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Institutional Investors and Securities Markets: Which Comes First?

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Introduction[1]

Institutional investors comprise pension funds, insurance companies and mutual funds. Of the three, pension funds have traditionally been the most important component with resources exceeding 50 percent of GDP in a score of countries around the world. Insurance company assets, especially life insurance assets but excluding any pension fund assets managed by insurance companies, rarely exceed 30 percent of GDP, while mutual fund assets have until recently been well below 20 percent of GDP in most countries.

Recently mutual fund assets have grown at a very fast rate in the United States and many other countries. In fact, assets of US mutual funds now exceed 50 percent of GDP, although some of these represent investments by company pension funds. Moreover, with the recent growth of personal pension plans, the traditional distinction between pension and mutual funds has been blurred considerably. In 1996, retirement plans of all kinds accounted for 35 percent of total mutual fund assets in the United States, while retirement plans invested in mutual funds accounted for 19 percent of all retirement assets (Investment Company Institute 1998).

Although retirement-linked mutual funds have a longer horizon than ordinary mutual funds, the ability of savers to switch across funds and the increasing use of commingled funds for both retirement and other purposes suggests that pension funds and mutual funds increasingly have the same policy implications for securities markets irrespective of the purpose for which they are held. Historically, however, (company) pension funds had different structures and objectives and their policy implications may have differed from those of mutual funds.

The Sequencing Issue

Implicit in the title of this paper lies an important policy question. Should a country promote the creation of private pension funds, insurance companies and mutual funds in the

[1] I am grateful to Tom Glaessner, Fernando Solis-Soberon, Alfred Steinherr, and Salvador Valdes-Prieto, discussants of the paper, for their comments and insights.

absence of well developed securities markets?[2] The answer to this question varies for each type of institutional investor.

With regard to pension funds, the policy question can take two forms. The first and stronger form asks whether a country should undertake systemic pension reform with a compulsory fully funded pillar in the absence of well developed securities markets.[3] The weaker version asks whether a country should offer tax incentives for the voluntary creation of funded pension schemes.

To address the stronger form first consider an imaginary country that lacks all the fundamental elements of a well functioning financial system: no solvent banks and insurance companies; no mutual funds and securities markets for bonds and equities; no long-term financial instruments and annuity products; no experienced regulators and supervisors; no bankers and actuaries; no accountants and lawyers; and no rating agencies. Should such a country reform its pension system and introduce a mandatory retirement savings scheme? Normally, my answer would be a firm no. Such a country should not even have a traditional unfunded social security system and if it happens to have one, it is virtually certain that it would be malfunctioning, suffering from evasion, incomplete records, administrative inefficiencies, and strategic manipulation.

There are, however, three preconditions whose fulfillment would allow even a country lacking all the essential elements of a well developed financial system to consider undertaking systemic pension reform. These include: a strong, long-term and persistent government commitment to implement a successful pension reform; introduction of effective arrangements for the safe custody of pension fund assets (to prevent theft and misuse of assets); and free access to foreign expertise. These preconditions are not easy to fulfill. The first implies a holistic approach to economic reforms and a willingness to proceed with banking, insurance and capital market as well as macroeconomic and fiscal reforms. It also implies that successive governments even if they come from different political parties would be committed to the success of pension reform.

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[2] The term securities markets is used here to refer to both equity and debt instruments, although traditional concern was often focused on the underdevelopment of equity markets.

[3] The merits and demerits of systemic pension reform, which involves a move away from complete reliance on an unfunded public pillar, are not discussed in this paper. For a comprehensive review of the arguments for systemic pension reform, see World Bank (1994). A more succinct overview is provided in Vittas (1996).

Openness to foreign expertise implies a willingness to see large foreign financial institutions play a leading part in the funded pillar, ideally in joint ventures with large local groups, and by extension in the domestic financial system. Ensuring safe custody of pension assets also implies reliance on institutions with the large financial resources and advanced technical capabilities that are required for providing an effective custodial service.

