Institutional Investors and Corporate Governance

(Room Document N°18, Session 5)

Conference on

PENSION REFORM IN RUSSIA:

From legislation to implementation

Moscow, September 24-26, 2003

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Systems of corporate ownership in OECD countries

"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 number of institutional and retail investors

In both systems the potential arises for conflicts of interest between owners and managers

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
- This 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
- Poor governance increases financial market risks

Finding good corporate monitors (investor activism)

- 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.
- 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, for some institutions, performing the monitoring function has not always been so straightforward.

Dimensions of "activism" (Investing)

"Passive" Investors

- Try to match the returns from a broad average of securities at lowest possible management fee
- Rationale is that it is extremely difficult to *consistently* out-perform the market
- Many major pension funds and insurance companies hold a significant portion of their equity portfolios in an "indexed" form

"Active" Investors

- Attempt to enhance the value of their portfolios by adjusting their holdings in accord with their assessment of corporate valuations and market conditions.
- Rationale is the belief that some securities or market segments may be miss-priced

Dimensions of "activism" (Monitoring)

Active investors

- Investors who *actively* manage their portfolios may actually be quite *passive* when it comes to asserting their rights as owners of corporations and obliging corporate management to act in the interests of investors
- They may be more inclined than other investors to simply sell shares in companies that are seen to under perform rather than incur the costs of engaging in active monitoring (*i.e*. they may be passive monitors).

Passive investors

- Institutions following *passive* (e.g. indexed) strategies are committed to holding onto shares and, thus, in the interests of fulfilling their fiduciary mandates and enhancing the returns on the assets held may be inclined to put pressure on the management of underperforming firms (*i.e*. they may be active as monitors).

Common Characteristics of Institutional Investors

Long-term savings vehicles

- Managed professionally
- Special Regulatory Regime

Fiduciary duty to investors supported by

- Law and regulation
- Market competition

Other Issues

- Differing liability for future payments
- Tax status
- Execution of investment strategy

Approaches to Regulation of Institutional Investors

Directive

- Portfolio allocation guidelines
- Discourage product innovation
- Limit risk taking

Non-Directive

- Prudent man (person)
- Disclosure based
- Allow risk taking

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.

- Many pension funds delegate responsibility for fund management
- Insurance companies are active in fund management
- Both insurance and pensions make use of CIS vehicles

Institutional investors and the fund management industry (cont.)

Types of institutional arrangements for fund managers:

1. fund management or trust departments of banks;
2. separately capitalised fund management firms, which may be affiliates of banks, securities firms, or insurance companies;
3. wholly independent fund management companies; or
4. in-house management departments of large insurance companies and pension funds.

Institutional Investors, fund management and governance

- From a governance/monitoring point of view, institutional investing often involves principals (*e.g*. investors or beneficiaries) hiring a first-tier set of agents (*e.g*. fund managers) 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 watched and given appropriate incentives.
- In this context, it is perhaps not surprising that institutional investors in some countries have been more active (effective?) as monitors compared to other domestic investors and to their counterparts in other countries.

Factors influencing investors' incentives to monitor

Country-specific factors

- Legal and regulatory system
- Institutional arrangement

Investor-specific factors

- Size
- Investment horizon
- "Corporate culture"

General factors

- Active monitoring is expensive and there are "free riders"

Factors influencing corporate governance activities by pension funds

Legal and regulatory environment

- Public sector vs. private funds
- Defined benefit vs. defined contribution
- Existence of statutory rules regarding decisions
- Direct or indirect qualitative controls on the role of pension funds in corporate affairs
- Quantitative limits on share ownership and ownership concentration rules
- Diversification requirements
- Restrictions against exercise of control
- Measures to promote monitoring

Institutional factors

- Use of external fund managers
- Size: large holdings, interrelated with investment horizon and investment strategy also makes for more active governance activities.
- Portfolio diversification: domestic and international
- Passive vs. active investment strategy
- Industry code or "best practise" guidelines
- Internal guidelines or a commitment to exercise fiduciary responsibilities (e.g. voting) in accordance with published guidelines