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# INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE

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**Abstract:** The growing dominance of equity holdings by institutional investors, both domestic and international, is casting a sharp focus on their activities and owners and monitors of firms. It is suggested that whereas some general considerations arise in all cases, it is useful to separate discussion of the developments in the Anglo Saxon countries and continental Europe/Japan. The former is showing an increase in direct influence of institutions in place of the previous reliance on the takeover mechanism to discipline managers. This has arguably led to improved corporate performance. The latter remain more firmly in the bank-relationship based governance paradigm. On the other hand, such differences should not be exaggerated, and some convergence is discernible on a modified form of the Anglo Saxon paradigm where institutions are the primary actors in corporate governance generally. In Europe, EMU will provide a major spur to such convergence.

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## Introduction

The development of institutional investors, and their growing dominance as owners of corporations has had a pervasive influence on corporate governance. The basic issue is simply stated. Given the divorce of ownership and control in the modern corporation, principal-agent problems arise, as shareholders cannot perfectly control managers acting on their behalf. Managers, who have superior information about the firm and its prospects and at most a partial link of their compensation to the firms' profitability[2], may divert funds in various ways away from those who sink equity capital in the firm, notably expropriation[3] or diversion to unattractive projects from a shareholder's point of view.

This article first examines the relation between growth of institutions and equity finance, which is the basis of corporate governance. Some general considerations and models of corporate governance are then outlined. The article then successively examines the themes arising from corporate governance in the Anglo Saxon countries and in Continental Europe.

## 1 Institutional investors and the growth of securities markets

Underlying the issue of corporate governance by institutional investors are changes in financing patterns which have led to a rise in the importance of securities market finance for enterprises, and therein, a growth in influence of institutions. A view of developments in financial structure over time is shown in Tables 1-4 for the G-7[4] countries. The tables show data for end-1997, drawn from National Flow of Funds Balance Sheets, and comparative data for 1980.

Table 1 shows that the volume[5] of financial claims relative to GDP has grown sharply in all of the G-7, albeit varying in terms of levels. This has coincided in most cases with an increase in financial intermediation - the proportion of claims held indirectly in banks or institutional investors as opposed to being held directly. In other words, the growth of financial markets has not led to a fall in intermediation, indeed quite the contrary. But the locus is changing - of the intermediated claims, a growing proportion has been in the form of institutional investment (including life insurance, mutual funds and pension funds). It is noteworthy that this tendency is apparent across all countries shown and not just the so-called Anglo-Saxon ones, although differences in levels are still marked.

[2] Performance related pay, the use of share options and similar devices may help to align managers' and shareholders' interests. But such contracts may themselves worsen the governance problem by leading to heightened incentives for self dealing, with managers negotiating such contracts when they know performance may improve.

[3] Beyond theft, transfer pricing and asset sales, expropriation may take forms such as perquisites, high salaries, diversion of funds to pet projects and general entrenchment even in cases when managers are no longer competent or qualified to run the firm.

[4] UK data exclude offshore bank loans and deposits (i.e. the eurocurrency market)

[5] The size indicator shows the total value of all financial assets of the conventional economic sectors in the System of National Accounts (household, corporate, banks, non-bank financial institutions, government, foreign).

These changes have coincided with in most cases a sharper rise in securities (i.e. bonds and equities) than in deposits and loans, implying that bank assets and liabilities have declined relative to the total (Table 2). Meanwhile, households have tended to shift the composition of their balance sheets to institutions and away from deposits as well as directly-held equities and bonds (Table 3), although again levels still differ. Patterns for companies are less clear, but there would appear to be a tendency for them to reduce their dependence on loans and increase their reliance on equities, as shown in Table 4 (it being borne in mind that the balance sheet composition reflects capital gains as well as new issuance). The leverage of equity holders in corporate governance is hence potentially enhanced. On the other hand, in levels terms, the table still shows the expected difference between Anglo Saxon and other countries in terms of the importance of bank loans to companies, it being below 20% in the former and above it - at times well above - in the latter. Finally, use of corporate bonds is particularly low in all the EU countries shown – including the UK.

We now go on to use the data on financial structure indicators for the G-7 countries shown in Tables 1-4 to investigate further the potential effects of growth in institutionalisation on corporate finance and capital markets, as background to the discussion of institutions and corporate governance. The simple estimates shown utilise the data on financial structure indicators using 5 yearly observations over the period 1970-95 as a panel (pooled cross section and time series) dataset. An additional variable was monthly equity market volatility averaged over quinquennia. There are in effect 42 observations for each series, with 6 observations each for 7 countries. We then regressed various indicators of the size of the institutional sector on the indicators of financial structure. We used both of the standard panel data estimation techniques, namely testing for random and fixed effects. The latter being considered more appropriate, we only report results of this (while noting the random effects results are very similar). The work thus differs from otherwise-comparable work such as Demirguc-Kunt and Levine (1996), which estimated correlations on purely cross sectional data. It should be emphasised that the results will not have any causality implication, but rather show what patterns or changes in financial market structure and behaviour has accompanied institutionalisation. It cannot be ruled out that other causes have affected both dependent and independent variables (such as liberalisation generally and technological change). As the time series observations are not independent, “t” values will be overstated. Finally, the datasets are small so again conclusions must be drawn cautiously; outliers may have a disproportionate effect. More generally, further and more systematic investigation is needed.

