Fostering and Regulating Institutional Investors

by Stephen A. Lumpkin, OECD

Role and Growth of Institutional Investment

Four categories of "investors" in OECD capital markets

- **Fundamental investors**: traditional long-term investors. Maintain open positions and are typically not leveraged
- **Hedgers**: in the market to limit exposure in funding markets or to off-lay other particular risks
- **Arbitrageurs**: assess the value of financial instruments on a relative, versus absolute, basis. Compare current market values with historic norms to identify opportunities for mean reversions
- **Speculators**: traditional contrarians.

Role and Growth of Institutional Investment

Institutional investors:

- entities that invest savings of individuals and in some cases non-financial corporations in financial markets
- sector basically comprises the non-depository financial institutions, sometimes referred to as the financial "contractual and investment" institutions
- key characteristic is that funds are being managed <u>professionally</u> or <u>institutionally</u>, as distinct from funds retail investors manage on their own behalf

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

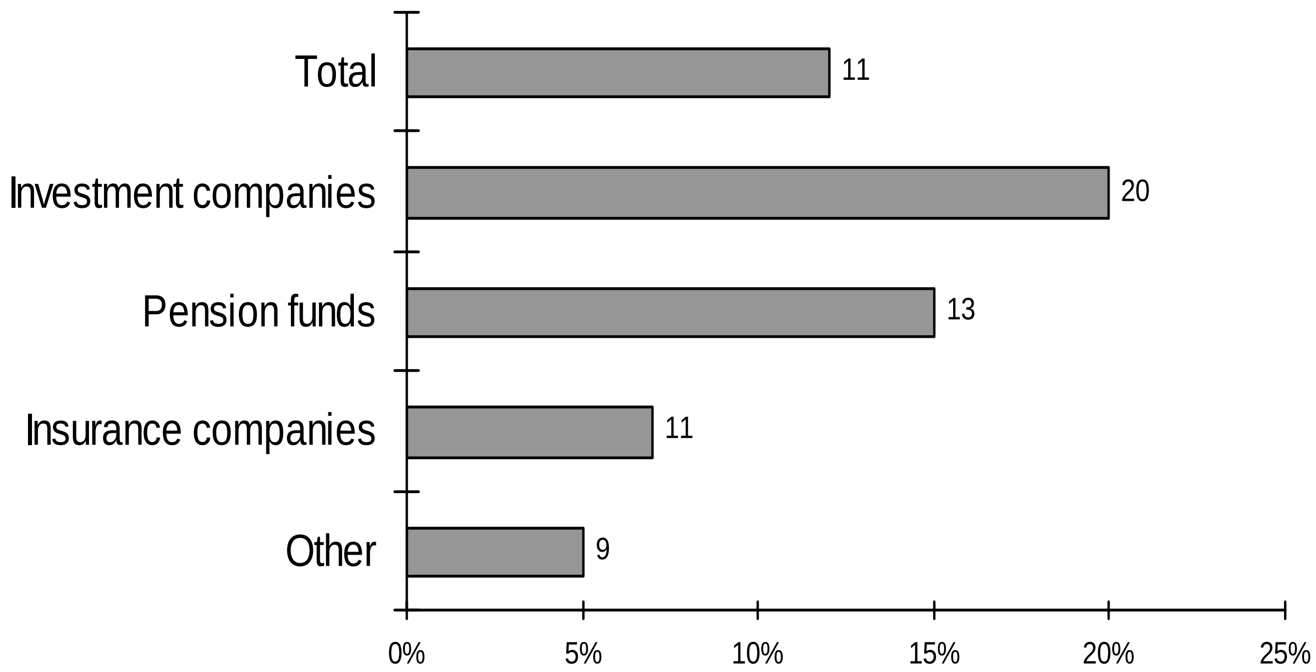
Other Issues

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

Categories of Institutional Investors

Insurance companies (life and non-life)
Pension funds
Collective investment schemes
  Open-end funds
  Closed-end funds
  Other
Endowment funds
Foundations
Hedge funds
Trusts
Others

Average Annual Growth Rate of Financial Assets (1990 to 1999)



