INSTITUTIONAL INVESTORS, CORPORATE GOVERNANCE AND THE PERFORMANCE OF THE CORPORATE SECTOR

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Abstract

- Proportions of equity held by institutional investors are rising across all OECD countries. Four paradigms of corporate governance are outlined, of which three involve a key role for institutions. These are characterised as market control via equity (the takeover sanction), market control via debt (LBOs) and direct control via equity (corporate governance activism). Evidence at a micro level for favourable effects of these mechanisms on corporate performance is mixed, but on balance positive.

- Such results have a wider significance given that the countries where institutions are currently unimportant to corporate governance (relationship banking or direct control via debt) are tending to switch to Anglo Saxon approaches, inter alia due to pension reform and EMU.
- As a contribution to the discussion, we present results for effects of institutional holding on corporate sector performance at a macro level. These suggest marked effects, which often differ between “Anglo Saxon” and “relationship banking” countries

Structure

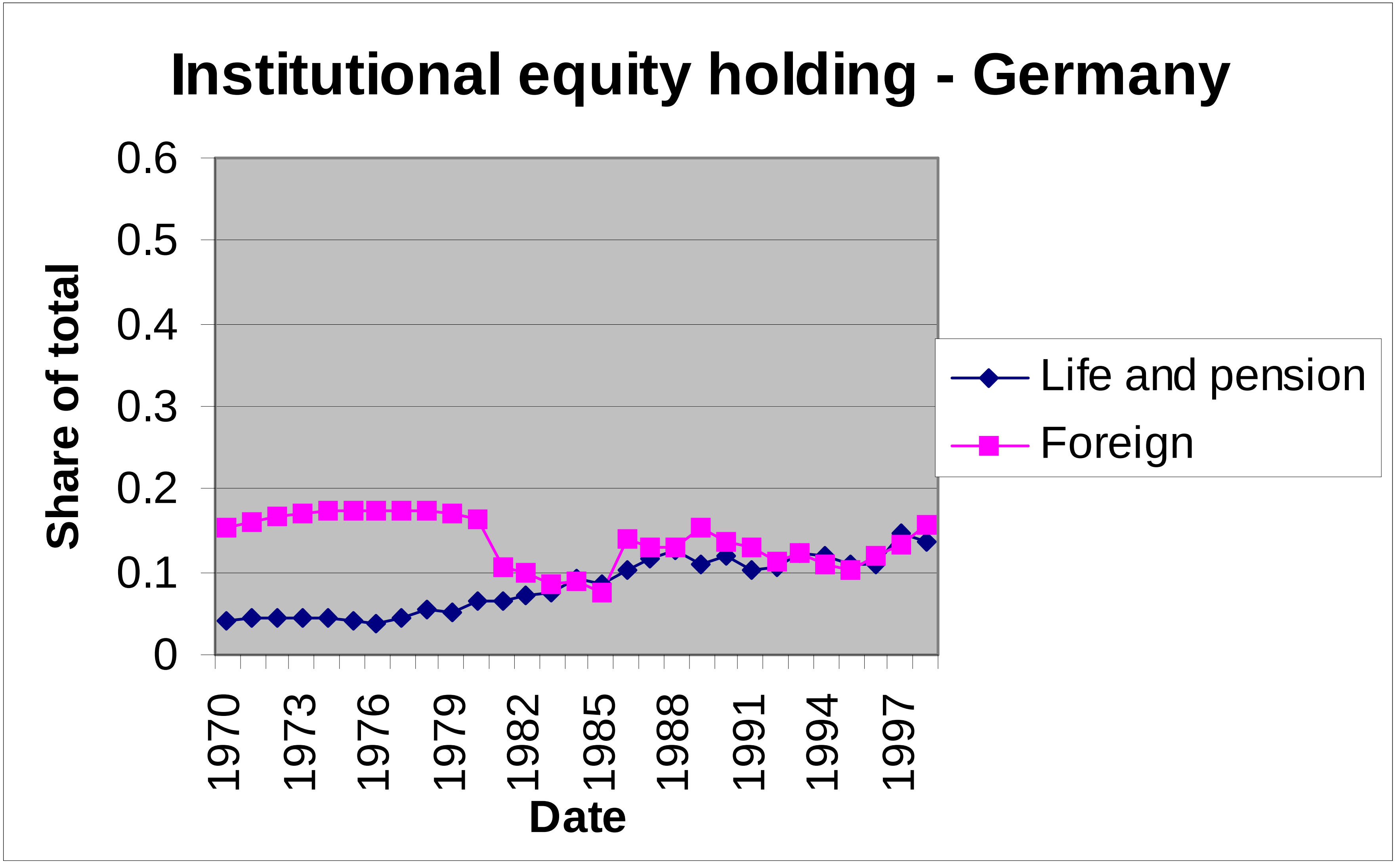
1. **Institutional investors, equity holdings and the growth of securities markets**
2. **Broad themes in corporate governance**
3. **Four Paradigms of Corporate Governance**
4. **Empirical evidence; takeovers, short termism and activism**
5. **Institutional Investors and Bank-Based Systems of Corporate Finance**
6. **Estimation of the effects of institutionalisation on the corporate sector**