With these caveats in mind the results for the G-7 (Table 5) tend to indicate the following: higher levels of institutionalisation (measured by the share of total financial assets) accompanies a larger size of the financial superstructure (total financial assets/GDP), even when national differences in levels of the latter are taken into account by the dummies. Second, higher institutionalisation accompanies a higher share of equity in total financial assets, again potentially boosting corporate governance. Third, there is no significant link of the level of institutionalisation to volatility. Of course, average volatility may still be consistent with occasional, disruptive, peaks of volatility.

Concerning household sector portfolios, the share of institutional investment in households' portfolios appears to be negatively related to the share of deposits and bonds, suggesting some substitution. Looking finally at company liabilities, the share of institutional investment in total financial assets tends to accompany higher levels of the share of equities in corporate liabilities and lower levels of loans. Concerning bonds, the coefficient is insignificant. It is notable that strong substitution is indicated for both key elements of banks' balance sheets, namely household deposits and company loans. The influence of banks via their traditional business is thus seen to decline while institutional leverage increases.

We split the sample between the "Anglo Saxon countries" i.e. the UK, US and Canada (with 18 observations) and "Continental Europe and Japan", i.e. Germany, France, Italy and Japan (24 observations) see Table 5. Were the results for the G-7 "driven" by only one group, bearing in mind that institutional growth has been much more marked in the Anglo Saxon countries. If so this raises the issue of whether the results are only applicable to a certain type of financial system. In fact, there are a number of results that appear consistently for both groups examined separately. In each case, the rise of institutions in total financial assets has accompanied a larger overall financial superstructure as shown by total financial assets/GDP; the growth of institutions' share of household portfolios has accompanied a decline in deposits; and a higher level of institutional assets as a proportion of total assets has accompanied a higher level of corporate equity and a lower level of corporate loans. Interesting "idiosyncratic" results are that in the Anglo Saxon countries, a larger institutional sector is indeed associated with a lower level of capital market volatility; that there is strong substitution from equities and bonds to institutions in households' portfolios in the Anglo Saxon countries (i.e. "institutionalisation" of portfolios); and some evidence of higher bond shares in company liabilities in Continental Europe and Japan as institutions increase in size and importance.

## 2 Broad themes in corporate governance

In the context of the above information, which shows a growing predominance of equity finance and institutional holdings thereof, we now go on to discuss corporate governance in more detail. As noted in the introduction, given the divorce of ownership and control in the modern corporation, and imperfect control of managers, who have superior information about the firm and its prospects and at most a partial link of their compensation to the firms' profitability, agency costs may arise. Managers may divert funds in various ways away from those who sink equity capital in the firm, notably expropriation or diversion to unattractive projects from a shareholder's point of view.

Evidence for such agency costs includes the frequent observation that share prices of bidder firms fall when acquisitions are announced (Roll 1986); resistance of managers to takeovers that threaten their positions (Walkling and Long 1984); and the premium offered to shares with voting rights (Zingales 1995). Whereas it may be argued that desire of managers to maintain reputation in the market will help

to protect shareholders (Kreps 1990), it may not be sufficient to protect shareholders and ensure the viability of external financing. And although there is evidence that investors' overoptimism may play a role in pricing of external finance[6], it is hardly a viable basis for provision of external finance. As noted by Schleifer and Vishny (1997), shareholders are much more vulnerable than other stakeholders in the firm, as for example workers and creditors can withdraw labour, debt finance etc. and apply pressure on the managers by that means.

Principal-agent problems in equity finance imply a need for shareholders to exert control over management, while also remaining sufficiently distinct from managers to let them buy and sell shares freely without breaking insider trading rules. If difficulties of corporate governance are not resolved, these market failures in turn also have implications for corporate finance in that equity will be costly and often subject to quantitative restrictions[7].

A key to all successful forms of corporate governance is mechanisms for legal protection of shareholders (e.g. of the right to vote on important corporate matters, notably mergers, as well as elections of boards of directors); it may be supported by a legally enforceable duty of loyalty by managers to shareholders (Schleifer and Vishny (1997)). In this context, in all models of governance, boards of directors, and in particular non-executive directors, act as shareholders' representatives in monitoring management and ensuring the firm is run in their interests. Shareholder influence is ensured by their right to vote on choice of directors (as well as other elements of policy proposed by management). On the other hand, boards, if weakly supervised, may well be captured by management and act in their interests rather than those of shareholders (Jensen 1993), or at least are passive in all but extreme circumstances (Kaplan 1994).

Hence, effectiveness of corporate governance typically also requires presence of large investors, be they banks, other companies or institutional investors. They will have the leverage to oblige managers to distribute profits to providers of external finance. They are needed because individual investors may find it difficult to enforce their rights, even if they are legally enshrined, notably owing to difficulty of acting in a concerted manner against management as well as free rider problems which make it not worthwhile for an individual to collect information and monitor management. Conversely, large investors may find it easier to enforce their rights in court. (Note that this argument suggests that households will be justified in being more willing to provide equity finance via institutions than they would directly – as is indeed implied to be the case in the data shown in Section 1.)

