The developing role and responsibilities of institutional shareholders

The **Governor**[1] *discusses '... how institutional investors can make a larger contribution to improving the economic performance on which the well-being of their own shareholders and beneficiaries ultimately and directly depends'.*

He starts by describing the market environment in which institutions invest and notes the growing concentration of investment and equity holding into the hands of the institutions. This concentration of ownership brings obligations: '... shareholders cannot themselves avoid responsibility for the difficulties of companies to whose boards they have been insufficiently attentive'.

As economic recovery is consolidated '... companies and investors will need to pay much greater attention to the non-price aspects of competitiveness, such as innovation, design and development and marketing'. This requires '... a readiness on the part of institutional investors and others deliberately to hypothecate part of their budgets for investment in new higher value-added areas of activity'.

The role of the pension fund investment manager has an importance which goes beyond the service he provides to his fund and the pensioners which depend on it. The capital market and major investors in it actually or potentially exert a significant influence on our overall economic performance, and it is on that wider aspect of your activities that I want to concentrate this talk. I hasten to say at the outset that I do not presume to confront you with a set of prescriptions. None of us can afford to be complacent about these matters, but much of what I would regard as best practice in the institutional investment area is manifested within your industry, and I believe that the major task is that of raising general standards and professionalism to what is already achieved by the best.

I want to address first the market environment in which each of you does his job. The British capital markets are both larger and more highly sophisticated than those in most other industrialised countries, except the United States, and British companies have historically been able to rely on the capital markets for a much higher proportion of their external financing needs than their competitors elsewhere, particularly in Europe. In consequence, and although term lending by the banks has increased substantially over the past decade and resort to the corporate debenture market has been very limited, British companies generally have stronger balance sheets than their Continental counterparts. There has often been criticism that this financing pattern for British business is too cautious and that the banks in particular should be ready to allow much higher gearing and to lend for longer terms. But I believe that the robustness of our system has been amply demonstrated through the phase of exceptional pressure on companies in the recession from which we are now emerging and, while there are many lessons to be learned from this experience, they do not in my view challenge our basic financing structures.

These structures, and such regulation as is associated with them, have not only served British business well but they have also afforded the institutional investor with a very attractive investment environment. I am not of course referring to the environment with respect to rates of return, for these have indeed been generally far too low and are only now starting to show signs of improvement in many companies. What I want to underline is that the institutional investor in this country operates in conditions which are liberal, in the sense that he has substantial freedom within the policy laid down by his own board or trustees as to where and how to invest, and he is able to operate within an array of relatively liquid and well-regulated markets. The constraint of exchange control was removed in 1979. Although, as you will recall, there was a good deal of argument in the 1970s that some part of the new accruals to institutions should be invested in particular ways, what was presented as the public interest argument for direction of part of your investment was not accepted, and you remain free of any such direction. I am convinced that is right, and that pension fund trustees and directors of other investing institutions should continue to enjoy very wide discretion as to the allocation of investment resources, subject only to appropriate prudential requirements.

(1) In a speech at the 1984 investment conference of the National Association of Pension Funds Ltd., on 23 February.

This very substantial investment discretion is complemented and indeed to some extent made possible by the high standard of corporate disclosure, which reflects not only companies legislation but also the demanding requirements laid down by the Stock Exchange and the accountancy bodies, Although there are areas in which further development may be desirable, for example in working out a generally accepted framework for segmental reporting of company results and the important matter of accounting for inflation is one to which I will refer later, the scope and quality of corporate disclosure in this country compare very well with that in the United States, where disclosure obligations rest on a much more elaborate statutory framework than has been considered necessary here. And, as in the United States, control of companies is ultimately a matter for the shareholders, to whom all the directors are normally equally accountable.