1 Institutional investors, equity holdings and growth of securities markets

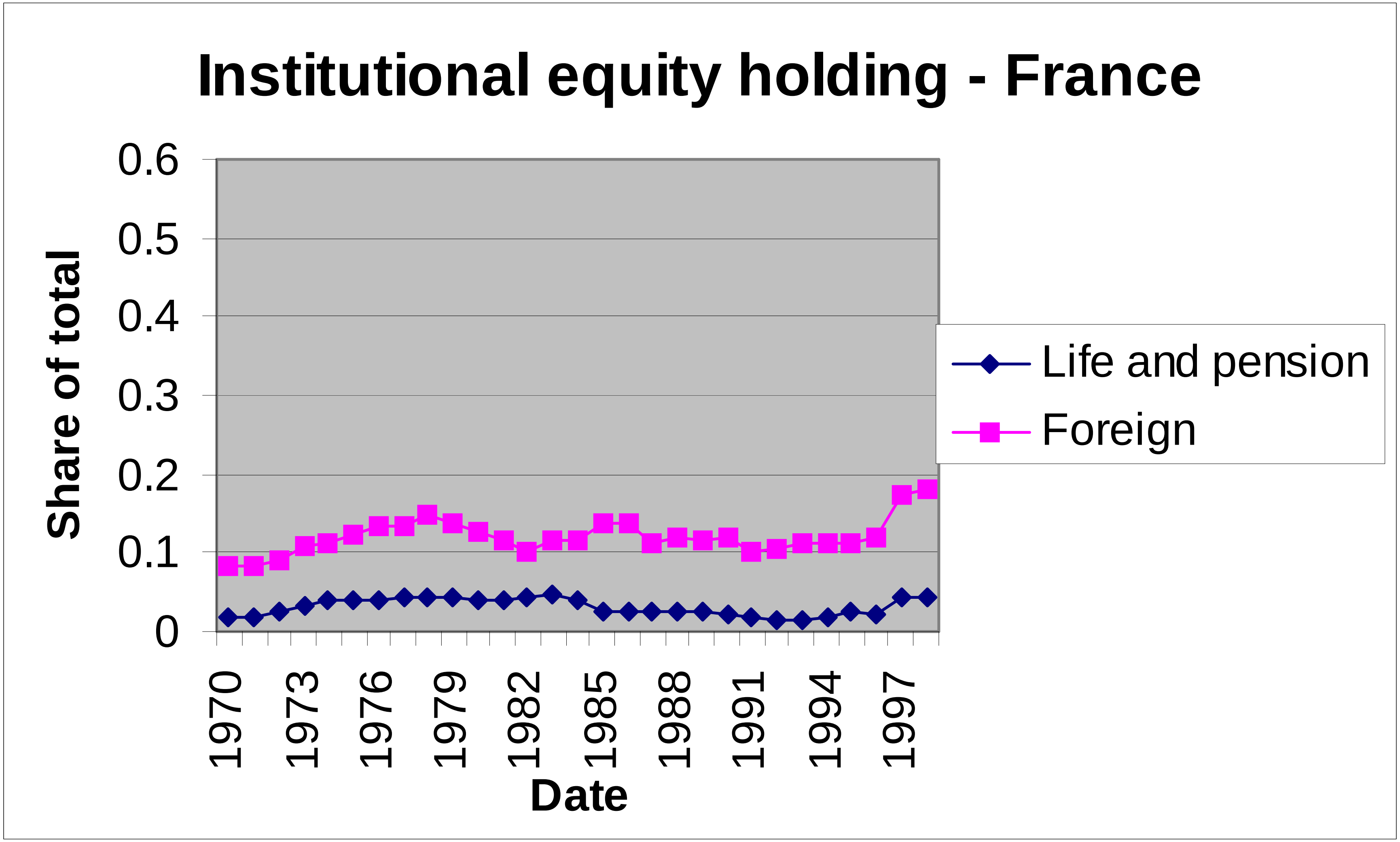
- Rising share of domestic and foreign institutions in equity holdings since 1970
- Reaching high, albeit differing levels across the G-7
- Background is development of institutional investors as holders of corporate liabilities and household assets – prospects for further increases, especially due to demographics
- Impact on corporate governance patterns?

Table 1: Corporate equity holders by sector end-2000 (percent of total)

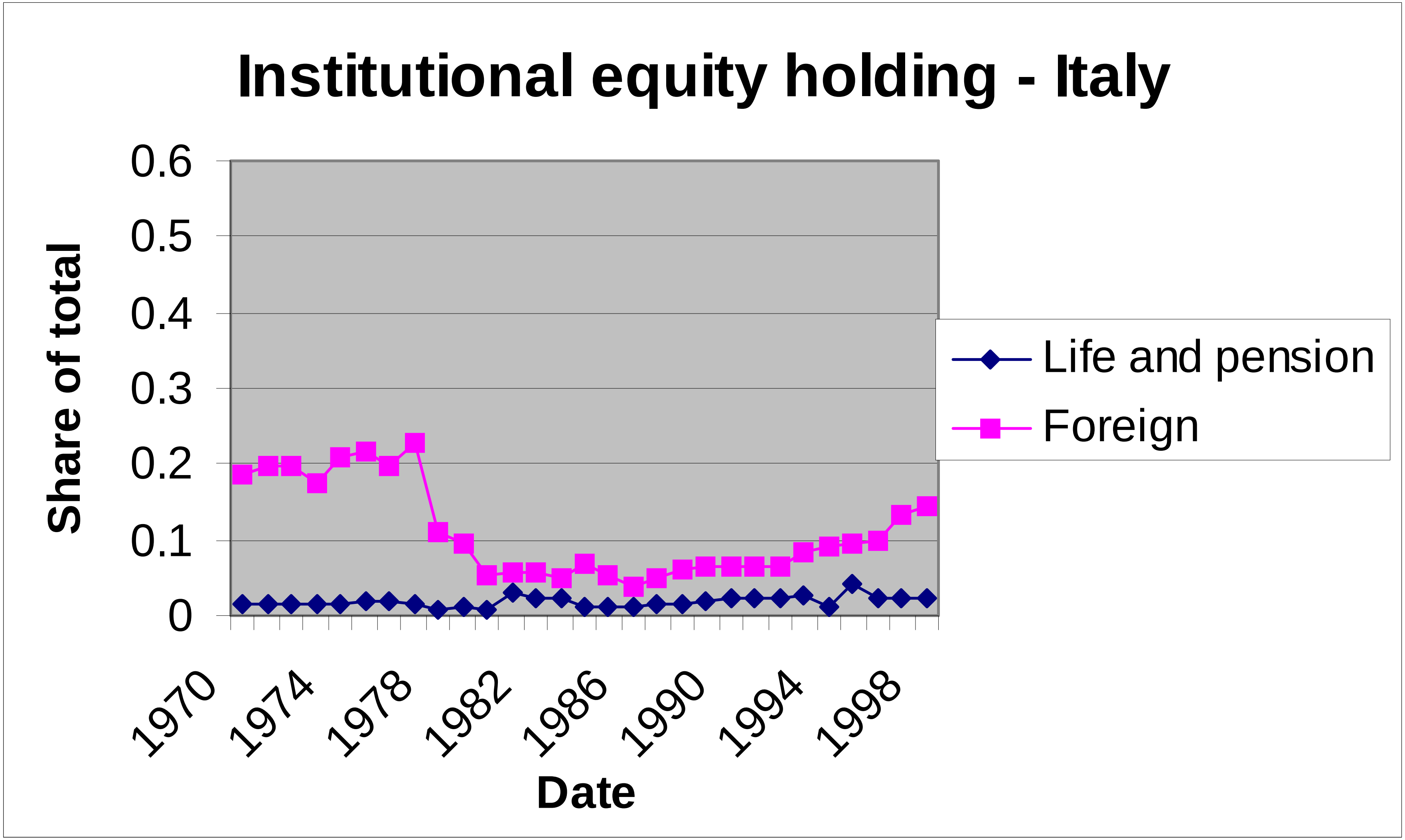
	UK	US	Germany	Japan	Canada	France	Italy
Households	20	35	17	18	41	21	35
Companies	4	14	31	24	25	35	28
Public sector	0	1	3	2	3	3	6
Foreign	37	9	16	18	6	20	14
Financial	39	41	33	38	25	21	17
Banks	2	2	12	12	3	12	8
Life/pension	27	23	8	17	12	4	4
Mutual funds	9	16	13	3	8	5	6