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[6] See for example evidence on the overvaluation of junk bonds used to finance US take-overs in the 1980s in Kaplan and Stein (1993) and of new equity issues by Ritter (1991).

[7] In practice, even in the Anglo Saxon countries, new equity is typically issued by established firms with good reputations in the markets and prospects for steady dividend growth; by firms being floated for the first time; for high return/high risk ventures which cannot be wholly financed by debt; and to restructure the balance sheet of firms in `financial distress'. Finally, experience shows that - probably owing to the difficulties outlined above - equity markets are highly unreliable as a source of funds, being subject to cyclical "feasts and famines".

There is also a "downside" to large investors, as they may override the interests of minority shareholders. Consistent with this, Morck et al (1988) found that profitability is higher for firms with shareholders with up to 5% stakes, but beyond that, profitability falls. This may link to larger investors tending to use firms to generate private benefits of control that are not shared by minority shareholders. 5% is precisely the type of maximum shareholding that institutional investors usually seek.

There are well-known systemic contrasts between the behaviour of financial institutions and markets in the major OECD countries, notably as they relate to the financing and governance of companies. The general division is between the "Anglo-Saxon" systems of the UK, US, Canada and Australia, together with the international capital markets (or "euromarkets"), on the one hand, and the systems which prevailed historically in Continental Europe and Japan (CEJ). We would characterise the traditional distinction between the two systems in terms of the finance and control of corporations as that between *direct control via debt* and *market control via equity.* (Davis 1995a).

*Direct control via debt* implies relationship banking along the lines of the German or Japanese model. This typically involves companies forming relationships with a small number of creditors and equity holders. There is widespread cross shareholding among companies[8]. Banks are significant shareholders in their own right and in Germany are represented on supervisory boards both as equity holders and as creditors. It is the control rights offered to creditors by offering short term debt, as well as when firms default or violate debt contracts that arguably is most important. Nonetheless, banks in these countries have also been able to exert control through the voting rights conferred on them by custody of bearer shares of individual investors who have surrendered their proxies. Meanwhile, the influence of other (institutional) shareholders is often limited by voting restrictions, countervailing influence of corporate shareholders and lack of detailed financial information, as well as the right of other stakeholders (employees, suppliers, creditors) to representation on boards. Implicitly, monitoring of managers is delegated to a trusted intermediary - the bank. In practice, equity holders are often discriminated against in such systems, to the advantage of the creditors, e.g. in terms of dividends (Hoshi et al (1993) show how profitable Japanese firms sought to avoid the costs of bank links when access to public debt issuance was liberalised). Such discrimination may make minority investors unwilling to invest, which leaves equity markets themselves underdeveloped[9]. However, as noted below, institutions from the Anglo Saxon countries are beginning to fight back against such discrimination.

Meanwhile, as regards *market control via equity,* the principal advantage of take-over activity is that it can partly resolve the conflict of interest between management and shareholders; those firms which deviate most extensively from shareholders' objectives - and which consequently tend to have lower market values as shareholders dispose of their holdings - have a greater likelihood of being acquired. And indeed there is evidence that takeovers act to address governance problems (Jensen 1993). The

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[8] Although bidirectional crossholdings are typically means of cementing alliances or collusion rather than exerting control.

[9] Note that there is also evidence that banks may be inadequate as monitors, not seeking to discipline managers so long as the firm is far from default (Harris and Raviv 1990).

threat of take-over, as much as its manifestation, acts as a constraint on managerial behaviour. Institutional shareholders, both directly and via non-executive directors can have an important role to play in this context both in complementing take-over pressure as a monitoring constraint on management behaviour, and in evaluating take-over proposals when they arise.

Research on the best form of corporate governance is inconclusive (Mayer 1996). The insider model of direct control via debt, with its emphasis on private information and on stakeholder relationships rather than public disclosure and liquidity, may be superior at implementing policies needing consensus among stakeholders, encouraging high levels of fixed investment by the firm and of the employees in firm specific skills, in the context of long lived corporations. On the other hand, the outsider models in which institutions play a greater role may be better at responding to change and building up new firms.

As argued by Allen and Gale (1994), capital market financing could well be economically beneficial with emerging industries, with high financial and economic risks and where knowledge about industry is uncertain (IT, biotechnology). In contrast, banking may have a comparative advantage in industries where markets are mature and innovation and uncertainty are low, as banks can then accurately monitor and diversify risk among companies.[10]

## 3 The Anglo Saxon countries; new paradigms of corporate governance

The willingness of banks - and institutions, via junk bonds - to finance highly leveraged buyouts (LBOs) and take-overs in the 1980s in the UK and US brought to the fore a new form of control, *market control via debt*. A key source of conflict between managers and shareholders stems from firms' retention policies. Debt issue can ease tensions, since by increasing interest payments, the internal resources at managers' disposal are reduced, while the equity stakes that managers usually take on in LBOs increases their incentives to perform well. This forces them to incur the inspection of the capital markets either via debt issue or equity issue for each new project undertaken. Jensen (1986) argues that desire for improved corporate control by means of debt could have been an important motivation behind the wave of leveraged take-overs and buyouts in the 1980s. A disadvantage of increased gearing is that potential conflicts between shareholders and debt holders become more intense[11]. Jensen and Meckling (1976) suggest that shareholders in highly-leveraged firms have an incentive to engage in projects that are too risky and so increase the possibility of bankruptcy. If the projects are unsuccessful, the limited liability provisions of equity contracts imply that creditors bear most of the

[10] It may be added that mature industries, unless in difficulty, may well generate sufficient internal funds to cover investment needs in any case.

