Original Article

Recent trends in institutional investor responsibilities and stewardship

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ABSTRACT This article examines the key topics relating to institutional investor responsibilities and stewardship. It reviews the developments contributing to the increasing scrutiny of institutional shareholders and the standards and guidelines introduced to promote active ownership. The article also analyses the criteria to evaluate stewardship and suggests how asset owners should discharge their share-ownership obligations.

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INTRODUCTION

Sparked by corporate scandals and collapses in the United Kingdom, United States and other markets, corporate governance has attracted considerable attention worldwide over the past two decades. Its focus, initially on practices at listed companies, has increasingly turned to the ownership behaviour of institutional investors, which have become a dominant force in many countries.

This article explores the key issues relating to institutional investor responsibilities and stewardship. It begins with a discussion of the developments contributing to the increasing focus on institutional shareholder responsibility and follows with an examination of the standards and guidelines promulgated to promote active ownership, including in the aftermath of the global financial crisis. Thereafter, it analyses the criteria to evaluate stewardship and suggests how pension funds and other asset owners should discharge their share-ownership obligations.

THE ROAD TO INSTITUTIONAL INVESTOR RESPONSIBILITY AND STEWARDSHIP

Throughout the world, institutional investors have become significant shareholders. In developed

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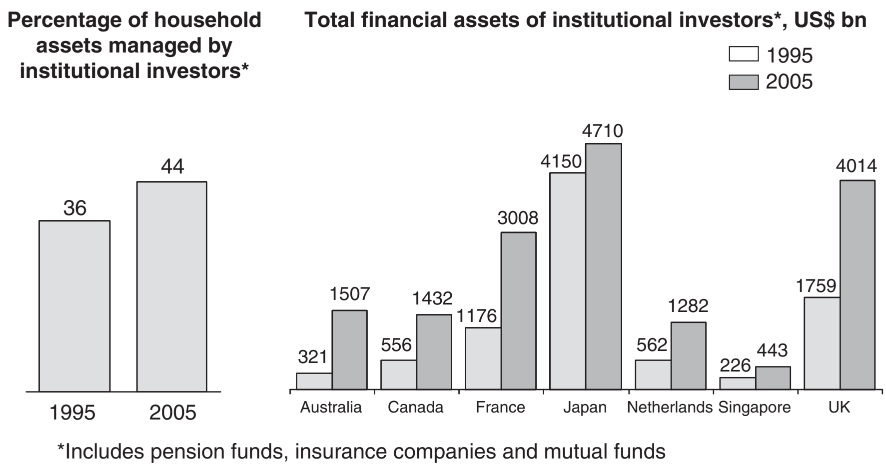

Figure 1: Assets managed by institutional investors have grown significantly in many countries.
Source: BIS (2007).

markets, the proportion of household assets managed by pension funds, insurance companies, mutual funds and other institutional investors increased from 36 per cent in 1995 to 44 per cent in 2005 (see Figure 1).[1] At year end 2009, the top 300 pension funds globally held assets of US$11.3 trillion,[2] whereas the top 500 investment managers had $62 trillion under management (with the top 20 firms managing 40.2 per cent of total assets).[3]

In the United Kingdom, institutional investors collectively own 70–75 per cent of the listed equities in that market. Correspondingly, institutional ownership of the top 1000 US-listed companies (by market capitalisation) climbed from 49.5 per cent in 1990 to 73 per cent in 2009.[4]

In the eyes of policymakers, the general public and others, the significant growth of institutionally managed assets holds the promise that institutional investors would exert discipline on the boards and management of investee companies to deliver strong and sustainable performance. With significant stakes in individual companies, institutional investors should have the incentives to engage in active monitoring. At the same time, the explosive growth in assets managed – reaching hundreds of billions US dollars for pension funds and trillions US dollars for asset managers – means that they should also be able to afford the resources to do so.

This belief – combined with the progressive 'retreat' of government through privatisation and deregulation, greater reliance on private savings to fund the retirement of the workforce at large, and strengthening of shareholder rights in many markets – has led to increased scrutiny of the actions of institutional investors as shareowners.