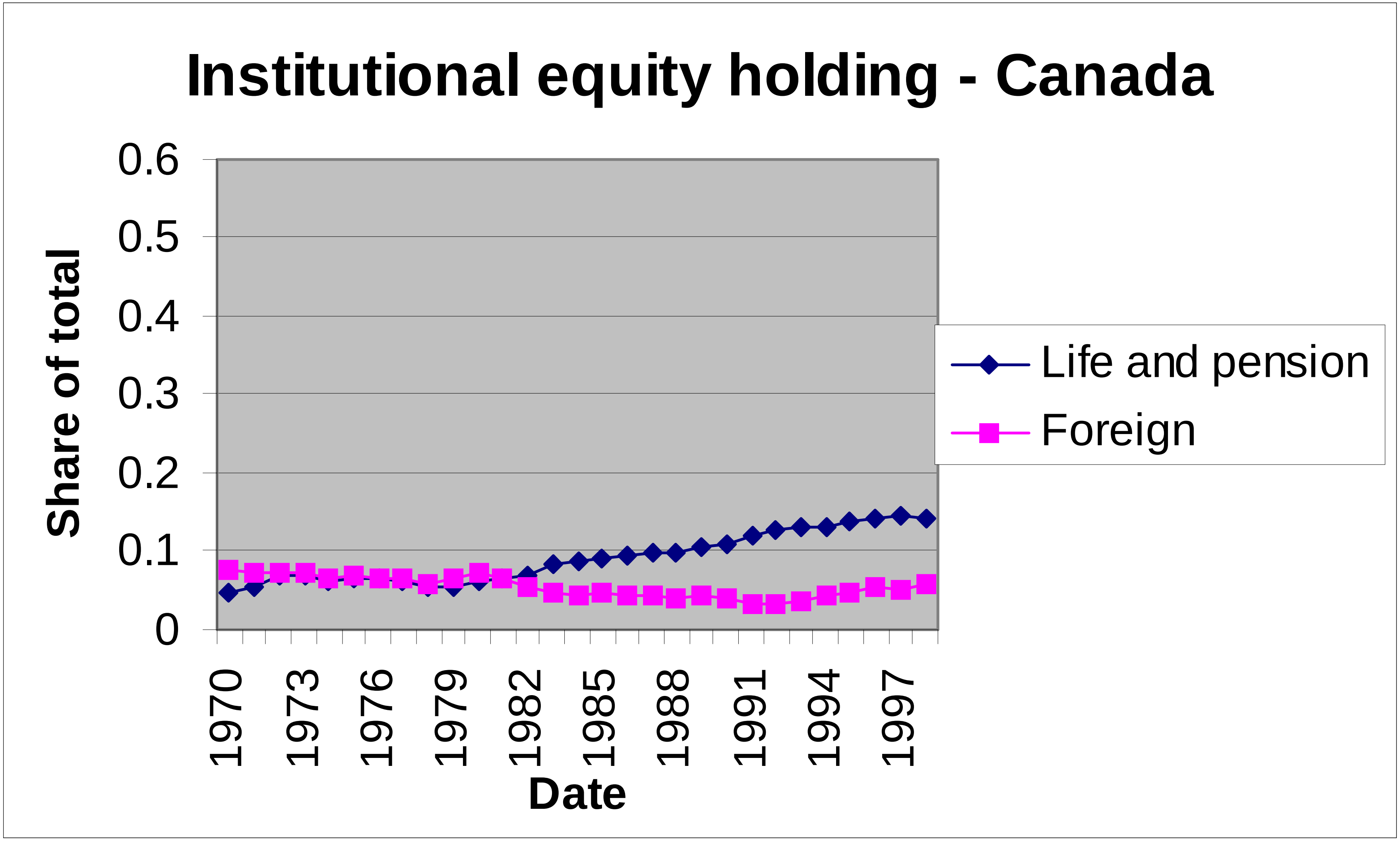
Institutional equity holding - Germany
Share of total
0.6
0.5
0.4
0.3
0.2
0.1
0
1970
1973
1976
1979
1982
1985
1988
1991
1994
1997
Date
Life and pension
Foreign