Very few, if any, countries satisfy these unlikely sets of conditions. Countries that lack all the essential elements of well functioning financial systems would also be unlikely to show the strong commitment to holistic reform, effective safe custody, and free access to foreign expertise. For the majority of countries that are characterized by somewhat weaker commitments and somewhat better developed financial systems, the important financial preconditions for systemic pension reform would include commitment to macroeconomic stability and presence of at least a small number of sound and well functioning banks and insurance companies. Prior development of securities markets would not be necessary, although willingness to implement capital market reforms and openness to foreign expertise would be essential for the long-term success of pension reform.

Thus, to determine a country's readiness to implement systemic pension reform, it is more important to assess the commitment of the authorities to a holistic reform program than to evaluate the state of development of its securities markets. A basic reason for this is that the creation of private pension funds involves a gradual accumulation of long-term financial resources. This provides sufficient time to a reforming government to take all necessary steps for establishing robust and well-regulated securities markets.

In fact, in cases of systemic pension reform involving a gradual accumulation of assets, the most pressing issue in implementing the reform program may well be ensuring a sufficient technical capability for collecting contributions and keeping records rather than an adequate supply of long-term financial instruments. Initially, at least, the relatively small resources of pension funds can be invested in treasury bills and bank deposits. As pension fund assets increase, a growing proportion can be allocated to longer-term government bonds and corporate securities. Technical constraints as well as political opposition and the burden of the transition cost are usually greater obstacles to systemic pension reform than the state of development of securities

markets. This is in some sense ironic because among the main benefits of systemic pension reform are the positive externalities associated with the development of securities markets.

If the answer is affirmative to the stronger form of the question, it will also be affirmative to its weaker version. In the absence of well-developed securities markets, voluntary employer-sponsored pension funds will invest in book reserves, effectively nonmarketable equity of the sponsoring employers. This was widespread practice in all countries, including Anglo-American ones, prior to the 1950s, but has persisted into the present in Germany and some other European countries. Book reserves can be combined with holdings of government bonds and bank deposits. Over time book reserves have been replaced, especially in Anglo-American countries, with marketable government and corporate securities.

The argument in favor of private pension funds counters a long-standing criticism of traditional social security experts against funded pension schemes. The criticism was that in the absence of well-developed capital markets, funded pension schemes would fail because they would be used as captive sources for financing large budget deficits at negative real rates of interest. The traditional criticism of funded pension schemes was probably valid before the 1970s when government policies in most developing countries were inflationary and financial market development was not an important objective of government policy. But it overlooked the dynamic interaction that could develop between pension funds and capital markets once government policies focused on maintaining financial stability and on removing obstacles that inhibited the development of markets. The experience of several OECD and, more recently, Latin American countries shows that both private pension funds and capital markets can thrive under the right macroeconomic policies, meaning low inflation (or moderate inflation with indexed instruments), small budget deficits and positive long-term real rates of interest.[4]

Insurance reform is also primarily sought for its own sake, as insurance business is underdeveloped in most low and middle income countries. In addition to achieving macroeconomic stability, reforming the insurance sector implies the removal of repressive

[4] The interaction between securities markets and pension funds may materialize even if private pension funds represent a small, but significant, part of the pension system. It is not necessary to implement a complete privatization of social security to obtain the capital market benefits of private pension funds. In fact, a mixed private/public pension system may be preferable as it allows a diversification across providers and may offer better protection against the long-term volatility of capital markets (Vittas 1996).

regulations that impede competition, innovation and efficiency. Insurance sectors in developing countries are often dominated by state-owned entities with limited participation by private or foreign companies and are characterized by inadequate capital, high operating costs, limited product innovation, low investment returns, lax control over brokers, high levels of receivables, extensive fraud, unduly large claims by some insured but otherwise low claims and settlements for the majority of customers, protracted disputes and long delays in settlement, and generally widespread mutual mistrust between insurance companies and the insured.