Reflecting the growing societal expectation of institutional investors, several sets of international guidelines have been developed over the past decade to encourage them to be active and responsible owners. In 2003, the International Corporate Governance Network (ICGN) – established in 1995 by a global grouping of pension funds and other investors – developed principles calling on institutional shareholders to 'contribute to improving and upholding the corporate governance of companies and markets in which they invest' and follow up on 'serious corporate governance concerns that may affect the long-term value of their investment'.[5]

Similarly, whereas the original 1999 Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance were largely silent on the responsibilities of institutional shareholders, the 2004 version declared that 'the effectiveness and credibility of the entire corporate governance system and company oversight will … to a large extent depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest'.

These guidelines were bolstered by the introduction of the United Nations Principles for Responsible Investment (UNPRI) in 2006. Developed by an institutional investor working group under the auspices of the United Nations Environment Programme Finance Initiative and United Nations Global Compact, the UNPRI extended the call for active share ownership to a broad array of environmental, social and governance (ESG) matters. Specifically, it requires signatories to undertake the following:

- incorporate ESG issues into investment analysis and decision-making processes;
- be active owners and incorporate ESG issues into ownership policies and practices;
- seek appropriate disclosure on ESG issues by investee companies;
- promote acceptance and implementation of the principles within the investment industry;
- work together to enhance effectiveness in implementing the principles;
- report on activities and progress towards implementing the principles.

The UNPRI has been remarkably successful, attracting more than 850 signatories – including nearly 700 asset owners and investment managers – by the end of 2010.

In parallel, several countries promulgated guidelines on active share ownership for domestic institutional investors. In 2002, the UK Institutional Shareholders' Committee (ISC) developed the Statement of Principles on the Responsibilities of Institutional Investors and Agents. This document provided guidance on the development of a responsible ownership policy, monitoring of performance, voting and engagement, escalation of intervention and evaluation and reporting of activities. In addition, references to institutional shareholder responsibilities have appeared in best practice guidance in Australia and the Netherlands.

Notwithstanding the efforts exerted to promote shareholder responsibility, the 2008–2009 global financial crisis revealed that institutional investors by and large failed to discharge the obligations expected of them.

Examination by the OECD into the contributing causes of the global financial crisis concluded that institutional shareholders 'have tended to be reactive rather than proactive and seldom challenge boards in sufficient number to make a difference'.[6] It also mentioned that 'in some instances shareholders have been equally concerned with short-termism as have managers and traders, neglecting the effect of excessive risk taking'.

In the United Kingdom, the Treasury Committee concluded that 'institutional investors have failed in one of their core tasks, namely the effective scrutiny and monitoring the decisions of boards and executive management in the banking sector, and hold them accountable for their performance'.[7] Former City Minister Lord Myners was more scathing, accusing institutional investors of being 'absentee landlords'.

At the same time, the European Commission (EC) has questioned whether institutional investors can be relied upon to act as responsible owners, noting in particular that the 'financial crisis has shown that confidence in the model of the shareholder-owner who contributes to the company's long-term viability has been severely shaken'. The EC added that the 'disinterest or passivity of shareholders with regard to their financial institutions … raises questions about the effectiveness of corporate governance rules based on the presumption of effective control by shareholders'.

In response, some countries have sought to toughen the obligations for institutional shareholders, including demands that they serve as 'stewards'. The United Kingdom, for instance, has promulgated the Stewardship Code, which seeks to 'enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities'. Its provisions (see Figure 2) are drawn principally from the ISC Statement of Principles on the Responsibilities of Institutional Investors and Agents, meaning that its