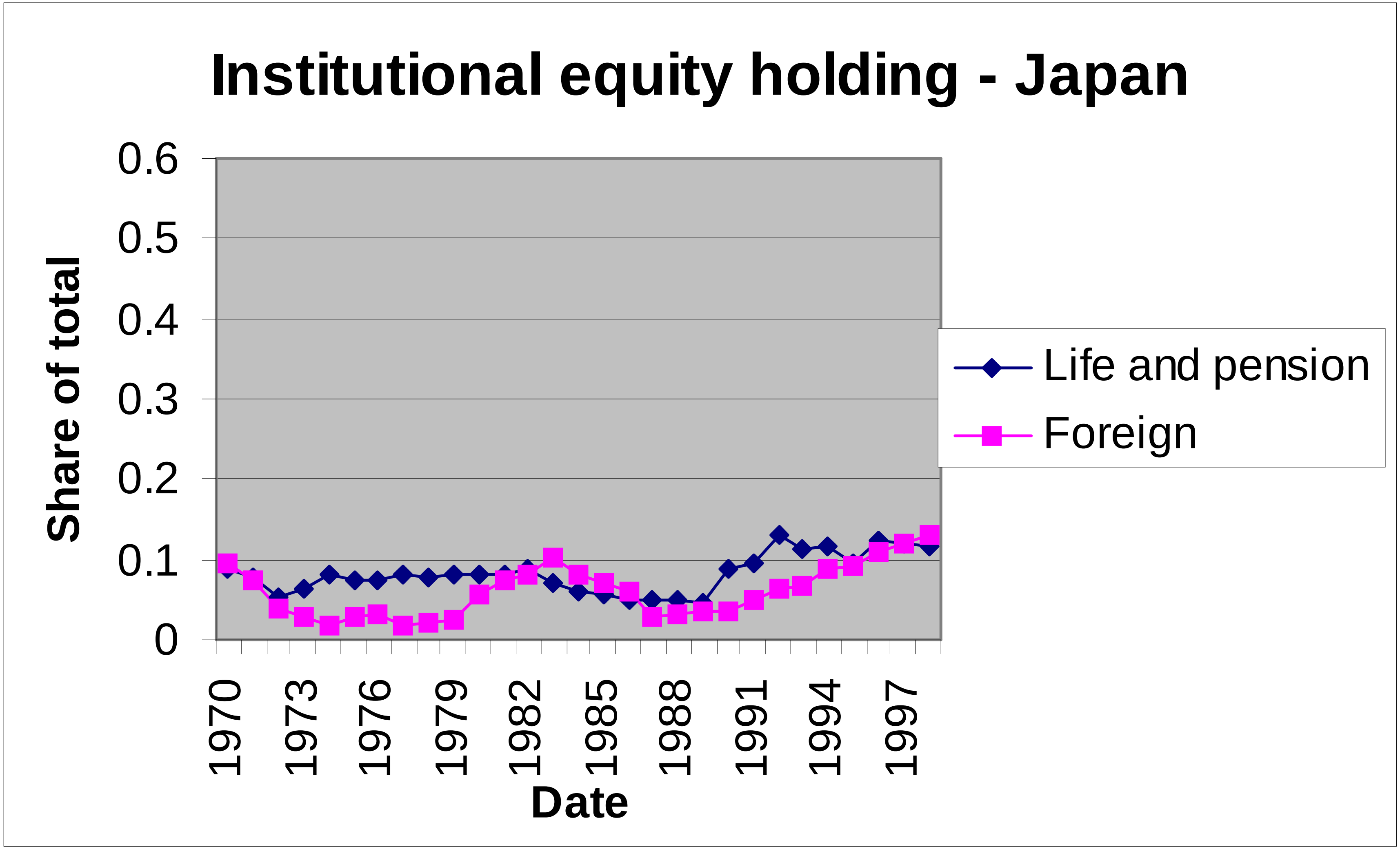


Institutional equity holding - France
Share of total
0.6
0.5
0.4
0.3
0.2
0.1
0
1970
1973
1976
1979
1982
1985
1988
1991
1994
1997
Date
Life and pension
Foreign

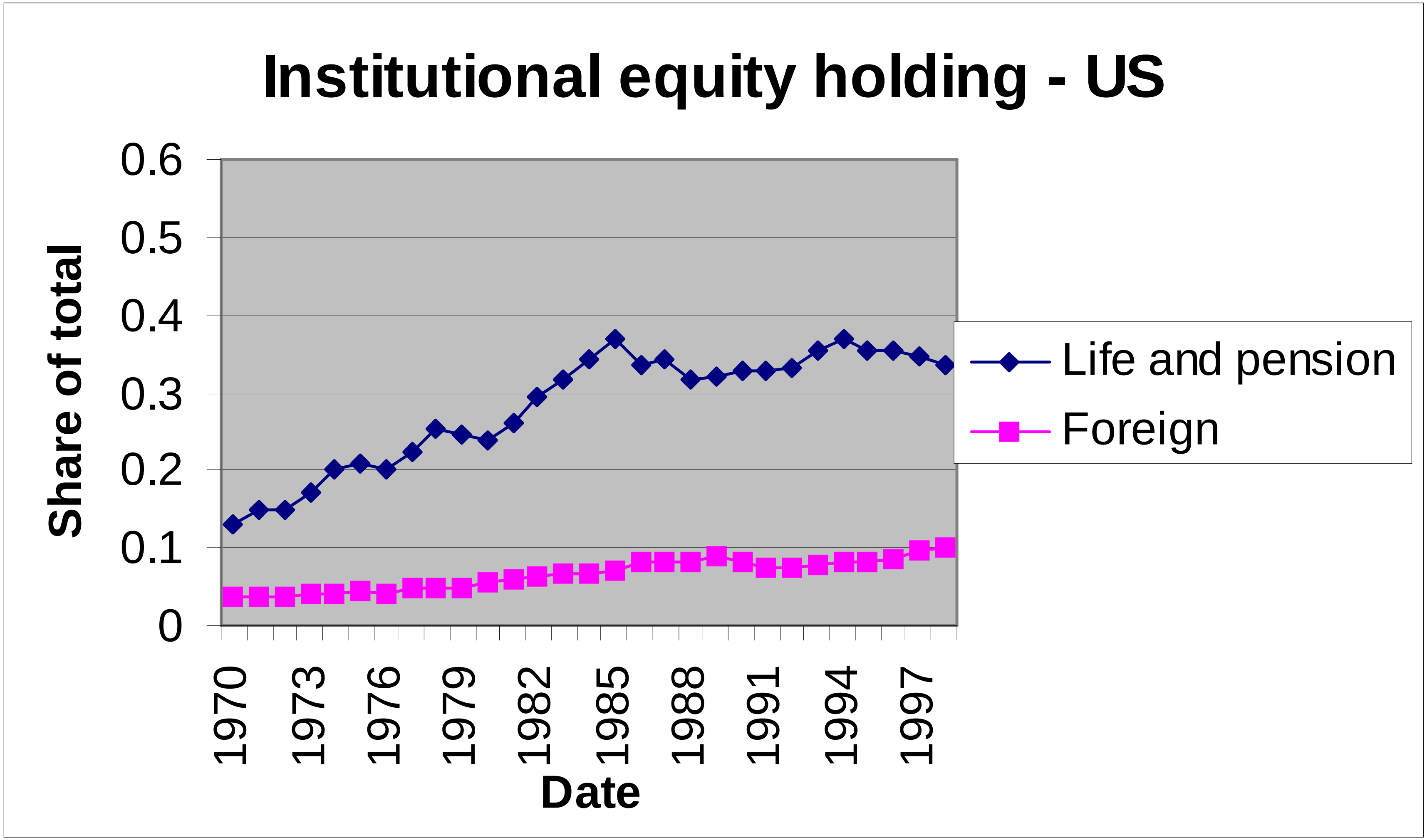


Institutional equity holding - Italy
Share of total
0.6
0.5
0.4
0.3
0.2
0.1
0
1970
1974
1978
1982
1986
1990
1994
1998
Date
Life and pension
Foreign