Improving financial returns is only one of many actions that can be taken to enhance the performance of the insurance sector. Because of a smaller accumulation of financial assets by insurance companies in comparison to pension funds, the impact of insurance reform on capital market development is also less extensive. In contrast, improving financial returns is more central for pension funds, which specialize in offering long-term capital accumulation accounts. Nevertheless, insurance reform may be an essential element of systemic pension reform because of the derived demand for term life and disability insurance by active workers and of annuity products by retiring workers.

The situation of mutual funds is different. Passing mutual fund legislation and creating an enabling environment for their establishment is usually an integral part of measures to promote capital market development. But mutual funds specializing in particular instruments are unlikely to thrive unless the markets for those instruments are also well developed. In many developing countries, the mutual fund industry is dominated by funds investing in government bonds or bank deposits, with only a small part accounted for by equity funds. In most cases, this is probably explained by the usually high level of real interest rates on debt instruments and the continuing lack of confidence in equity markets. Whatever the reasons, this experience suggests that mutual funds follow the development of securities markets, unlike pension funds, which often predate them, and insurance companies, whose development is often unrelated to the development of securities markets.

Dynamic Interaction

The sequencing issue, whether different types of institutional investors lead or follow the development of securities markets, is an interesting question but it is less important than the

interactive issue. Experience from Anglo-American countries suggests large potential benefits from the interactive process between institutional investors and securities markets. Institutional investors can act as a countervailing force to the dominant position of commercial banks and thus promote competition and efficiency in the financial system. They can also stimulate financial innovation, modernize capital markets, enhance transparency and information disclosure, and strengthen corporate governance. The efficiency gains from these qualitative changes in the functioning of financial systems may far exceed the growth effects from the quantitative development of banks and securities markets that have been documented in recent years (Levine and Zervos 1996). Although empirical quantification of these efficiency gains remains to be done, there is considerable evidence attesting to the enhanced efficiency of the financial system.

The efficiency gains from the development of institutional investors are not automatic. They are less likely to materialize if institutional investors are required to invest only in nonmarketable government securities as has long been the case with the national provident funds of Singapore and Malaysia. Although these funds have avoided the fate of provident funds in African countries, where high negative real rates of return have eroded the real value of fund balances, they have failed to provide a direct stimulus to the development of domestic securities markets. In similar vein, although to a much lesser extent, institutional investors in continental European countries have been constrained by quantitative investment limits and by conservative investment policies from exerting a beneficial effect on capital market development. In contrast, in Anglo-American countries, institutional investors have made a stronger contribution to capital market development. Operating under the “prudent person” rule, they have also been able to earn higher rates of return than in countries with quantitative investment limits (Davis 1997).

The emergence of institutional investors as large financial institutions is quite recent in developing countries. The remainder of this paper examines the impact of institutional investors on the US financial system, with occasional references to the experience of other Anglo-American countries as well as Chile and Argentina, two reforming countries where institutional investors have started to have an impact on financial market structures and practices. It is, however, important to remember that the interactive process between markets and institutions that is emphasized in this paper takes considerable time to come to fruition. Patience and persistence are strongly recommended.

Countervailing Force

One of the main benefits of the growth of institutional investors is the intensification of competition in the financial system. The development of new sources of finance, whether from new entry of foreign banks, access to foreign markets, or the growth of institutional and other nonbank financial intermediaries (such as leasing and factoring companies) forces dominant commercial banks to become more competitive and to start seeking out their customers rather than waiting for prospective borrowers to visit them. In the United States, this change in bank behavior seems to have taken place in the 1940s and 1950s, followed within a decade or so by other Anglo-American countries, and in subsequent years by most developed and developing countries.

In the United States, the process was stimulated not only by the growth of institutional investors but also by a notable change in the investment policies of life insurance companies, a group of institutions that commanded a significant share of US financial assets since the beginning of the century. Life insurance companies controlled 11 percent of the total assets of US financial institutions in 1900 against 66 percent for commercial banks. This rose to 17 percent by 1929 and to 25 percent by 1940, when commercial bank assets had declined to 55 percent (Krooss and Blyn 1971). In the 1940s and 1950s insurance companies lowered substantially their holdings of government bonds and agricultural mortgages and increased their holdings of nonfarm mortgages and especially of privately placed corporate debt (Calomiris and Raff 1995). Private placements were favored by borrowers who had limited access to the public bond market and for whom the total issue costs of private placements were lower than those of public placements (Calomiris and Raff 1995 and Carey and others 1993). The growth of insurance company lending to industrial and commercial companies increased competition to bank loans.