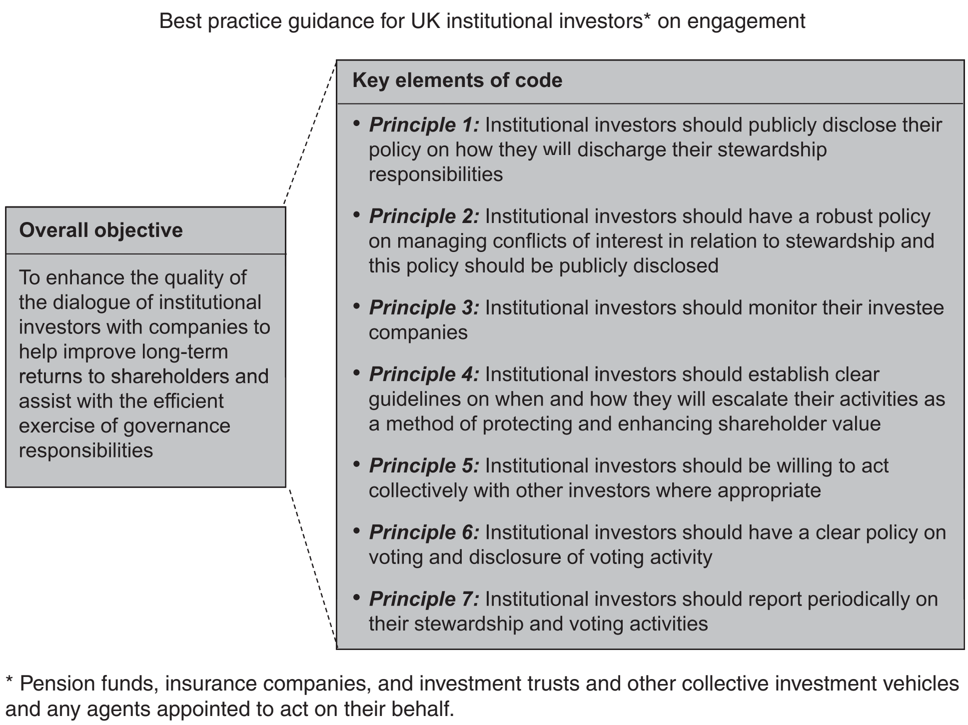

Figure 2: The UK Stewardship Code.

requirements are largely familiar to UK institutional shareholders.

Importantly, the Stewardship Code calls on institutional investors to publicly state whether they have applied its provisions and, if not, to explain why. Equally noteworthy, the code is supervised by the Financial Reporting Council rather than the fund management industry.

Even though the Stewardship Code is targeted principally at investment managers, pension funds and other asset owners are encouraged to report whether and how they have complied with it.

In addition to the United Kingdom, variants of the Stewardship Code have been developed or are under consideration in Canada, France, the Netherlands and South Africa.

The stakes for institutional investors are high. If they do not change their conduct as shareowners, regulations may be imposed and, in some countries, shareholder rights may also be weakened. UK Financial Reporting Council Chairman, Lady Hogg, noted that 'to prevent these [shareholder] rights being overridden by international regulators, shareholders need to be able to demonstrate they're used responsibly and effectively'.[8] Similarly, a pension fund executive in Australia recently remarked that 'Australian shareholders have strong rights and if they don't use them, the rights may be taken away'.

EC Commissioner Michel Barnier mentioned recently of the need to ensure that shareholders 'play their roles fully'. He added that 'we have spoken for years about shareholder rights. It is time to also talk about shareholders' obligations'.

DEFINITION AND CATEGORISATION OF STEWARDSHIP

Although 'stewardship' has entered the lexicon in the debate on institutional shareholder responsibilities, it is not a well-defined concept. We support the articulation of Tomorrow's Company that stewardship involves 'the active and responsible management of entrusted resources now and in the longer term, so as to hand them on in better condition'.

It is important to acknowledge that not all institutional investors must be stewards and stewardship can take different forms. For example, investment managers who have short-term investment strategies may legitimately be exempted from the Stewardship Code, although asset owners with long-term obligations should assess carefully whether investing with managers such as event-driven hedge funds or momentum-driven 'quant' funds is consistent with their long-term investment objectives and fiduciary obligations.