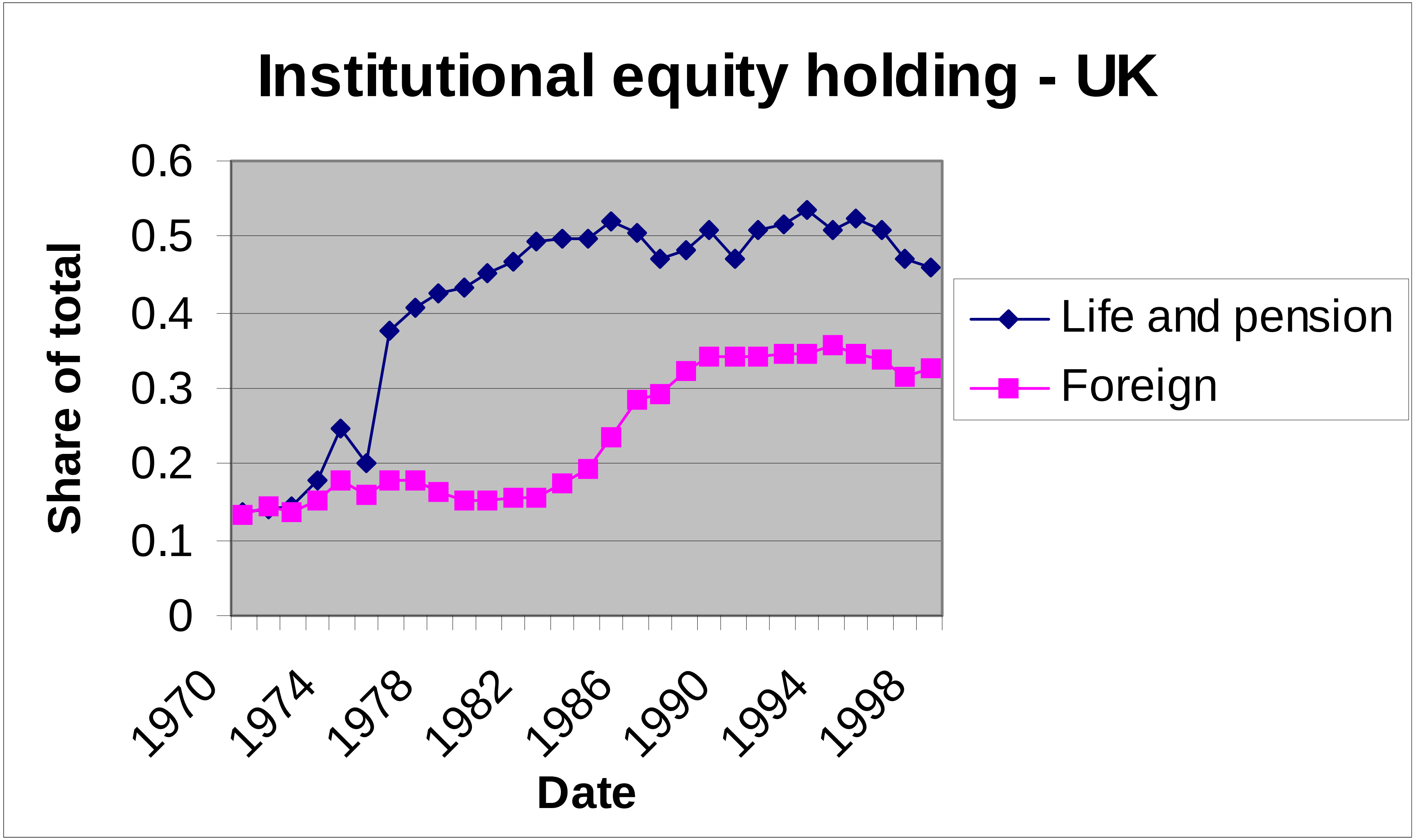

Institutional equity holding - Canada
Share of total
0.6
0.5
0.4
0.3
0.2
0.1
0
1970
1973
1976
1979
1982
1985
1988
1991
1994
1997
Date
Life and pension
Foreign



Institutional equity holding - Japan
Share of total
0.6
0.5
0.4
0.3
0.2
0.1
0
1970
1973
1976
1979
1982
1985
1988
1991
1994
1997
Date
Life and pension
Foreign



Institutional equity holding - US
Share of total
0.6
0.5
0.4
0.3
0.2
0.1
0
1970
1973
1976
1979
1982
1985
1988
1991
1994
1997
Date
Life and pension
Foreign


Institutional equity holding - UK
Share of total
0.6
0.5
0.4
0.3
0.2
0.1
0
1970
1974
1978
1982
1986
1990
1994
1998
Date
Life and pension
Foreign

