Conrads Dehousse, CFO ING Pension Fund Manager
Juan Ignacio Guiresse, CFO Cuprum Pension Fund Manager
Sra. Patricia Yotsumoto, CFO Planvital Pension Fund Manager.
Alejandro Charme, Head Legal Department Pension Fund Superintendence.

Moderator: Álvaro Clarke

Task Force Objectives

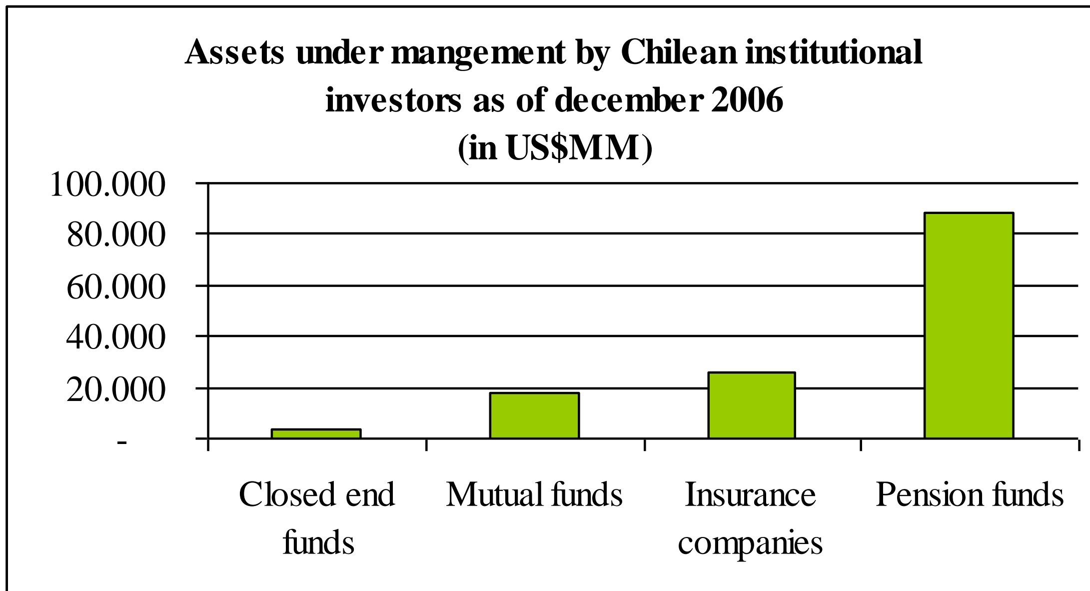
The main objective of the Task Force was to consider diverse opinions from institutional investor representatives of the Chilean market, whose experience in the system and knowledge on public policies could enrich the debate on the role of institutional investors in improving corporate governance in listed companies.

The participants are active leaders from the public and private sectors: regulators, pension funds, insurances companies, closed end investment funds, open ended (mutual) investment funds, and the stock exchange.

This effort is aimed at developing an agenda with relevant topics to be debated throughout the region in the framework of the Latin American Corporate Governance Roundtable, organised by the OECD in co-operation with the World Bank Group and Latin American co-sponsors.

[4] Mr Etchegaray stepped down as SVS Chair two weeks after the meeting.

Chart 3



Source: Superintendencia de Valores y Seguros and Superintendencia de AFP

Table 1

Closed End Investment Funds	3.540
Open Ended (Mutual) Investment Funds	18.226
Insurances Companies	25.543
Pension Funds	88.070

Selected Questions

From the questions proposed to be discussed, three questions were selected:

1. Risks or problems of corporate governance existing at the local market in the institutional investors and invested corporations.

2. The role of Institutional Investors in promoting good corporate governance practices.
    a. Are Institutional Investors in positions to influence or promote good corporate governance practices in the invested corporations?
    b. How do institutional Investors promote good corporate governance practices?

c. What further actions should Institutional Investors follow to promote good corporate governance practices?

3. Measures proposed to improve the contribution of institutional investors to improving corporate governance practice in Chile.

Principal Issues Mentioned

Independent Directors

In relation to independent directors, some attendees observed a problem in the definition of "independence" in the Chilean regulation. In accordance with the law an independent director is a member of the board that has not been elected with the decisive votes of the controlling shareholder, which implies that the concept is built in relation to the controlling shareholder and not in relation to the issuer.