Source: OECD Institutional Investors database

Factors Underlying Growth of Institutional Savings

Shift from bank finance to capital market finance

- Lower cost funding
- Higher return for savers

Need for retirement savings

- Aging populations
- Distrust of public pensions

Competition for retail fund management

Strengthened legislative and regulatory regimes

Policies to promote institutional investors

- To provide increased retirement income for an ageing population, thereby relieving pressures on budgets associated with state-financed pay-as-you-go systems;
- To promote the development of an equity culture
- To make risk capital available to new or smaller enterprises
- To increase the range of choices available to investors and firms
- To develop more efficient financial intermediation and more effective systems of corporate governance

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 strategies of institutional investors

- Institutional investors operate on the basis of well-defined risk-return criteria.
- Some institutions are highly risk averse, while others are free to invest in riskier assets with higher expected returns.
- Myriad investment strategies exist in practise, stretched across numerous asset dimensions: fixed-income versus equity, mature versus emerging market, domestic versus international, etc.
- Some funds are actively managed, while others use passive investment strategies based on indexing to broad market benchmarks.

Investment strategies of institutional investors (cont.)

- The specific strategies used may differ considerably across categories of institutions, across regions and countries.
- These differences are a direct consequence of the differences in the nature of the liabilities and the fiduciary mandates across categories of institutional investors, as well as the regulatory and tax regimes under which the institutions operate.
- Other important factors include the needs and preferences of the end-investors or beneficiaries.

Institutional Investors and the Investment 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 Investment Management Industry (cont.)

Fund managers actively compete for mandates to manage funds from pension plans, foundations, life insurance companies, and others.

Renewal of the mandate and the fund manager's compensation typically has been based on the fund manager's relative investment performance, often compared to benchmark indexes

- Disciplined approach to investment
- Diversified portfolios
- Tailored to needs of the investor

Institutional Investors and Asset Allocation

Equities

- More volatility
- Indexation versus active management
- Investor activism

- Growth
- Value
- Sectoral
- Small capitalisation

Institutional Investors and Asset Allocation (contd.)

Bonds

- Especially important for retirement products
- Match assets and liabilities
- Less volatility
- Higher current income
- Vulnerable to inflation

Institutional Investors and Asset Allocation (cont.)