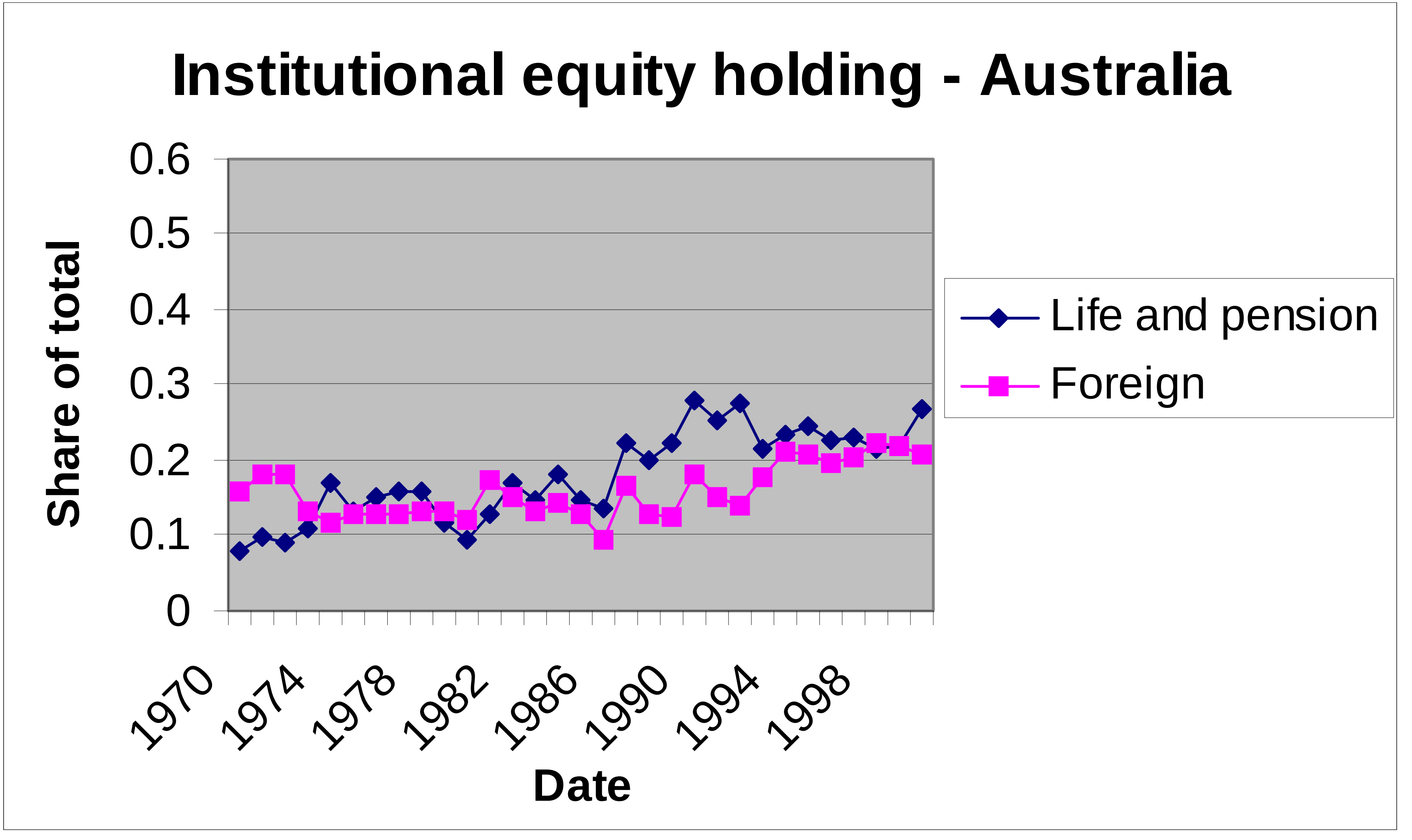

Institutional equity holding - Australia
Share of total
0.6
0.5
0.4
0.3
0.2
0.1
0
1970
1974
1978
1982
1986
1990
1994
1998
Date
Life and pension
Foreign

Table 2: Aspects of financial structure 1998 (1970)

	Size indicator (total financial assets/GDP)	Financial intermediation ratio	Of which: Bank intermediation	Of which: Institutional intermediation
Germany	6.6 (2.9)	47% (44%)	74 (84)	23 (10)
France	9.2 (4.4)	41% (34%)	66 (94)	29 (5)
Italy	5.6 (3.4)	35% (36%)	92 (98)	10 (6)
United Kingdom	10.2 (4.7)	58% (32%)	46 (58)	40 (28)
Canada	7.3 (4.7)	40% (29%)	42 (45)	36 (23)
Japan	8.9 (3.8)	45% (39%)	32 (45)	19 (10)
United States	8.6 (4.1)	44% (33%)	21 (58)	46 (31)

Table 3: Financial instruments as a percent of GDP, 1998 (1970)

	Equities	Bonds	Deposits	Loans
Germany	87 (28)	114 (23)	147 (89)	178 (97)
France	275 (92)	85 (15)	202 (105)	205 (210)
Italy	137 (37)	130 (45)	98 (95)	107 (119)
United Kingdom	235 (83)	99 (37)	158 (47)	175 (66)
Canada	200 (94)	115 (77)	97 (74))	112 (79)
Japan	59 (27)	119 (26)	219 (97)	206 (113)
United States	181 (85)	148 (68)	56 (65)	113 (80)

Table 4: Household sector assets 1998 (1970)

	Equities	Bonds	Deposits	Institutional investment
Germany	9 (10)	13 (8)	40 (59)	32 (15)
France	30 (27)	2 (6)	29 (49)	31 (6)
Italy	30 (11)	18 (19)	23 (45)	10 (8)
United Kingdom	15 (24)	1 (7)	21 (34)	55 (23)
Canada	30 (27)	4 (14)	30 (31)	34 (22)
Japan	4 (12)	2 (6)	60 (55)	28 (14)
United States	23 (36)	6 (13)	13 (28)	50 (22)

Table 5: Corporate sector liabilities, 1998 (1970)

	Equities	**Bonds**	**Loans**
Germany	36 (27)	2 (3)	44 (47)
France	63 (41)	5 (3)	19 (54)
Italy	54 (32)	1 (8)	37 (60)
United Kingdom	72 (49)	7 (7)	21 (15)
Canada	51 (46)	17 (12)	17 (15)
Japan	21 (16)	7 (2)	45 (48)
United States	64 (55)	12 (14)	9 (15)

2 Broad themes in corporate governance

- Agency costs and equity finance – link to information asymmetries and incomplete contracts between shareholders and managers
- Evidence for agency costs
  - share prices of bidder firms fall when acquisition announced (Roll)
  - manager resistance to takeovers threatening position (Walkling and Long)
  - premium to shares with voting rights (Zingales)

- Equity holders vulnerability compared to other stakeholders – need control mechanisms but also remaining distinct from management
- If not resolved equity finance costly/unavailable
- Right to vote in meetings/ appoint non executive directors
  - Managers' duty to serve shareholders, legally enforceable
  - But boards captured by managers (Jensen) or passive in all but extreme circumstances (Kreps)
- Hence need for large investors with leverage to complement legal rights
  - overcome free rider problems for shareholders, but beyond 5% may exploit minorities

3 Four Paradigms of Corporate Governance

- Direct control via debt (relationship banking)
- Market control via equity (takeovers)
- Market control via debt (LBOs and leveraged takeovers)
- Direct control via equity (the “corporate governance movement”)

- **Direct control via debt**
  - relationship banking – banks maintain corporate control via credit, also as equity holders/representatives sitting on boards
  - cross shareholdings among companies
  - low liquidity of equity markets
  - low public information disclosure
  - voting restrictions and discrimination against minorities
  - Institutional investors largely passive (delegate role to banks)

- **Market control via equity**
  - Anglo Saxon shareholder capitalism
  - Voting rights enforced and minorities protected
  - High public information disclosure
  - Importance of liquidity
  - Agency problem resolved by takeovers
  - Institutional investors active in assessing takeover proposals/selling poorly performing firms’ shares
- Problems
  - takeovers are so costly that only major performance failures are likely to be addressed;
  - they may increase agency costs when bidding managers overpay for acquisitions;
  - and they require a liquid capital market
  - possible “short termism”

- **Market control via debt**
  - New paradigm emerged in 1980s, complementing equity control
  - View retention policy key to agency conflict (“free cash flow”)
  - Debt issue reduces conflict cash flow pre-empted (encouraged by institutional investors)
  - Managers given equity stakes to perform well
  - Capital market inspects new investment
  - Debt availability prerequisite
  - Higher leverage raises creditor/shareholder conflict

- **Direct control via equity - the "corporate governance" movement**
  - Board representation supplemented by direct contacts by institutional investors at other times
  - Challenge excessive executive compensation, takeover defences, combined chairman/CEO, remove under performing managers, appoint more non executive
  - Codes of conduct for firms
  - Mechanism of shareholder initiative
- Motivations
  - indexation and need to improve performance directly
  - active managers and large stakes (illiquidity)
  - collapse of takeover wave
  - role of public pension funds

- Regulatory preconditions
  – collaboration among institutional shareholders permitted (required with 5% stakes)
  – fiduciary obligation to vote
  – rules on disclosure of executive remuneration

