



Governance of and by Institutional Investors

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The need for good corporate governance

- High-profile defaults and episodes of corporate malpractice have exposed conflicts of interest and other governance problems involving financial institutions and their clients
- Poor governance increases financial market risks
- Awareness of the risks has led to wider acceptance of the need for autonomy of the audit function, appropriate procedures for determining who sits on boards of directors and committees, and the importance of the monitoring role of banks and shareholders
- Managerial capitalism works best when the monitoring function is performed with due diligence

Systems of corporate ownership in OECD countries

The potential for conflicts of interest between owners and managers arises in both types of systems in the OECD area.

“insider systems”

- Ownership concentrated among identifiable groups of insiders (e.g. family interests, allied industrial concerns, banks & holding companies)
- Often supported by large cross-shareholdings

“outsider systems”

- Ownership dispersed among large numbers of institutional and retail investors

Finding good corporate monitors

- The monitoring function should be the responsibility of all concerned parties, but it is a special concern of shareholders, who may be particularly vulnerable to the principal-agent problems associated with the separation of ownership from control in many large corporations.
- However, shareholders in some jurisdictions have only limited legal rights and in others they have failed to exercise this responsibility.
- Although all investors can benefit from effective monitoring of managerial actions, monitoring is an expensive proposition, and most minority shareholders, who would be expected to be the most independent of management, lack the necessary resources.
- To the extent that active monitoring ensures that corporate managers act in a disciplined way, it benefits not only the monitor, but other investors as well, including any rival institutions.

Institutional investors and corporate governance

- Thus, effective governance has typically required the presence of large investors or stakeholders that have the leverage to oblige managers to refrain from activities that are not in the best interests of owners and other stakeholders.
- Not surprisingly, the growing dominance of institutional investors as holders of equity has brought with it a sharp focus on their activities as owners and monitors of firms.
- However, while a more active role of institutional investors in governance activities has been widely touted, its efficacy has been the subject of considerable debate.

Institutional investors are delegated monitors

- Indeed, for some institutional investors, performing the monitoring function has not always been so straightforward.
- Institutional investing involves principals (*e.g.* investors or beneficiaries) hiring a first-tier set of agents (*e.g.* fund managers) and asking them to watch a second-tier set of agents (corporate managers).
- The difficulty with this arrangement is that the first-tier set of agents are themselves entities subject to potential conflicts of interest, who need to be monitored and given appropriate incentives.
- For instance, while corporate managements are subject to the disciplinary threat of hostile takeovers, proxy fights, and other corporate control transactions, the managements of many institutional investors are not.

Common Characteristics of Institutional Investors

Long-term savings vehicles

Special Regulatory Regime

Managed professionally

Fiduciary duty to investors supported by

Law and regulation

Market competition

Other Issues

Differing liability for future payments

Tax status

Execution of investment strategy

Investment activities of institutional investors

- Institutional investors operate on the basis of well-defined risk-return criteria.
- However, the specific strategies used may differ considerably across categories of institutions, across regions and countries, owing to differences in the nature of the liabilities and fiduciary mandates, as well as regulatory and tax regimes under which the institutions operate.
- Some institutions are highly risk averse, while others may invest in riskier assets with higher expected returns.
- Some funds are actively managed, while others use passive investment strategies based on indexing.

Institutional investors and the fund management industry

- Some institutional investors carry out these functions in-house.
- More commonly, a share of the funds under management is placed with professional fund managers, who develop asset allocation strategies and make investment decisions on behalf of their institutional investor clients.
- The relationship between the institutional investor and the investment manager depends on the structure of the industry and the nature of the investment mandate.
 - Many pension funds delegate responsibility for fund management
 - Insurance companies are active in fund management
 - Both insurance and pensions make use of CIS vehicles

Incentives for asset managers

The delegation of the management of a portfolio to external fund managers raises principal-agent problems.

To mitigate the consequences of agency problems, institutional investors typically have incorporated various incentive-based features in these contracts, such as:

- offering fund managers only short-term mandates,
- subjecting the manager to frequent performance evaluations, and tying renewals of the mandate and the fund manager's compensation to the manager's relative investment performance
- establishing limits on risk-taking
- and indexing.

Factors influencing institutional investors' incentives to monitor

Country-specific factors

- Legal and regulatory system
- Institutional arrangements

Investor-specific factors

- Size (large holdings, interrelated with investment horizon and investment strategy may lead to more active governance activities)
- Investment horizon (longer term investing favours more active role)
- “Corporate culture” (portfolio mgrs. generally do not show great enthusiasm for active use of governance rights)

General factors

- Active monitoring is expensive and there are “free riders” (i.e. to the extent that active monitoring ensures that corporate managers act in a disciplined way, it benefits not only the monitor, but other investors as well, including any rival institutions).

Institutional investors and corporate governance

Governance *of* institutional investors

- Quantitative limits on share ownership and ownership concentration rules
- Diversification requirements
- Restrictions against exercise of control
- Measures to promote monitoring
- Measures to address conflicts of interest
- Codes of conduct

Governance *by* institutional investors

- Measures to promote monitoring
- Rules or codes on voting
- Restrictions on shareholdings or exercise of control
- Rules regarding board membership
- Disclosure requirements
- Internal guidelines or a commitment to exercise fiduciary responsibilities (e.g. voting) in accordance with published guidelines

Institutional investors and corporate monitoring

- Governance practises in most OECD Member countries are changing
- The importance of producing reasonable returns to non-controlling shareholders is being recognised as a high priority of corporate policy and companies are restructuring.
- investors are demanding that companies respect international standards of disclosure and transparency and institutional investors have begun to more actively assert their rights as owners of corporations and major users of financial infrastructure.
- Corporate governance practises are developing that make it easier for shareholders to obtain necessary information and to influence company management through legal redress.
- The role of boards is being defined more precisely to include effective oversight of management and allied interests for the collective benefit of shareholders and other stakeholders.