

Institutional Investors and Corporate Governance Reform

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Defining Corporate Governance

- # The proper fulfillment of fiduciary responsibility by corporate managers to corporate owners

 - # Firms need not make long-term profitability the sole objective, but:
 - additional objectives and their priority must be transparently stated; and

 - management actions must be honestly and clearly reported
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Implications of Healthy Corporate Governance Practices

- # Places priority on the strength of broader national economy rather than on specific firms
 - # Generates growth through more efficient allocation of domestic capital
 - # Generates growth through incentives for foreign investment
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Prominence of Institutional Investors

- # In the US, own more than 50% of equities in 1999 (6% in 1950) – equities representing 181% of GDP
 - # In Europe, holdings range from 39% in Germany to more than 75% in the UK; and grew by more than 50% in all three in 1990-1995
 - # In Japan, less prominent, but both domestic and foreign institutional investors still very large
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Dual Role of Institutional Investors

- # Fiduciary obligations to beneficiaries
- # As holders of equity, many firms have fiduciary obligations to institutional investors
- # If either set of obligations neglected, serious risk to economy

Weaknesses in some Institutional Investors

- # Public institutional investors often seen as off-budget source of funds
 - # Relationships between some institutional investors and related companies lead to conflicts of interest
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When faced with poor corporate governance practices, institutional investors may:

Sell shares

- (vote with their feet)

Hold shares and demand change

- (express voice)

Hold shares and stay silent

- (express loyalty to management)
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Effectiveness of shareholder activism difficult to measure:

- # A lot can be done without external observation
- # Connection between activism and share value difficult to trace – exposure of problems may lead to “appropriate” decline in share price

Some empirical support for benefits of active institutional investors

- # Davis (2001) found that stronger role of institutional investors in US, UK, Aus and Canada:
 - Boosts dividends
 - Lowers within-firm investment levels
 - Increase overall productivity

Other Research Findings

- # Company performance improves after activist investors buy shares (Bethel, Liebeskind and Opler, 1988)
- # Positive connection between large investors and management turnover (Kang and Shivdasani, 1995)

Conclusions

- # Institutional investors have fiduciary obligation to demand more performance from invested companies
 - # Institutional investors hold considerable potential to demand improved corporate governance practices
 - # By becoming more active, institutional investors can also play important role in generating more dynamic growth and job creation
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