4 Empirical evidence; takeovers, short termism and activism

- **Takeovers:**
- Performance of mergers – capital market
  - use event study and focus on share price (Jensen/Ruback, Firth)
  - UK more pessimistic results for bidder firm than US
- Performance of mergers – profitability
  - little evidence that it is boosted (Scherer)
- Benefit to shareholders, if exists, may link to reallocation of wealth from others such as customers/workers

- **Short termism**
- Excessively high discount rate on future earnings, due to threat of takeover?
- Pro
  - Miles – some evidence of e.g. higher discount rates on cash flow further in future
  - Poterba and Summers – mean reversion in stock prices seen as evidence of short termism
- Anti
  - Incoherent as prices depend on future earnings
  - Markets favour capital gains over dividends
  - Announcement of capital expend and R and D boosts share prices
  - Pension funds hold shares for long periods

- **Institutional activism**
  - Successful in changing management structures
  - Mixed evidence on increased returns
  - May link to political focus of public pension funds
  - Private relationship investors (Warren Buffett) better at getting results over long term

5 Institutional Investors and Bank-Based Systems of Corporate Finance

- US institutions put pressure on “direct control via debt” to improve corporate governance
- Firms seek access to international capital markets
- Cross holdings begin to unwind (tax reform, legal changes)
- Beginning of takeovers (e.g. Mannesmann)
- Banks seek to reduce relationship links/sell equity and become investment banks, as profitability of traditional lending declines

- Barriers to Change
  - need to reform laws and company statutes
  - shareholder blocs slow to change (including cross-holders)
- EMU and Corporate Governance
  - EMU likely to speed development of capital markets
  - Companies’ desire to issue equity, hence satisfy institutions’ requirements (dividends etc.)
  - Euro corporate bond market facilitates LBOs
  - Also international diversification of institutions
  - Hence decline of relationship banking
  - Future pension reform will increase pressure

6 Estimation of the effects of institutionalisation on the corporate sector

- Hypotheses:
  - Distribution of profits in dividends stimulated
  - Fixed investment itself lower as institutions oppose unprofitable investments.
  - If use of capital and labour is improved by institutional investment, productivity growth might be improved.
  - If pressure by institutional shareholders improves overall profitability via increased efficiency, this may be apparent in indicators such as share prices or the return on equity.

Specification

- Panel estimation for G-7 plus Australia, Anglo Saxon (UK, US, CA, AU) and Continental plus Japan (DE, FR, IT, JP)
- Basic error-correction model in each case for determining the variable in question, plus the difference and lagged level of the domestic and foreign institutional share of equity
- Cross-section weighted GLS balanced panel, with fixed effects for each country and cross section weights, White heteroskedasticity consistent standard errors

- “Test regression” to determine GDP growth – no effects – suggests that correlations are not just spurious and linked to investment patterns
- Overall results suggest that in “Anglo-Saxon” countries, institutions boost dividends, and restrain investment; domestic institutions boost total factor productivity. Few significant effects on equity returns per se.
- In CEJ countries, weaker effects in a similar direction for dividends; only domestic institutions restrain investment, while foreign boost it; for TFP, domestic institutions boost while foreign restrain. Stronger effects on equity returns, with institutional share generally negative effect

- G-8 a composite of these results
- In rest of specifications, dividends strongly related to GDP growth (and level in CEJ); standard flexible accelerator investment functions accepted by data; TFP linked to GDP growth (endogenous growth); standard equity determinants in Anglo Saxon (growth, GDP, real long rate and real share price volatility). In CEJ, only growth and lagged share price significant (equity markets less efficient and less anchored in real economy).
- Further work could include estimation after 1985 (more institutional influence?), use of patents, takeovers, R and D and profit mark-up as possible dependent variables.

Table 6: Results of panel estimation for log-difference of real dividends

GLS, Fixed effects, cross-section weights, White heteroskedasticity consistent standard errors

	G-8	Anglo-Saxon	CEJ
DEQLPS	-0.132 (0.075)*	-0.046 (0.124)	1.04 (0.71)
DEQFRS	0.457 (0.229)**	0.032 (0.43)	0.06 (0.43)
EQLPS(-1)	0.038 (0.04)	0.173 (0.064)**	0.606 (0.34)*
EQFRS(-1)	0.43 (0.093)**	0.359 (0.144)**	0.035 (0.41)
DGDP	1.55 (0.098)**	1.55 (0.11)**	2.21 (0.54)**
DGDP(-1)	0.72 (0.095)**	0.616 (0.108)**	1.96 (0.56)**
LRDIV(-1)	-0.0199 90.028)**	-0.163 (0.036)**	-0.27 (0.058)**
LGDP(-1)	0.062 (0.019)**	-0.021 (0.023)	0.197 (0.047)**
R2	0.414	0.49	0.37
SE	0.127	0.082)	0.154
DW	1.7	1.4	1.8
Observations	216	112	108

Table 7: Results of panel estimation for log difference of investment

GLS, Fixed effects, cross-section weights, White heteroskedasticity consistent standard errors

	G-8	Anglo-Saxon	CEJ
DEQLPS	0.157 (0.237)	-0.118 (0.0028)**	0.217 (0.3)
DEQFRS	0.183 (0.292)	-0.029 (0.0069)**	0.539 (0.27)**
EQLPS(-1)	-0.271 (0.129)**	-0.06 (0.004)**	-1.19 (0.23)**
EQFRS(-1)	0.697 (0.2)**	-0.077 (0.011)**	1.11 (0.21)**
DLGDP	6.49 (0.27)**	0.097 (0.008)**	6.63 (0.23)**
DLGDP(-1)	0.614 (0.57)	0.054 (0.0009)**	-0.42 (0.82)
LKS(-1)	-0.275 (0.022)**	-0.092 (0.018)**	-0.29 (0.028)**
DLKS (-1)	-0.736 (0.066)**	-0.683 (0.074)**	-0.747 (0.1)**
LGDP (-1)	0.064 (0.024)**	0.082 (0.015)**	0.019 (0.026)
R2	0.744	0.477	0.812
SE	0.217	0.211	0.272
DW	2.0	2.0	2.0
Observations	216	112	108

Table 8: Results of panel estimation for log-difference of total factor productivity

GLS, Fixed effects, cross-section weights, White heteroskedasticity consistent standard errors