The development of institutional investors also contributed to the advent of competitive bidding for corporate issues of securities. Historically, new issue business was highly rigid and hierarchical. Investment banks were jealous of their syndicate positions and their ranking in particular issues. The large investment banks cultivated close relations with large corporate issuers, acted as sole managers for new issues, and organized large syndicates for underwriting and distributing them. Relative positions in these syndicated issues were rigidly respected

(Chernow 1990). Although the SEC promoted the use of competitive bidding through regulatory means in the 1930s and 1940s, the market impact was limited. The SEC first required sealed bids for new issues of corporate securities in the 1930s and then implemented rule 50 on competitive bidding in 1940. But because of strong opposition from investment banks, this was only applied on bond issues by large utility companies and railroads. Issues by industrial and commercial corporations as well as private placements, which had the largest issue spreads, were exempted (Carosso 1970).

But what was not achieved by regulatory fiat was brought about by the growth of institutional investors, the resources of which reached critically large levels in the 1970s. While traditional investment banks maintained unrivaled close relations with large corporations, new investment banks that specialized on trading rather than issuing and underwriting securities developed close relations with institutional investors. The greater availability of financial resources encouraged corporations to place new issues directly with institutional investors, to replace sole management of their public issues by several joint lead managers, and to set up "Dutch auctions" for their new issues and invite competing syndicates of underwriters.

In the 1980s and 1990s, institutional money fueled the operations of corporate raiders, the use of leveraged buyouts, and the growth of high-yield securities, all of which contributed to greater competition in financial markets and facilitated the corporate restructuring that took place in the 1980s and 1990s. Institutional investors have also supported the growth of venture capital funds and the provision of private equity, both of which help finance new and expanding smaller firms.

Another benefit of the growth of institutional investors was the decline in both new issue and trading costs. The first was not just a result of the countervailing force of institutional investors, but it also reflected lower marketing and monitoring costs of issues targeted at institutional investors. Studies report narrower spreads for new issues by companies in which institutional investors are large shareholders (Hansen and Torregrosa 1992, Hansen and Pinkerton 1982). The fall in trading commissions was associated with the rise of bloc trading that was prompted by the growing importance of institutional investors. Trading commissions for large trades fell by 40 percent after the abolition of minimum commissions in New York in 1975

(Chernow 1990). Large trade commissions also fell in London after the stock exchange reform in 1986 and in all the stock markets that have followed in the steps of New York and London.

Financial Innovation

The past three decades witnessed major new financial innovations as well as a large expansion of the financial services industry. Most of the innovations in the 1970s were prompted by the increase in the level and volatility of interest rates, but institutional investors, and especially pension funds, were major forces stimulating this innovative process (Bodie 1990). Financial innovation was also influenced by regulatory changes.

The response of most lenders and borrowers to the high and unpredictable interest rates of the early 1970s was a move to the use of floating rate debt, including adjustable rate mortgages, a process that had already taken place in Britain during the 1960s. However, pension legislation enacted in 1974 codified the liabilities of US private pension funds and imposed minimum funding requirements. This created a strong demand for long-duration fixed-income securities by pension funds and contributed to the emergence and growth of both zero-coupon bonds and mortgage-backed securities.

It is interesting to note that mortgage securitization did not take off until another unrelated and ill-advised regulatory change provided a strong incentive for the supply of securitized mortgages. This regulation allowed thrift institutions to sell their low fixed-rate mortgage loans in the early 1980s, when market interest rates were very high, and to amortize the losses over a longer period (Barth 1991). Mortgage securitization also facilitated the regional diversification of mortgage portfolios of US commercial banks and thrift deposit institutions. Securitized mortgages, and especially collateralized mortgage obligations with their successive maturity tranches, provided an attractive outlet for the long-term resources of institutional investors, who now hold about one third of all outstanding agency securities in the US financial system.