These participants remarked the necessity of extending the concept to the relation with the issuer following the line traced by the U.S. Sarbanes-Oxley (SOX) legislation. This implies to establish additional provisions with respect to the issuer, for example, not to have any commercial relation with the issuer in the last five years, not to have been a worker or former executive of the issuer, etc.

Professional Directors

There was a perception of a need to strengthen attention devoted to having professional directors specialised in effective functioning of the board and with capacity to devote enough time to the board responsibilities. There exists a certain level of criticism of those directors that are appointed to an exaggerated number of board chairs.

Development of polices to select director candidates to be elected in the boards.

Institutional investors, particularly pension fund managers, are able to elect directors in most of the publicly traded corporations. This capacity is reflected empirically, for example, in the election of two out of seven directors in a specific issuer[5]. Moreover, those directors are considered independent in accordance with the law and must also be part of the Directors Committee (auditing committee), which is in charge of overseeing related parties transactions, auditor and rating agencies appointments, and executive compensation schemes, among other things. Once elected, the directors should represent the company independently, in other words all shareholders, rather than either the pension funds or controller groups that elected them.

Most of the corporations in Chile are controlled with a high proportion of the equity stake, around 60% to 70%. Therefore, the role of institutional investors as part of the minority shareholders, indeed the

[5] Given that most of boards in Chile are integrated by 7 to 9 members, a 30% minority stockholdings is enough to elect 2 or 3 directors.

most sophisticated of them, is quite relevant. To the extent that they are active they also produce positive externalities for all of the market.

From this point of view, the development of policies related to election of directors to the board is quite important. In this regard, pension funds have some valuable experiences to contribute:

- Rotation of directors after six years of being appointed. This initiative has been backed by Provida and Habitat, the largest pension fund managers in Chile. The objective is to preserve the independence of directors.

- Selection of directors by a professional entity. Provida, Habitat and Santa María hired Egon Zender International, a headhunter firm, to propose director candidates supported by pension funds to be presented before shareholders meetings.

- AFP Cuprum, the third largest pension fund manager, recently released a document “Buen gobierno corporativo es buen negocio para todos”. This document is a complete guide to good corporate governance practice. Topics cover different issues such as board composition and representation, role of the chairman, election of board members, rotation of board members, conflict of interest, role of directors committees, information disclosure, and executive compensation, shareholder protection before mergers and acquisitions, and social responsibilities, among other things. This document is actually a practice-by–practice code in order to guide investment decisions and the role of the AFP in the shareholders meetings.

How to evaluate director performance

Institutional investors would like to have an assessment of the directors elected for them in a corporation. Nevertheless this seems to be very complex. It is hard to find explicit variables to measure director performance. For example, board minutes are not explicit in reproducing the differences in opinion of the board members; usually these reflect just the agreement taken rather than the debate that occurred. It is difficult to get an objective evaluation of performance.

Shareholder activism

Currently, in Chile there is a lack of formal quantitative research to demonstrate the actual effect or added value of good corporate governance on issuers. To carry out these kinds of measuring could help to create an effective incentive for corporations to incorporate better corporate governance standards. However, the empirical difficulties to cast and compute the appropriate variables make it difficult to produce authoritative studies.

Relevant studies are based on surveys (McKinsey-Icare) or present some problems in the specification of the model and quantifying of variables, for example, multicolineality.

Role of Rating Agencies

Rating Agencies have been including corporate governance assessment as part of the risk assessment of issuers. This trend is just beginning and there is no explicit result up to now. Issuers are reluctant to pay for this extra service without being totally convinced of its usefulness; neither are institutional investors asking for this kind of rating.

Foreign Minority Investors

The process of gathering information about candidates for directors, especially to differentiate those supported by the controlling shareholder in relation to those supported by minority investors, could be facilitated. It would be very useful, for example, to inform before the voting in the shareholders meeting, which candidates are independent in accordance with the law. If by regulatory mechanisms this information could be formally released, it should help foreign investors to determine how to vote and to create a wider base of active minority shareholders.