At the same time, differences in investment styles may also warrant variation in the way stewardship responsibilities are discharged. For example, it may not be reasonable to expect mainstream institutional funds to adopt the same resource-intensive approach to engagement with individual companies as focus funds, the latter of which are generally better positioned to challenge boards and management on the intricacies of strategy and performance.

Notwithstanding differences in investment styles, we believe it is important for institutional shareholders to declare their stance on stewardship, not least because it alerts companies to the investment objectives and engagement approaches of their investors. The spectrum of stewardship defined by Tomorrow's Company provides a helpful framework for further consideration and development. According to Tomorrow's Company, stewardship activities fall into the following categories:

1. *No engagement*.
2. *Voting practice* – establishing and operating a clear corporate governance policy on votes at annual general meetings.
3. *Reactive engagement* – monitoring and engaging in a dialogue with the CEO and chairman, but pursuing the full process of engagement only when trouble has been flagged or the company's explanation (for example, for non-compliance with a provision of the Corporate Governance Code) is felt to be unacceptable.
4. *Strategic engagement* – recognising an obligation to participate in the process necessary to make engagement effective and thereby playing its part, both individually and with other like-minded investors, across a range of relevant activities (for example, engagement in the nomination of directors, regular strategic dialogue and challenge, regular engagement not only with the chairman and/or CEO, but between fund managers and each non-executive director).
5. *Stewardship engagement* – directly exercising ownership responsibilities, possibly on a portfolio restricted to allow focus, or through the shared exercise of such stewardship with other investors across a wider portfolio, with the focus of engagement on assessment of leadership, approval of board and committee composition, endorsement of strategies and objectives and appraisal of performance.

Shareholders should declare whether they apply the Stewardship Code and specify where they position themselves on the stewardship spectrum. Correspondingly, companies that wish to attract investors that are both loyal shareholders and good stewards should develop mechanisms to encourage such behaviour.

Governments can also promote loyalty and good stewardship through making changes to the tax regime, for example, by reducing capital gains tax for long-term holders.

Loyalty can be defined as a minimum of, say, 2 years on the share register with shares that have not been lent. Good stewardship can be defined by reference to the Tomorrow's Company or equivalent framework.

In additon to lower tax burdens, other rewards for loyalty and good stewardship could include enhanced dividends, extra voting rights and bonus shares.

WAY FORWARD AND CONCLUSION

How then should pension funds and other asset owners strive to fulfil their ownership obligations? In our view, asset owners with long-term obligations – such as pension funds, insurance companies, endowments and sovereign wealth funds – should endeavour to embrace the upper end of the stewardship spectrum for their listed equity portfolios. As most asset owners delegate some or all investment decision making to external managers, they should also ensure that their fund managers follow suit.

To create a conducive environment for fund managers, asset owners should make certain that the performance metrics and financial incentives applied to their investment managers are consistent with good stewardship. According to the Marathon Club, an organisation that promotes long-term investing, fund managers should be evaluated using a 5–7-year time horizon, and annual reviews should focus on the manager's investment process and whether the portfolio assets – in terms of number of holdings, degree of concentration, types of assets, turnover level, valuation ratios and so forth – match the stated philosophy.

In terms of fee arrangements, options include introducing performance fees and spreading fee payments over multiple years. To ensure that a fund manager's incentive structure does not promote excessive risk-taking, the investment management agreement should specify the level of risks that the asset owner is prepared to assume.

If fund managers are unable or unwilling to faithfully carry out the stewardship objectives of their asset owner clients, the latter should appoint specialist providers to do so.

To conclude, the global financial crisis showed that institutional investors were not effective as good stewards. Whereas not all shareowners need to embrace stewardship, the challenge is to encourage more good stewards than exist at present.

Good stewardship is not presently well-defined and the stewardship spectrum articulated by Tomorrow's Company provides a good starting point for further discussion and development. Lastly, we believe rewards should be introduced to encourage investors to be loyal shareholders and good stewards.

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