The immunization strategies of pension funds also promoted the use of derivative products, such as index options and futures contracts, while pension funds also spurred innovations in the equity markets. The first indexed (or index-tracking) mutual fund was created for pension funds in 1971, in response to the growing realization that active investment management failed on average to achieve higher net returns than a fund that was passively

invested in a market index. The first index-tracking fund for retail investors was established in 1976 (Bogle 1994). Since then there have been several additional innovations with index-tracking funds for bonds, midcap and small cap equities, value and growth equities, and international equities.

More recently, in response to the growing popularity of defined contribution retirement plans and the demand for a more effective management of investment risk, new synthetic investment products have been developed. These minimize the downside risk of equity investments (by providing a floor on the value of investments over some period of time), while allowing some participation in the upside potential of the equity market (Bodie and Crane 1998).

Financial innovation in developing countries that have implemented systemic pension reform has been faster and more directly linked to the creation of private pension funds. In Chile, which reformed its pension system in 1981, pension funds supported the development of both mortgage and corporate bond markets (Diamond and Valdes-Prieto 1994). The outstanding volumes of mortgage and corporate bonds grew from negligible levels in 1981 to respectively 9 percent and 4 percent of GDP by 1993, while government bonds and central bank securities amounted to 28 percent of GDP in 1993. Pension funds and insurance companies (which benefited directly from the pension reform program) held over 95 percent of each category of these bonds.

In Argentina, which reformed its pension system in 1994, financial innovation has allowed pension funds to invest in synthetic products with a more attractive risk/return tradeoff than either bank deposits or marketable securities. For example, the vast majority of bank deposits (covering 23 percent of total assets) were placed in December 1997 in certificates of deposit with a variable return linked to an underlying bond or stockmarket index. Although these innovations involve products with embedded options that are difficult to price, they benefit pension funds by limiting their downside risk, while allowing them to share in the upside potential of the underlying index. Nevertheless, they expose them to counterparty risks, which can be very large if the financial institutions offering such instruments are not consistently and at all times properly hedged. However, the banks offering such synthetic products to the Argentine pension funds are large international banks that have the expertise and internal control systems to ensure their ability to honor these contracts. Argentine pension funds also invested in securitized instruments based on

credit card and other receivables. In both Chile and Argentina, the private pension funds have also been able to invest in the securities of privatized enterprises.

Market Integrity

Most investors are concerned about market integrity and fair prices, which depend on the timely disclosure of meaningful information and the protection of minority shareholders from market manipulation and other exploitation by controlling groups of shareholders. Institutional investors, which are managed by trained professionals, are usually more aware than ordinary investors of the potential conflicts of interest and agency problems facing corporate management and are better able to insist on investor protection legislation that will ensure market integrity.

Investor protection rules cover prohibition and penalties on insider trading and reporting of insider positions as well as rules on self-dealing, takeovers and changes in corporate controls, asset valuation, prospectuses for new issues, and disclosure of audited consolidated statements on public companies. Investor protection rules are better developed in countries where large institutional investors hold diversified minority positions in a large number of companies than in countries where institutional investors are either underdeveloped (e.g. Germany) or tend to hold large controlling positions in a small number of companies (e.g. South Africa). At the same time, a stronger legal protection of minority shareholder rights may have contributed to the earlier and on a larger scale diversification into equities of institutional investors in Anglo-American countries compared to continental European countries.

Mindful of the need to protect the long-term interests of workers affiliated to the new private pension funds, the authorities in Chile, Argentina and other reforming countries have taken measures to strengthen investor protection, especially in the areas of insider trading, self-dealing, and takeover rules. The publication of consolidated statements following internationally accepted accounting and auditing standards is not yet fully implemented, although pressures for the disclosure of timely and meaningful information on corporate performance are mounting.