I would like to mention two other favourable elements in our capital market environment. The first is that initiatives in the last two to three years have increased the attractiveness to institutional investors of what were formerly unlisted shares. The establishment of the Unlisted Securities Market (USM) has facilitated diversification of institutional portfolios into relatively young and fast-growing businesses; and the provisions of the Companies Act 1981 which in certain circumstances permit companies to buy their own shares have no doubt eased the disincentive to investment in unlisted securities by providing a means, short of a flotation on the USM, whereby a shareholder may be able to sell and realise a gain.

Second, substantial change is currently in train in the structure and dealing methods of the securities industry itself. The Stock Exchange has for long served institutional investors well in the provision of liquid and well-regulated markets, notwithstanding that many—and not only institutional investors—have been critical of the fixed commission arrangements, soon now to be brought to an end. The changes that are currently in prospect or under active discussion will tend to increase disclosure of market transactions and to create a sharper competitive edge for those engaged within the market. I would hope that a major result of the developments that are now in train is that the British securities industry gains a much larger slice of global securities activity, and that this will include winning back some of the overseas portfolio business of British institutional investors—most of which is currently transacted through foreign houses—and restoring the earlier position of the Stock Exchange as a major market in overseas securities. The international dealerships which are now being planned within the framework of the Stock Exchange are a significant first step on the way. These ambitions will, of course, only be achievable through vigour and determination in improving the competitiveness of our securities industry; but while most of this effort will have to come from within the Stock Exchange and securities firms themselves, users of the markets, and the institutional investor in particular, will share the fruits of success.

In sum, the environment in which the institutional investor operates in this country is a relatively liberal and competitive one. The bulk of the regulation that is in place is oriented to proper prudential concerns and the maintenance of orderly markets, and is administered with a degree of freedom from bureaucratic deadweight which is envied in some other markets. Such an environment is in my view necessary for the maintenance of a healthy capital market, in turn a source of considerable strength to the British economy. But the freedom and the right to operate in this market environment which the institutions enjoy does not of course come without complementary obligations. The market will only function well if those who use it do so perceptively and responsibly, and these obligations are of course greater the larger the size of the user.

Increased concentration of investor power

One of the most significant changes in the British financial and industrial scene over the last quarter century has been the growth in the proportion of holdings of UK ordinary shares in the hands of financial institutions. According to the survey published last year by the Stock Exchange, based on a sample of listed UK companies, nearly 58 per cent by market value of equity shareholdings were in the hands of financial institutions. This compares with little more than 30 per cent in 1963. For this purpose, institutions principally comprise insurance companies, pension funds, unit trusts, investment trusts and other financial companies. The holdings of pension funds among the various institutional groups have shown the strongest growth, from just over 6 per cent by market value in 1963 to almost 27 per cent eighteen years later. The total value of equities under institutional management at the end of 1982 was £66 billion, of which pension funds accounted for £35 billion and insurance companies £22 billion. The aggregate inflow into financial institutions in the same year was the equivalent of £53 million each working day.

The increase in institutional and, particularly, pension fund holdings reflects the extension of occupational pensions to most categories of employees in all but the smallest firms; the consistent improvement in the level and quality of benefits provided by pension schemes; the significant fiscal advantages enjoyed by certain types of contractual saving; and a shift—which became marked in the early 1960s—in the balance of institutional portfolios into equities and away from fixed-interest securities. The counterpart of the growth in the share of equity in institutional hands has been a decline in the holdings of individuals from around 54 per cent twenty years ago to 28 per cent at the end of 1981. This situation is radically different from that in the United States, where 62 per cent of listed common stock is held by individuals, a proportion that has remained broadly unchanged for the last decade. On the other hand, private investors play a relatively small part in the government bond market in the United States, accounting for some 5 per cent of debt outstanding compared with 15 per cent in this country.