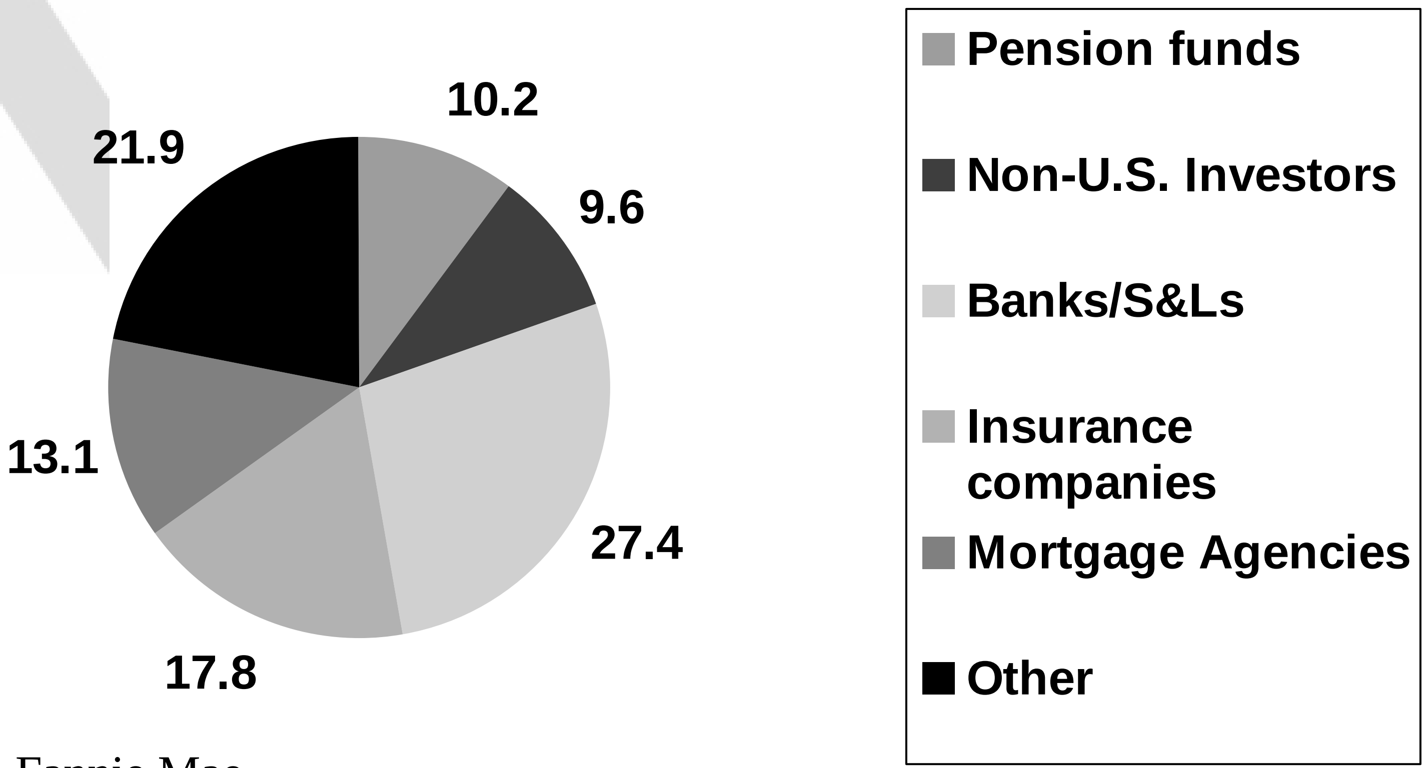
Types of Fixed-Income securities

- Government
- Mortgage bonds / Mortgage-backed securities
- Corporate bonds
- Asset-backed securities
- Inflation indexed