Pension reform led to the development of an effective risk classification system in Chile under a committee comprising public officials and representatives of the private pension funds. This committee rates various instruments for their suitability as pension fund investments. They screen ratings prepared by private rating agencies and thus avoid to some extent the problems

caused by an alleged low quality of private ratings. The quality of private ratings is also raising concerns in Argentina. In both countries competition among a large number of rating agencies seems to have resulted in a lowering of standards. This may, however, be a temporary setback. The quality of ratings is likely to improve once a consolidation of rating agencies takes place and higher quality standards are adopted.

Modernization of Market Trading

Institutional investors also exert pressures for modern and efficient trading facilities. This covers not only the trading activity per se but also clearing and settlement facilities as well as the creation of central depository agencies. Efficient trading systems are characterized by low transaction costs, high transparency, high liquidity, and low volatility. There is often a tradeoff between these characteristics and especially between high liquidity and low volatility on the one hand and low transaction costs and high transparency on the other.

Although there are several different ways in which trading systems can be organized, institutional investors have contributed to the development of more efficient trading systems. As already noted, the use of bloc trading led to the abolition of minimum commissions and the restructuring of stock markets in many countries around the world. Institutional investors have also played an important part in promoting more efficient clearing facilities and establishing central depository agencies that facilitate the move to book-entry systems and provide safekeeping services. And they have exerted pressure for modern efficient and reliable back-office operations that have suffered in all countries with emerging securities markets as existing facilities could not cope with fast growing trading volumes.

The impact of institutional investors on trading and market liquidity depends on their investment policies and the extent to which they trade actively their portfolios. Newly established private pension funds tend to adopt a policy of "buy and hold." This is often explained by the gradual but steady increase in their financial resources at the start of their operations. Any rebalancing of their investment portfolios can be easily effected by redirecting new inflows of funds, without requiring large sales of existing holdings. The limited supply of suitable securities is also another reason behind such "buy and hold" strategies.

In this respect, it is instructive to note that a similar pattern was followed in the United States and the United Kingdom when corporate pension funds started to place their reserves in corporate equities. For instance, a "buy and hold" strategy was advocated by the trust department of Morgan Guaranty in the early 1960s (Chernow 1990). Morgan Guaranty had the largest trust department among commercial banks and was one of the designated managers of the pension fund of General Motors that had decided in the early 1950s to allocate up to 50 percent of its pension reserves into equities. Similarly the Imperial Tobacco Pension Fund diversified into equities in the late 1940s and followed a "buy and hold" strategy while it was building its equity portfolio.

The initial and amply justified "buy and hold" strategies delay the beneficial impact of institutional investors on market liquidity. However, they do not justify the conclusion that the development of a fully-funded pension system is unlikely to develop local stock markets per se (Reisen 1997). Over time, pension funds and their asset managers are likely to adopt more active trading policies, enhancing the liquidity of markets and leading to higher efficiency and lower transaction costs.

Corporate Governance

The role of institutional investors in corporate governance has evolved in line with their growing importance as corporate owners. As long as their equity holdings were small and diversified in a large number of companies and as long as they represented a small fraction of market capitalization, institutional investors adopted a passive approach to corporate governance. They tended to vote with management and if they were unhappy with corporate performance, they could sell without suffering a big fall in market price.

But with continuing growth in their accumulated assets, institutional investors became collectively dominant shareholders of many nonfinancial corporations. Among large US corporations, institutional investors owned in 1988 86 percent of the equity of Amoco, 82 percent of General Motors, 74 percent of Mobil and 70 percent of Citicorp (Coffee 1991). With such dominant positions, they could no longer exercise the "exit" option without disrupting the market and suffering big falls in market prices.

Recent attempts to develop effective means for exercising "voice" in corporate affairs are a response to the decline of the "exit" option. In addition, institutional investors have been

adopting investment policies based on passive indexation as an effective strategy for achieving diversification with market returns and low transaction costs. Passive indexation policies have limited their ability to divest from poorly performing companies and have increased pressures for more effective monitoring of corporate performance and for increasing the accountability of corporate managers.