The present degree of concentration in institutional hands is not necessarily totally irreversible; fiscal action taken to stimulate investment by individuals in smaller businesses, in particular through the Business Expansion Scheme, may lead in the long run to a restoration of the balance to some degree in favour of the private shareholder as companies expand and obtain listings for their shares. But it remains the situation—and one which is unlikely to change at least in the short term—that a small number of large investors can together often command a dominant holding in many listed companies, and are able, if so minded, to exercise considerable influence over the direction of the business.

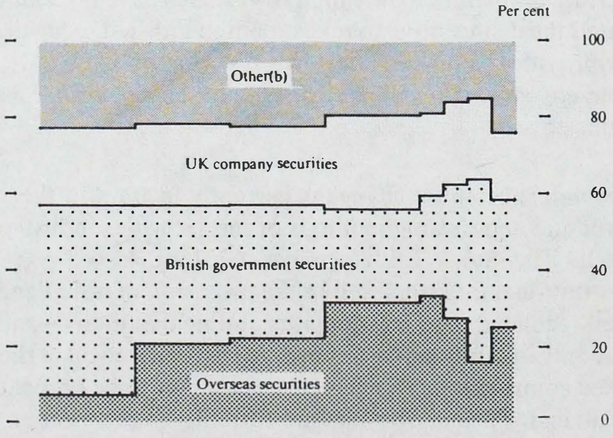
Before turning to ways and means by which such influence might best be exerted, I would like briefly to mention two particular matters—lest my failure to do so causes you to suppose that I do not regard them as important—the debate on the structure of pension provision and the extent of overseas portfolio investment. On the first of these, I welcome the inquiry into provision for retirement that is in train, which is initially focussing on the question whether portability of pensions should be improved. I do not want to address this question substantively now, but I do want to register the single point that, while any move toward greater portability may lead in the longer term to a shift in the pattern of the flows of savings as between institutions or institutional groups, I doubt whether such a move would in practice increase very materially the investments held directly by individuals, or reduce in any material way the overall importance of institutional investment.

Since the ending of exchange control in October 1979, there has been a large increase in the overseas portfolio holdings of the institutions. Their holdings of overseas securities totalled £6½ billion at the end of 1978 and had risen to around £30 billion by September of last year. It seems clear that a significant part of this increase represented a once-for-all change to make up for forty years of enforced restraint, and I would imagine that this stock adjustment is now close to completion, if not already completed, for most institutions. It has been argued that this accumulation of overseas holdings has disadvantaged domestic industry by depleting the resources available for investment here. But this seems to me to be a simplistic and misconceived view, and I am not aware of any evidence that the understandable concern of institutional investors to improve the overall balance of their portfolios has led to any domestic capital market deficiency. One specific form of benefit for British industry has come through increased exposure of institutional investors to new technology, and we are now seeing the beginnings—it may already be more than that—of a process of technology transfer into new productive investment in this country which represents a spin-off from some of the more imaginative institutional investment in the United States.

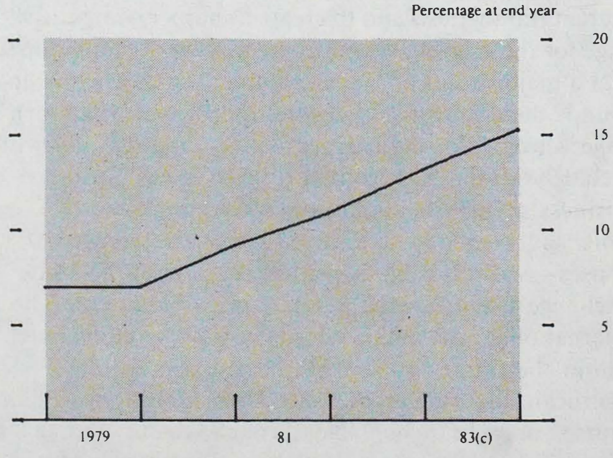
Much more generally, we need to keep in mind that this substantial build-up of overseas holdings, the earnings on which are already starting to benefit our invisibles balance, represents an accumulation of assets which partly offsets the depletion of our North Sea resource. And while this portfolio outflow will have had some effect in making domestic interest rates somewhat higher than might otherwise have been the case, there has been an offset to this negative aspect for industry in the shape of downward pressure on the exchange rate which, in circumstances in which inflation has been brought increasingly under control, has helped to improve our competitiveness. The last observation that I want to make on the matter of outward investment is that, whereas the flow was substantially one-way in the immediate aftermath of the abandonment of exchange control, we are now seeing a significant portfolio inflow from your homologue institutions in the United States, who now enjoy enhanced investment freedom in the wake of a more liberal interpretation of the relevant framework for their investment decisions.