[11] Perhaps more importantly, high leverage is likely to have various deleterious consequences. By raising the bankruptcy rate, it increases the incidence of dead weight bankruptcy costs arising from legal costs, diversion of managerial energies and break-up of unique bundles of assets, for example. And at a macro level increased corporate fragility is likely to magnify the multiplier in the case of recession (Davis (1995b)).

cost[12]. Given this risk, monitoring of managers by creditors may become so intense as to preclude investment altogether. Indeed, it is commonly argued that LBOs are a transient form of corporate organisation, which may be helpful in unwinding earlier excesses in terms of diversification etc.

Institutions in countries such as the US have however, been increasingly disenchanted with take-overs and buyouts. As noted by Schleifer and Vishny (1997), takeovers are so expensive that only major performance failures are likely to be addressed; they may increase agency costs when bidding managers overpay for acquisitions that bring them private benefits of control; and they require a liquid capital market (e.g. for junk bond issuance) to provide finance. Also one may instance increasing use of take-over defences by managers of weak companies and/or greenmail payoffs of raiders, regardless of shareholders' interests; increased dissatisfaction with managerial compensation and performance under the protection of such devices; high costs in terms of fees to investment bankers etc.

Combined with new regulations on US institutions allowing institutions to collaborate[13] more readily, this discontent brought to the fore a 'corporate governance movement' based on *direct control via equity*[14]. The dominance of institutions as shareholders gives ample scope for leverage - they own 50% of the top 50 US companies, and the top 20 US pension funds own 8% of the stock of the ten largest companies. Such influence may be exerted via selection of boards of directors, as noted above. But these mechanism may be supplemented by direct links from institutional investors to management[15] either formally at annual meetings, or informally at other times. This is precisely what has been observed in recent years.

A further important motivation has been development of indexing strategies, which force funds to hold shares in large companies as long as that policy is maintained, and thus encourage them, following their fiduciary duty as well as in the interests of returns, to improve management of underperformers to boost overall asset returns, see Monks (1997)[16]. Even active investors holding large stakes in a company must bear in mind the potentially sizeable cost of disposing of their share holdings, thus again encouraging activism; in effect, they are driven to seek direct control due to illiquidity (see Coffee 1991). With growing institutionalisation it becomes much easier and cheaper to reach a small number of

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[12] But this benefit to shareholders may only be temporary. Since creditors are assumed to understand the incentives facing shareholders and are aware of the risks involved when loans are negotiated, ultimately the owner will bear the consequences of the agency problem in terms of a higher cost of debt.

[13] If collaboration is ruled out, institutions are likely to be in a "prisoners dilemma" situation in respect of corporate governance, with each finding acting in their own interests (e.g. selling the shares in an underperforming company) leads to a worse outcome than could be realised by acting collectively (e.g. by requiring improvements to management structure and performance).

[14] Note that the argument presented here from an institutional investors point of view generalises to the extent that any large shareholder, be it an individual, bank or company, may exert direct influence on a firm and thereby overcome corporate governance problems. A number of studies showing effective exercise of governance in Germany, Japan and the US are noted in Schleifer and Vishny (1997).

[15] Note that in countries such as Italy, direct control via equity is exerted in pyramidical groups of companies, where those (larger firms) higher up hold shares in those (smaller) lower down (OECD 1995).

[16] This is an important observation, since it is often suggested in countries such as the UK that the longer term relationships, close monitoring of company performance and large shareholdings needed for alternatives to take-over to operate will not be present in the case of indexation.

well-informed key investors who will command a majority of votes (note however that such coalition building is essential for effective institutional control to be exerted, as either by law or by strategy of diversification, institutions do not seek to hold large stakes in firms).

In the US, the change in attitude was crystallised by two events, first a 1988 ruling by the US Department of Labour (the Avon letter) that decisions on voting by pension funds were fiduciary acts of plan asset management under ERISA[17], which must be performed either directly by trustees or delegated wholly to external managers. Note however that despite their growing importance there is no equivalent to this for mutual funds. Second, there are shareholder initiatives on social issues (South Africa, the environment) in the late 1980s, which stimulated increased interest by public pension funds in the importance of proxy issues generally. The collapse of the take-over wave itself at the turn of the decade[18] helped to boost activism, by removing an alternative means of corporate control. Under the recently enacted "lead plaintiff" provision of the US Private Securities Litigation Act of 1995, large shareholders can seek to be named controlling parties on class-action shareholder lawsuits against company management.