Regulation vs. Self-regulation

The improvement of corporate governance standards can be done through changes in the formal regulatory system (legal infrastructure) or by means of a self -regulatory model. Both approaches also can be combined. Then a country can choose which corporate governance principles are applied via the regulatory framework and which are more suitably encouraged through a self-regulatory approach.

In Chile, most of the progress in corporate governance standards has been achieved through changes in the law, which is the regulatory approach. Some advantages of this model are:

- The corporate culture in a Continental Europe legal environment. That is the case of Chile, where economic agents are used to operating under a written regulatory framework.
- The jurisdiction signs the corporate governance standard rather than any firm in particular. Therefore investors' interests rely on the legal and regulatory system.
- The capacity of enforcement depends on the regulatory body.
- It is more transparent for foreign investors. They are protected by the jurisdiction and the supervisor. Besides, a legal framework is more stable.

However, some countries have adopted a self-regulatory approach based on a code of good practices of corporate governance. A typical model is the so-called comply or explain code. For example, Colombia is implementing a "country code", supported by the main entrepreneurial associations. Some pros and cons of this model are:

- It easy to implement; there is no need to go through the Congress to debate a bill that takes time in being approved,
- The initiative is perceived as private sector-driven and therefore companies may be more receptive to it;

- Clearly the most important difficulty to succeed in this process is the capacity to enforce the code.

In order to advance in setting a higher standard for corporate governance, the attendees were asked about which would be the better way: regulation or self-regulation.

In general, the Task Force recognises that Chile has made important progress in implementing a modern corporate governance regulatory framework and this has added value to the corporations and the economy. Also the legal value of the regulation has been positively recognised by investors inside and outside Chile. In the perception of the attendees it is the most reliable legal framework in the region. Nevertheless, for future developments, they lean more towards a self-regulatory[6] approach or an incentive-based model such as the "Novo Mercado".

In this regard, the two models were discussed. The first model discussed was the implementation of a "code of corporate governance and best practices", focused on complementing the regulatory framework, containing principles and practices, and backed by the major business associations and authorities. Two problems were pointed out: the capacity to enforce the code and the risk of the code ending up as a law.

The second model discussed was a "Prime Market" in the legal framework similar to the "Novo Mercado, meaning that there should be freedom for a corporation to choose whether it lists its shares in the more sophisticated market or remains under the current system.. The major advantage is the voluntary listing, meaning that corporations believing that the this segment add value would be leaning to participate

Corporate Governance for Pension Funds Managers (AFPs)

From the government point of view, the most important recent policy development was the bill to reform the pension system in Chile. In the section "higher flexibility and responsibility in the investment funds", many new initiatives have come out in the direction of liberalizing the investment statute of Pension Funds and increasing the corporate governance requirements for Pension Fund Managers (AFPs).

The regulatory model for pension funds is founded on an investment statute that aims to restrict the level of risk taken by pension fund managers. The underlying idea is to maximise returns subject to a level of risk given by this statute. Actually, the current regulatory framework for pension funds investment is extremely intricate and complex and has been based on a very large number of investment limits and combinations of them. Furthermore there exists a requirement of minimum return that has induced pension funds to choose similar portfolios[7]. These measures have meant that pension funds have diminished their freedom to allocate resources and, to the same extent, their responsibilities for the outcomes. In accordance with formal research, these restrictions also have resulted in lower returns for pension funds.

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[6] Normally the private sector prefers self-regulation

[7] This is the so called "manada" effect.

Taking into account the impact of higher returns of investment on final pension levels, in accordance with assessment, a percentage point of difference in yield throughout the active life of an affiliate's investments can have an impact of around 20% on the pension, the bill proposed, to increase the degrees of freedom to allocate resources by pension fund managers, a more flexible investment statute; a higher accountability of the of the top executives and board of AFP's; and more corporate governance requirements.

Concerning this last point, the bill proposed to:

- Increase AFPs board directors' responsibilities in the definition of investment policies.
    - Eligibility of instruments and issuers
    - Diversification policies
    - Definition of risk levels to be taken by pension funds
    - Disclosure of investment policies
- Compulsory investment committees.
    - To implement the investment policies defined by the AFPs board of directors;
    - To resolve disputes between pension fund affiliates and AFP shareholders and strengthen the regulation of conflict of interest.
    - To define criteria and select candidates to serve on corporation boards in which pension funds have invested.