Faced with persistently poorly performing corporations, some institutional investors increased their public criticism of overambitious expansion plans, excessive managerial compensation, and anti-takeover defenses that entrenched the position of incumbent managers at the expense of shareholders. Open public criticism has been instrumental in mobilizing collective action by disgruntled shareholders and in raising the threat of regulation and legislation to prohibit the alleged abuse and misbehavior.

In the United States, public criticism of poor corporate performance has been led by public pension funds, such as the California Public Employees Retirement System (CALPERS) and the New York State Common Retirement Fund, which were independent of corporate management. But another effective way of voicing public criticism has been the use of formal associations of institutional investors (such as the Association of British Insurers and the National Association of Pension Funds in the United Kingdom) or ad hoc groupings of interested institutional investors (such as the Institutional Shareholders Committee in the United Kingdom or the Council of Institutional Investors in the United States). The last-named group was created 14 years ago and is a forum for big institutional shareholders to discuss corporate problems. It regularly publishes a list of the 50 least performing companies and thus exerts pressure on the offending corporate managers without exposing any individual shareholder or pension fund manager to the threat of corporate retaliation.

Institutional investors have also emphasized the importance of strengthening corporate governance structures and especially of increasing the accountability of managers, a process that is ongoing. In the United Kingdom, three high level committees have published reports recommending various measures to strengthen corporate governance, while in the United States, two codes of corporate governance were issued recently, one by CALPERS and the other by the Council of Institutional Investors.

The measures that are contemplated to strengthen corporate governance structures and improve the effectiveness of corporate boards include the following: separating the functions of chairman and chief executive officer and appointing nonexecutive chairmen in all companies above a certain size; electing independent external directors; using cumulative voting for board elections; opening the proxy process to allow greater communication among shareholders; using confidential voting at board meetings; expanding the role of board committees that are independent of executive directors; disclosing the amount and rationale of managerial compensation; and opposing anti-takeover defenses that are designed to protect incumbent managers at the expense of shareholders.

Of these measures, the use of cumulative voting for board elections seems to be the most powerful tool for allowing institutional shareholders to elect directors that are truly independent of corporate managers and play an active part in protecting the interests of shareholders. Of major importance is also the increasing use of board committees consisting of nonexecutive directors to: select and appoint chief executive officers (to avert the perpetuation of the business policies of incumbent management); vet managerial compensation (to prevent excessive packages that are unrelated to performance); approve major expansion plans (to check managerial tendencies for empire-building); and evaluate and respond to friendly and hostile bids (to ensure that shareholders receive maximum value from takeovers).

It is, however, too early to assess the long-term effectiveness of recent initiatives. Nonexecutive directors and collective bodies may over time be captured by corporate management. Institutional investors are not interested in second-guessing management and they may well have a preference for liquidity rather than control. But their involvement in corporate governance may facilitate the forced replacement of underperforming managers. Over the past decade or so, several large US corporations, including American Express, General Motors, and IBM, replaced their management in response to pressure from large institutional shareholders (Monks and Minow 1995).

Financial Regulation

The development of securities markets and the growth of institutional investors require robust and effective regulation. Most developing countries lack a robust regulatory framework,

although copying laws and rules prevailing in more advanced countries is not a major exercise. The real challenge is the shortage of experienced supervisors and the absence of a strong tradition favoring compliance with the rules and discouraging regulatory forbearance.

The complex issues encountered in designing an effective regulatory framework are not addressed in this paper. However, three important points may be made. First, the gradual increase in the assets of institutional investors allows time for intensive training of regulators and for developing a more sophisticated regulatory regime as the needs of institutional investors and securities markets evolve and become more complex. Since its pension reform of 1981, Chile has strengthened considerably the regulation and supervision of both financial institutions and markets and other reforming countries in Latin America and Eastern Europe have engaged in long-term programs of upgrading their regulatory systems. Second, given the absence of long traditions in institutional investing, developing countries may well start by adopting a strict regulatory framework and then proceed to relax it as the supply of financial instruments evolves and the case for adopting the more flexible "prudent person" rule becomes more credible (Vittas 1998). Third, involving foreign institutions in the operation of institutional investors lowers the importance of strict regulations and effective supervision since large foreign institutions have both the resources and the expertise to operate prudently and effectively. And large foreign institutions also have their reputation at stake.