Since these developments, US funds have consistently voted on resolutions they might previously have ignored. Public funds such as the California Public Employees' (CALPERS) and New York Employees' (NYEPF) have been particularly active, notably in seeking to challenge excessive executive compensation and take-over protections, in seeking to split the roles of chairman and chief executive, remove under-performing chief executives[19], ensure independent directors are elected to boards[20], and that new directors be appointed by non-executives. These ends are reached by filing proxy resolutions and directing comments and demands to managers, either privately or via the press. Private pension fund trustees have been more restrained, perhaps due to the threat of retaliation on the parent firm (reflecting in turn the leverage that plan sponsors have over plan trustees).

The effectiveness of such shareholder activism remains a question of lively debate in the US; the bulk of empirical work seems to justify scepticism. Wahal (1994) surveyed activism by 9 public pension funds over the 1987-93 period and concluded that there was no evidence of improvement in the long term stock price performance of targeted firms, which rather continued to decline for three years after

[17] The US shareholder activist movement was further encouraged in the early 1990s by two new rules from the Securities and Exchange Commission (SEC), the US securities regulator. The first helped provide information; it enforced comprehensive disclosure of executive pay practices (salary, bonuses and other perks for the top five officers over a three year period) as well as policy regarding their relation to performance of the company as a whole, and details of share price performance over five years relative to the index and a peer group. The second enabled investors to collude more readily; now any number of shareholders can communicate orally without restriction, so long as they are not seeking to cast votes for others.

[18] This was attributable to such factors as recession, which made target companies less attractive to bidders and the retrenchment of banks from take-over finance, following their losses on property, as well as the anti-take-over strategies noted above.

[19] Examples in the early 1990s include those of IBM, Westinghouse, Kodak, Amex and General Motors.

[20] Celebrated cases include the CALPERS agreement to back Texaco management in a take-over bid, if they agreed to support independent directors, and CALPERS and the NYEPF pressure on General Motors to accept a resolution for more than half the directors to be independent.

targeting. Gillan and Starks (1995) found some positive returns in the short term but no statistically significant positive returns over the long term, leading them to question the overall effectiveness of shareholder activism. Smith (1996), looking at the firm which had been targeted by CALPERS, found that activism again led to no statistically significant increase in performance of the companies concerned, although activism had led to changes in that 72% of targets had adopted proposed governance structure resolutions or made changes sufficient to warrant a settlement. Moreover, there was a statistically significant increase in shareholder wealth; CALPERS gained an estimated $19 million over 1989-1993 at a cost to itself of $3.5 million. Karpoff et al (1996) found that shareholder initiatives were well targeted on firms with atypically poor prior performance, but had little effect on operating returns, company share values and top management turnover; the only exception was a significant improvement in returns on assets for the targets relative to a control group.

On the other hand Wahal (1996), in a sample of 43 cases, found efforts by institutions to promote organisational change via negotiation with management (as opposed to proxy proposals) are associated with gains in share prices. Strickland et al (1996) report that firms targeted for pressure by the United Shareholders Association (admittedly comprising mainly small investors) and which negotiated settlement with the group experienced positive abnormal stock returns, but corporate governance proposals per se had no effect.

Monks (1997) suggests that such results may reflect the fact that while public pension funds are well placed to raise "fairness" issues, the incentive structure of trustees is not such as to encourage the long term pressure on management needed to obtain positive excess returns in the long term. More effective institutional pressure may be exerted by so-called relationship investors such as Warren Buffett and the LENS fund; aided by backgrounds in business, commitment and unwillingness to be distracted. But as noted by Monks (1997), working together with public funds is at times fruitful.

Broadly similar tendencies towards shareholder activism are apparent in other Anglo-Saxon countries such as the UK and Canada - often aided by US involvement. In the *UK*, pressure from shareholders (and the Bank of England) led to formation of the so-called Cadbury Committee on corporate governance, which set a code of good practice. Its key recommendations include separation of chief executive and chairman, appointment of a minimum of three independent non-executive directors, disclosure of directors pay and that directors' appointments be only for three years. The National Association of Pension Funds has orchestrated pressure on managers to accept the Cadbury guide-lines, although it opposes compulsory voting by institutional shareholders. More recently, institutional investors have been active in opposing lax and overlong executive contracts, pensions and share options, which were not covered in detail by the Cadbury guide-lines. The guidelines were developed further in the recent Greenbury report. As examples of activism, there is the dismissal of Maurice Saatchi from his eponymous advertising firm, spearheaded also by US institutions.

In *Canada*, (Simon (1993)) activism has been encouraged by the US example, but also by poor performance of Canadian firms, and the scope for such pressure offered by the loosening grip of foreign multinationals and family owners. For example, in 1993 OMERS (The Ontario Municipal Employee Retirement System) one of the largest Canadian pension funds, published a list of proxy voting guide-lines, covering executive stock options, LBOs, unequal voting shares and environmental practices. Successes of shareholder activism include concessions by companies to allow secret voting, boosting the numbers of non-executive directors and better disclosure.

