



The Asia Foundation

Institutional Investors and Corporate Governance Reform

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The Future of Corporate Pensions in the United States and Japan

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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

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

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

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

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)

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