One regulatory policy that has caused considerable controversy is the imposition of investment limits on the portfolios of institutional investors in newly reforming developing countries and especially the prohibition or very low limits applied on holdings of overseas assets. In the long run, all types of financial institutions should be encouraged to hold diversified portfolios, which for institutional investors, especially pension funds and insurance companies, should include equities and overseas assets. In the short run, imposing some investment limits may be advisable given the small volume of accumulated resources and the need to develop asset management expertise, although the latter constraint may be overcome by encouraging use of internationally diversified local or foreign mutual funds. Any investment limits are unlikely to be binding given the strong "home bias" of institutional investors (Brennan and Cao 1997). In the long run, regulatory policy should move toward adoption of the "prudent person" rule with an

implicit or explicit requirement for adequate portfolio diversification and an emphasis on the fiduciary duty of asset managers to serve the interests of investors.

One final point before concluding this paper concerns the role of asset managers of institutional funds that are part of large financial conglomerates. If asset managers belong to the same group as large commercial banks (as is often the case in both developed and developing countries), why would they act as a countervailing force to their affiliated companies? There is clearly the possibility that group policies may steer asset managers away from undermining the competitive position of commercial banks. However, experience has shown that asset managers promote the development of new products and practices that weaken the relative role of traditional banks. This may be attributed to different objectives and constraints facing asset managers, especially the fiduciary duty imposed on them, or to differences in the relative importance of asset managers and banks in particular financial groups, or to the existence of some independent asset managers. But it may also be explained by the complementary nature of bank and nonbank types of financial services, which would imply that both banks and asset managers (as well as other parts of financial groups) benefit from the development of new products and services. However, given the recency of these developments and the continuing trend toward consolidation and conglomeration, the long-term impact of institutional investors on the behavior and performance of financial groups is an open question.

Concluding Remarks

This paper argues that the promotion of private pension funds and insurance companies should be pursued for their own sake and their potential economic, fiscal and financial benefits and should not be dependent on the prior development of securities markets. The situation of mutual funds is different since mutual funds are unlikely to thrive unless the markets for the instruments in which they specialize are themselves well developed.

The limited supply of suitable financial instruments should not be a major obstacle for the creation of pension funds and insurance companies. These institutions will accumulate their long-term financial resources on a gradual but steady basis, providing ample time to reforming governments to develop their securities markets. A far more important factor than the state of development of securities markets would normally be the existence of strong political

commitment to a holistic reform program that would need to cover not only pension and insurance reform but also broader macroeconomic, fiscal, banking and capital market reforms.

Given this commitment, institutional investors can provide a strong stimulus to the development of securities markets. They can act as a countervailing force to the dominant position of commercial banks, stimulate financial innovation, modernize capital markets, enhance transparency and information disclosure, and strengthen corporate governance.

The second half of this paper examines the impact of institutional investors on the US securities markets, noting the advent of competitive bidding for corporate securities, the development of mortgage securitization and derivative products, the introduction of indexed funds, the modernization of trading and related facilities, and the use of collective bodies and specialized monitors for strengthening corporate governance. Some developments in the United Kingdom as well as Chile and Argentina are also noted.

But the paper also emphasizes that it takes time for institutional investors to reach the critical level that would allow them to play a catalytic role in capital market development. Several of the practices now found in developing countries also characterized the US market in the 1940s and 1950s when institutional investors were about to come of age. Nevertheless, some of the beneficial effects of institutional investors are taking place faster in developing countries because of the experience gained in advanced countries and because of the transfer of financial expertise that electronic technology and globalization make possible in modern times.

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