An additional factor of major interest, which has been little researched, is the role of governance of the institutional investor itself in the context of the activism it carries out. It is well known in the US that public funds are the most active. O'Barr and Conley (1992) suggest that such activism relates partly to the size of the funds, which makes selling shares in poor performers potentially expensive, and indexation (which is more common in public than private funds). But also by being active on shareholder rights, public pension fund managers can pre-empt the pressure from politicians to use funds for social ends; and as public figures themselves, managers of public funds reap benefits from activism in terms of publicity. Private funds have been much less active, and generally support incumbent management. Whereas reasons put forward include lack of knowledge of other companies' business, O'Barr and Conley (1992), concluded that there was an underlying desire not to trouble other firms lest their pension fund retaliate, and thus cause difficulties for the fund managers vis a vis the sponsor's management. They would also see dangers of conflicts of interest if they become too heavily involved in running businesses.

Other types of institution whose incentives are less clear include bank controlled mutual funds - a key form of institution in Europe. It is to European experience and prospects that we now turn.

## 4 Corporate governance in Continental Europe: a revolution in corporate financing?

As noted, countries such as Germany, Japan and, to a lesser extent, France are often characterised as "bank dominated", with close relations between banks and firms based on sharing of information unavailable to other investors, a preponderance of bank lending in corporate finance and relatively underdeveloped securities markets (see Edwards and Fischer (1991), Davis (1993)). This is often seen as an advantage, giving scope for firms to obtain long term debt finance for investment and R&D, and for banks to mount rescues of firms in difficulty. Bisignano (1991) has pinpointed key underlying features, such as a low level of public information disclosure by companies, scepticism regarding the allocative efficiency of markets, preference for "insider control" and close holding of companies, and a maintenance of an informal rather than rule based system for governing financial relations.

Even in the bank-dominated countries such as Germany and Japan, US pension funds have introduced shareholder activism[21], and often encouraged domestic shareholders to be more willing to stand up to the status quo. Many firms in Continental Europe are already seeking access to international equity finance, and are accordingly being obliged to meet the needs for better accounting (based on the US GAAP) and hence more transparency, dividend payment etc. of Anglo-Saxon pension funds (Schulz (1993)). German firms have since 1985 raised DM 200 bn., more than double the amount of equity raised in 1950-85, inflation adjusted, thus increasing the scope of institutionalisation.

French domestic shareholders have been active in a number of cases such as Suez and Navigation Mixte. It is notable that European countries are developing their regulations in this area, for example a French law to protect minority shareholders in take-overs, under pressure from institutions. Other provisions that institutions press for are insider information restrictions (recently introduced in Germany), limits on dual classes of share (an important issue in Switzerland) and equal treatment of creditors in bankruptcy (to protect corporate bond holdings).

The scope of such convergence to date should not be exaggerated (Berglöf 1996), not least because of the large proportion of corporate firms which are private in Continental Europe and Japan. Nevertheless, growth of domestic institutions free and willing to invest in equity seems likely given pressure on social security pension systems. Complementing existing pressures from international institutions outlined above, growth of such domestic institutions, a class of institutions unlikely to be willing to be subordinate to banks, could in the opinion of the author (Davis (1993)) overturn the system and lead to convergence on the "Anglo-Saxon" model. Introduction of pension funds in Italy in the wake of social security reform (OECD 1995) - a country which Schleifer and Vishny (1997) highlight as having particularly poor legal protection for shareholders - may be a forerunner of changes elsewhere

The effect on corporate finance, for example, could be profound. Rather than the case at present, where equity holders are seen as co-equal partners with creditors and other stakeholders, there would be moves towards absolute primacy to equity holders, as ultimate owners of the firm. This could imply, for example, pressure on firms for higher and more sustained dividend payments; greater provision of information by firms; removal of underperforming managers; equal voting rights for all shares; pre-emption rights[22]; and equal treatment in takeovers. To back up these requirements, pension funds would demand laws and regulations such as take-over codes, insider information restrictions and limits on dual classes of shares, which seek to protect minority shareholders, as well as equal treatment of creditors in bankruptcy, to protect their holdings of corporate bonds. Shifts of corporate financing to securities markets would be reinforced by structural changes as outlined above, which will deprive banks of their comparative advantage in lending arising from superior information and ability to control

[21] Monks (1997) comments that greater activism of even private US funds abroad may show a lesser fear of commercial reprisal.

[22] That is, the right of existing shareholders to first refusal on a new issue of shares, to prevent dilution of their holdings.

firms. Partly due to free rider problems[23], securities market development would have the side effect of reducing banks' willingness to "rescue" firms in difficulty. Companies would need to reduce their gearing in response to this; a move that would be facilitated by the increased demand for equities from institutions[24].

Some such patterns are already discernible; flotations in countries such as Germany are at a record level[25] and on the side of universal banks, there are clear tendencies already to switch from traditional lending to investment banking activities and decumulation of shareholdings. Note also that on the side of companies, research suggests that there is a preference for reducing dependence on "relationship banks", to avoid the risk of exploitation (see Edwards and Fischer (1994), Hoshi et al (1993)), which is facilitated by the growth of securities markets, and takes place even though the result is a greater vulnerability to financial distress (Hoshi et al (1991), Elston (1993)). As noted by Hellwig (1991), this may link to desire to avoid exploitation in the context of an exclusive relationship. In addition, as argued by Petersen and Rajan (1993) so-called “commitment” relations may be vulnerable to increased banking competition, due to risk of poaching of borrowers by other lenders. Empirically, Gorton and Schmid (1996), attribute a disappearance of the favourable effects of German bank equity holding on firm performance between 1974 and 1985 to disintermediation, reductions in equity holdings by banks and greater interbank competition. All of these were thought to weaken banks' oversight over management.[26]

But radical change will take time. For example, company statutes in countries would need to be reformed if stakeholders were no longer to have a say in management. And company secrecy is to some degree protected by law, thus maintaining banks' comparative advantage over markets as a source of finance. Large blocks of shareholding, by banks, families or other firms, will disperse at most only gradually. The example of the Netherlands, where pension funds do not have a strong voice in corporate governance, show that pension fund growth alone is not sufficient to ensure radical change in

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[23] Because equity and bond holders would benefit from banks' actions.