	G-8	Anglo-Saxon	CEJ
DEQLPS	0.003 (0.017)	-0.037 (0.02)*	0.119 (0.048)**
DEQFRS	-0.04 (0.027)	0.043 (0.08)	-0.062 (0.027)**
EQLPS(-1)	0.034 (0.007)**	0.025 (0.0086)**	0.153 (0.042)**
EQFRS(-1)	-0.054 (0.014)**	-0.045 (0.017)**	-0.044 (0.027)*
DGDP	0.61 (0.027)**	0.537 (0.034)**	0.697 (0.043)**
DGDP(-1)	-0.17 (0.022)**	-0.153 (0.037)**	-0.184 (0.024)**
LTFP(-1)	-0.071 (0.0085)**	-0.132 (0.04)**	-0.0396 (0.012)**
LGDP(-1)	0.025 (0.0049)**	0.049 (0.013)**	0.009 (0.008)
R2	0.802	0.7	0.892
SE	0.009	0.009	0.0096
DW	1.74	1.9	1.6
Observations	216	112	108

Table 9: Results of panel estimation for log-difference of equity prices

Fixed effects, cross-section weights, White heteroskedasticity consistent standard errors

	G-8	Anglo-Saxon	CEJ
DEQLPS	-3.77 (0.63)**	-2.52 (0.85)**	-8.73 (1.8)**
DEQFRS	0.584 (0.59)	0.49 (0.91)	0.836 (1.14)
EQLPS(-1)	0.086 (0.32)	0.14 (0.38)	-2.44 (1.25)*
EQFRS(-1)	-0.59 (0.36)*	-0.23 (0.41)	-1.16 (0.62)*
DGDP	1.56 (0.61)**	1.54 (0.93)*	2.68 (1.32)**
DGDP(-1)	-1.7 (0.54)**	-1.8 (0.83)**	-1.94 (1.32)
LEQP(-1)	-0.16 (0.03)**	-0.147 (0.05)**	-0.221 (0.092)**
LGDP(-1)	0.25 (0.12)**	0.34 (0.16)**	0.378 (0.245)
RLR	-0.005 (0.005)	-0.013 (0.007)*	0.00058 (0.0094)
RLR(-1)	0.016 (0.005)**	0.014 (0.008)*	0.0119 (0.0073)
VOL	-0.92 (0.33)**	-1.6 (0.4)**	0.261 (0.524)
VOL(-1)	0.39 (0.19)*	0.68 (0.28)**	0.271 (0.406)
R2	0.41	0.5	0.30
SE	0.196	0.148	0.235
DW	2.1	2.2	2.14
Observations	216	112	108

Table 10: Results of panel estimation for return on equity

GLS, Fixed effects, cross-section weights, White heteroskedasticity consistent standard errors

	G-8	Anglo-Saxon	CEJ
DEQLPS	-262.2 (96.9)**	-98.7 (83.4)	-905 (214)**
DEQFRS	2.2 (104)	79.1 (119.5)	2.8 (127.7)
EQLPS(-1)	45.3 (35.3)	54.1 (32.4)*	-102 (114)
EQFRS(-1)	-82.0 (37.2)**	-47.4 (32.1)	-144 (63)**
DGDP	73.2 (72.7)	129.7 (102.1)	123.9 (134)
DGDP(-1)	-220.4 (74.4)**	-240.9 (97.8)**	-217 (135)
ROE(-1)	-0.054 (0.074)	-0.1 (0.11)	-0.053 (0.079)
LGDP(-1)	2.82 (10.6)	17.9 (10.1)	-11.3 (16.3)
RLR	-1.21 (0.97)	-2.8 (1.0)**	1.05 (1.05)
RLR(-1)	1.41 (0.77)*	1.4 (0.9)	1.2 (0.76)
VOL	-90 (38.5)**	-181.8 (34.5)	69.7 (62.9)
VOL(-1)	74.5 (38.5)	148 (49.4)**	-16.7 (47.5)
R2	0.17	0.4	0.32
SE	24.8	19.7	27.4
DW	2.1	2.3	2.2
Observations	216	112	108

Table 11: Summary of results

G-8	DLRDIV	DLTFP	DDLKS	DLEQP	ROE
DEQLPS	Negative			Negative	Negative
DEQFRS	Positive				
EQLPS(-1)		Positive	Negative		
EQFRS(-1)	Positive	Negative	Positive	Negative	Negative
Anglo Saxon					
DEQLPS		Negative	Negative	Negative	
DEQFRS			Negative		
EQLPS(-1)	Positive	Positive	Negative		Positive
EQFRS(-1)	Positive	Negative	Negative		
CEJ					
DEQLPS		Positive		Negative	Negative
DEQFRS		Negative	Positive		
EQLPS(-1)	Positive	Positive	Negative	Negative	
EQFRS(-1)		Negative	Positive	Negative	Negative

Conclusion

- Growing dominance of equity holdings by institutional investors casting a sharp focus on their activities and owners and monitors of firms
- Useful to separate discussion of the developments in the Anglo Saxon countries and continental Europe/Japan.
- Former showing increase in direct influence of institutions in place of the previous reliance on the takeover mechanism to discipline managers
- Latter remain more firmly in the bank-relationship based governance paradigm.

- Differences should not be exaggerated, some convergence discernible on modified Anglo Saxon paradigm where institutions are the primary actors in corporate governance generally
- In Europe, EMU will provide a major spur to such convergence.
- The empirical results link the development of institutional investors to important indicators of corporate sector performance, suggesting inter alia increased dividend distribution, less fixed investment and higher productivity growth.

Table A1: Results of correlation analysis on financial structure
(fixed effects regressions; variables significant at 95% level)

Dependent variable	**Independent variable(1)**	**G-7 Coun-tries**	**Anglo-Saxon**	**Contin-ental Europe and Japan**
Size indicator	Institutional assets/total financial assets	47.9 (9.1)	42.5 (5.6)	54.3 (7.5)
Equity/total financial assets	Institutional assets/total financial assets	0.8 (2.8)		1.28 (3.2)
Volatility of share prices (monthly s.d.)	Institutional assets/total financial assets		-35.2 (3.7)	
Household equity/ household financial assets	Household institutional assets/household financial assets		-0.4 (3.4)	
Household bonds/ household financial assets	Household institutional assets/household financial assets	-0.13 (2.0)	-0.24 (3.8)	
Household deposits/ household financial assets	Household institutional assets/household financial assets	-0.63 (4.4)	-0.45 (4.0)	-0.9 (3.4)
Corporate equity/corporate liabilities	Institutional assets/total financial assets	1.8 (3.4)	1.1 (1.9)	2.6 (3.2)
Corporate bonds and market paper/corporate liabilities	Institutional assets/total financial assets			0.35 (1.8)
Corporate loans/corporate liabilities	Institutional assets/total financial assets	-1.4 (2.9)	-0.56 (2.0)	-2.3 (2.8)