Derivatives

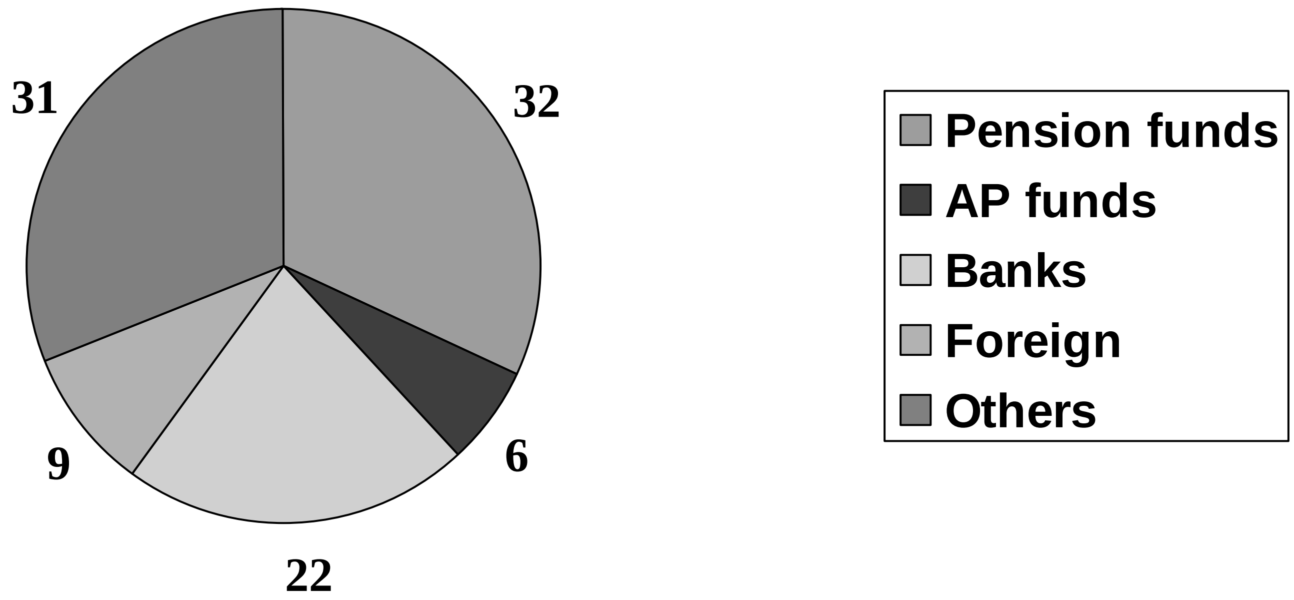
Mortgages and real estate

U.S.-Issued MBS by Investor Type



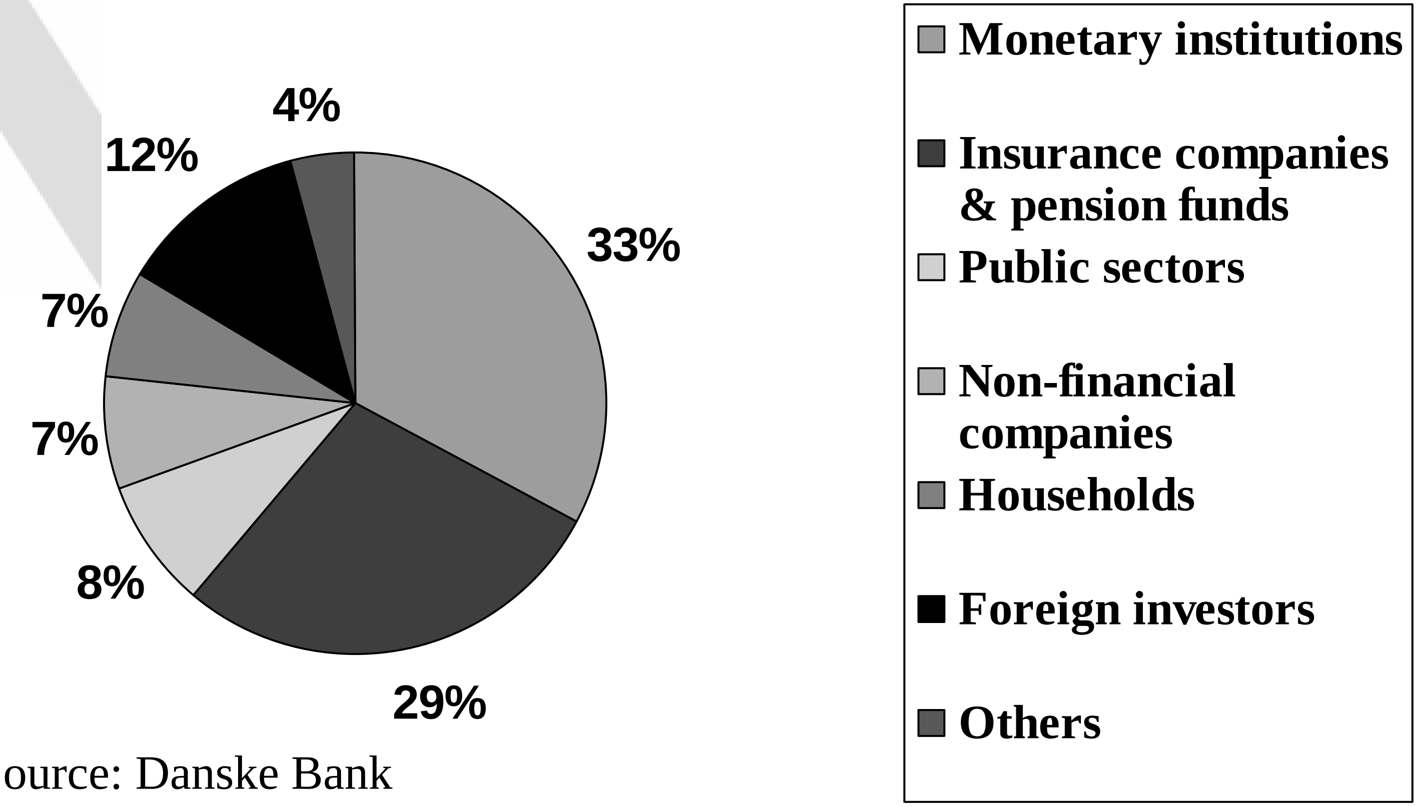
Source: Fannie Mae

Holdings of Swedish Mortgage Bonds (December 2001)



Source: Danske Bank

Investors in Danish Mortgage Bonds (2002:Q2)



Source: Danske Bank

Institutional Investors and Secondary Mortgage Markets

- Mortgages and mortgage-related securities can be attractive alternatives for institutional investors
- Legal and regulatory infrastructure
  - ownership of real property and title registration
  - issuance of enforceable mortgage liens
  - efficient foreclosure provisions
  - tax treatment of cash flows from mortgage borrowers to investors
  - capital treatment of the securities for institutional investors
- In turn, the participation of institutional investors helps to increase the capital available to finance home purchases