[24] On the other hand, the position of banks will to some extent be protected by shareholding structures, which give them both stakes and voting rights on behalf of custodial holders. Medium sized firms may prefer to avoid flotation to retain "insider control". Company statutes in countries such as Germany recognise the rights of stakeholders, including creditors, to a say in management. And company secrecy is to some degree protected by law, thus maintaining banks' comparative advantage over markets as a source of finance. Even if there is a broader switch to an Anglo-Saxon system, the banks could maintain control via dominance of securities issuance and fund management. And control over fund management could be used to avoid some of the changes in financial structure outlined above. However, in our view this is unlikely, given the Single Market and the superior performance of competitors from the UK and US. On balance, the position of European banks would be weakened by institutional growth, but not wholly compromised.

[25] As noted in Bowley (1998), establishment of the so-called Neuer Markt for small firms in Germany has facilitated flotation of small firms, albeit with the household sector and foreigners being a more prominent investor than domestic institutional investors. There has also been growth of venture capital, driven mainly by “adventurous foreign investors”. Interestingly, the article also suggests that “the Neuer Markt and the flows of venture capital are breaking down traditional relationships between companies and banks….moving closer to the Anglo-Saxon model in which growth is financed through equity…allowing new industries to flourish where under the old system they may have struggled to get off the ground”.

[26] Blockholding per se was still found to be an important favourable influence on company performance.

this area (Bolt and Peeters (1998), Hoogduin and Huisman (1998)) – although Dutch pension funds do apparently monitor their own debt exposures rather than delegating the task to banks.

EMU may compound these effects. Regarding *corporate finance and governance*, owing to EMU, institutional investors are seeking to diversify much more widely across the Union, and seek to ensure that corporate management perform in line with "shareholder value", be it via development of hostile take-overs or direct shareholder pressure. For restructuring, as well as to ensure robustness against shocks in a context of weaker bank relationships, companies will wish to issue equity, which implies a need to satisfy the expectations of institutional investors regarding dividends, information disclosure, minority protection and profitability. And indeed, in the wake of EMU, hostile takeovers have been undertaken or attempted in France and Italy; in Europe as a whole mergers and acquisitions were at a peak of 3000 in 1998. Development of a euro corporate bond market (Cooper 1998) helps to underpin a shift in modes of corporate governance by facilitating leveraged buyouts and take-overs as a means to discipline management. For example, Olivetti were able to issue euro 9.4 billion in bonds to finance its majority control of Telecom Italia. Companies, under pressure to maximise profits and also facing attractive prices in the context of pressures for institutions to diversify across the euro area, are divesting their cross-holdings thus eliminating a proportion of currently passive shareholders. Banks equally are seeking to further reduce equity holdings, partly owing to capital adequacy considerations.

Following EMU, banks seem likely to be less willing to mount rescues of firms in distress, or even lending to cushion needs to restructure. This is because owing to the risk of disintermediation as well as greater competition among banks they could not be certain to recoup their investment via higher lending spreads on the firm in question[27]. As noted in Luce (1999) it is not just takeovers that are being financed in the euro bond market but also firms are using bonds for the main source of their regular debt financing. This pattern again increases the need for equity issuance as well as potential incidence of bankruptcy. Among the most interesting outworkings of a shift in corporate governance will be in the governance of banks per se, which Dermine (1996) sees shifting from "market share based to value based" strategies in the EMU context.

There will be a need for adequate adaptation of information to creditors and investors. Whereas banks rely on private information derived e.g. from ongoing credit relations, knowledge of the borrowers deposit history[28] and use of transactions services, securities markets must rely on public information. In IMF (1997) it is argued that EMU will lower public information costs owing to the integration of markets for goods and services across the Union. This is because in such a situation there will be less need for detailed knowledge of local market conditions; sectoral specialisation by equity or credit analysts across the Union would be sufficient for pricing of equity and debt claims.

[27] See Edwards and Fischer (1994).

[28] Note that disintermediation may disturb these information sources.

If one accepts the above arguments, then during a transition to a more Anglo-Saxon financial system, there is the issue of whether alternative means of corporate control (hostile take-overs and direct influence by institutional investors) as well as means of reducing asymmetric information and aiding control by debt holders (rating agencies, changes in credit structure and possibly a lower debt/equity ratio) can rapidly develop. Otherwise, there could tend to be a "vacuum" in corporate governance and corporate finance, with possible misallocation of investment, heightened agency costs and increased credit rationing.

Some results in the literature underline the potential importance of this issue. The risk that fragmented shareholders will all "free ride" and hence corporate governance will be inadequate is a standard critique of capital market based financial systems (Grossman and Hart 1980). There may be similar free riding in bond markets which discourage monitoring owing to the public good features of information about the borrower (Diamond 1984). Equally, there is concern that initial lenders will be less careful regarding monitoring and credit risk in the case of loan packaging, while investors in such securities may be less able than banks to deal with rescheduling problems (Hellwig 1991), and syndicated loans may suffer from the interest of lead managers in their fees and their low exposure to credit risk (thus indicating difficulties for corporate finance). Again, US experience shows that bond markets generally find rescheduling after financial distress difficult, and banks generally play a major role in restructuring, acting in many ways like German or Japanese relationship banks (Gilson et al 1990).

Policy action could be considered in this respect, notably in terms of appropriate regulations to buttress shareholders' rights, although market forces (e.g. in terms of the requirements that institutions make before accepting equity issues) should also be an effective catalyst for change.

**Conclusions**

The growing dominance of equity holdings by institutional investors, both domestic and international, is casting a sharp focus on their activities and owners and monitors of firms. It has been suggested that whereas some general considerations arise in all cases, it is useful to separate discussion of the developments in the Anglo Saxon countries and continental Europe/Japan. The former is showing an increase in direct influence of institutions in place of the previous reliance on the takeover mechanism to discipline managers. This has arguably led to improved corporate performance. The latter remain more firmly in the bank-relationship based governance paradigm. On the other hand, such differences should not be exaggerated, and come convergence is discernible on a modified form of the Anglo Saxon paradigm where institutions are the primary actors in corporate governance generally. In Europe, EMU will provide a major spur to such convergence.

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**Table 1: Aspects of financial structure 1997 (1980)**

| | **Size indicator (total financial assets/GDP)** | **Financial intermediation ratio** | **Of which: Bank intermediation** | **Of which: Institutional intermediation** |
|---|---|---|---|---|
| Germany | 6.1 (3.6) | 47 (45) | 75 (86) | 22 (12) |
| France | 10.0 (4.8) | 35 (62) | 73 (68) | 27 (4) |
| Italy | 5.3 (3.9) | 32 (32) | 91 (98) | 9 (5) |
| United Kingdom | 11.4 (4.2) | 42 (34) | 42 (64) | 38 (26) |
| | | | | |
| Canada | 7.1 (5.1) | 41 (34) | 46 (55) | 33 (19) |
| Japan | 8.5 (5.1) | 45 (42) | 34 (36) | 19 (10) |
| United States | 7.7 (4.1) | 38 (37) | 26 (58) | 52 (31) |

Source: National balance-sheet data

**Table 2: Financial instruments as a proportion of the total, 1997 (1980)**

| | **Equities** | **Bonds** | **Deposits** | **Loans** |
|---|---|---|---|---|
| Germany | 15 (8) | 22 (12) | 28 (37) | 35 (43) |
| France | 40 (15) | 9 (5) | 20 (36) | 26 (43) |
| Italy | 23 (17) | 26 (11) | 21 (33) | 26 (33) |
| United Kingdom | 40 (24) | 9 (16) | 28 (35) | 18 (24) |
| | | | | |
| Canada | 25 (22) | 25 (19) | 21 (27) | 24 (28) |
| Japan | 10 (10) | 17 (16) | 36 (35) | 35 (38) |
| United States | 33 (19) | 29 (23) | 11 (22) | 24 (33) |

Source: National balance-sheet data

**Table 3: Household sector assets 1997 (1980)**

| | **Equities** | **Bonds** | **Deposits** | **Institutional investment** |
|---|---|---|---|---|
| Germany | 8 (4) | 14 (12) | 40 (59) | 30 (17) |
| France | 32 (12) | 3 (9) | 31 (59) | 29 (9) |
| Italy | 25 (10) | 22 (8) | 23 (58) | 10 (6) |
| United Kingdom | 20 (12) | 1 (7) | 21 (43) | 53 (30) |
| Canada | 28 (24) | 5 (8) | 30 (38) | 32 (21) |
| Japan | 5 (7) | 3 (9) | 62 (69) | 31 (13) |
| United States | 24 (21) | 7 (10) | 14 (33) | 47 (28) |

Source: National balance-sheet data

**Table 4: Corporate sector liabilities, 1997 (1980)**

| | **Equities** | **Bonds** | **Loans** | |
|---|---|---|---|---|
| **Germany** | 32 (20) | 2 (2) | 46 (52) | |
| France | 72 (34) | 4 (4) | 23 (60) | |
| Italy | 53 (52) | 1 (4) | 38 (43) | |
| United Kingdom | 69 (37) | 1 (2) | 11 (22) | |
| | | | | |
| Canada | 37 (41) | 17 (8) | 17 (22) | |
| Japan | 20 (22) | 7 (3) | 45 (45) | |
| United States | 58 (49) | 13 (17) | 12 (13) | |

Source: National balance-sheet data

**Table 5: Results of correlation analysis**
(fixed effects regressions; variables significant at 95% level)

| **Dependent variable** | **Independent variable(1)** | **G-7 Countries** | **Anglo-Saxon** | **Continental 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) |