Institutional investment[a]

Distribution of net new investment



Share of overseas assets in institutional portfolios



(a) By insurance companies, pension funds, investment trusts and unit trusts.
(b) Mainly land and property.
(c) Figures for 1983 are estimates—the end-year stocks shown in the lower panel being very rough ones.

Institutional investment and company performance

I want to turn now to the influence that the institutional investor may be able to exert on company performance. The theorist of efficient markets tends to argue that professional investment management brings little in the way of extra benefit compared with investing funds across the constituent companies of the index. I find this an unattractive and unpersuasive approach, for it implies that the market, and the investor within it, is not able to play much more than a passive role. At any rate for the larger funds, this is just not consonant with experience. Investment management of the kind which all of you practice in some degree is far from a zero-sum game. Market practitioners, by the signals they send in the course of their investment operations and by the way in which they respond to and participate in novel methods of financing, can exert a significant influence on the whole market and on the behaviour and performance of firms. The market in which shares are bought and sold is, in principle, a good mechanism for the proper allocation of resources and, where there is sufficient information available for all participants, for the transmission of signals about company performance. The effect on a board which can result from selling by relatively small shareholders is not to be underestimated.

But in some cases an institution may be unable to sell at a satisfactory price a holding which, though only a small proportion of the share capital of the company concerned, is still a large sum in absolute terms. The option of 'voting with its feet' is therefore by no means always available to an institutional holder, and the best course available to protect the value of an investment in a company with a less than satisfactory record may well be to seek further information and, in the light of this, to press for action to remedy major shortcomings. Such a course inevitably involves a willingness on the part of the institution concerned to become for a period an 'insider', with the consequent inhibition on its ability to deal in the shares.

Over a twenty-year period the real profitability of UK industrial and commercial companies has fallen by perhaps two-thirds. Many external influences have contributed to this erosion, in the sense that they were beyond the reach of individual firms. But in many cases the poor productivity of capital and labour which was evident from published data and from straightforward international and inter-firm comparisons was tolerated for too long by both management and proprietors. This stricture of course implies a view that this decline in performance and competitiveness was by no means wholly unavoidable, but this view would seem to be encouragingly and amply vindicated by the productivity gains and cost reductions which companies have achieved over the last recession when subjected to market disciplines which were often sharp and disagreeable. The reductions in costs which companies have made, often painfully, are now bearing fruit in significantly higher profits as demand recovers. The real rate of return on assets of manufacturing companies has risen from a low of $3\frac{1}{2}$ per cent in 1982 to about 6 per cent in 1983. Although this is still well below the level of profitability twenty years ago, the improvement is likely to continue as the efficiency gains won during the recession work through, always provided of course that managements can continue to keep a firm grip on their costs, so that the hard-won gains of the last few years are not frittered away.

All this confronts us with the question whether, since the general pressures executed by severe recession were capable of bringing such a toning-up in efficiency within our businesses, more could not in future be achieved by less painful and indiscriminate means to ensure that British companies respond effectively to competitive pressures to be more efficient. In tackling this question, I want to comment first on the distortion of company accounts by inflation.

The focus on historic cost measures, showing fairly consistent rates of return, has at times of high inflation often placed company performance in far too favourable a light. Shareholders, boards and managements have been given an impression of relative well-being at a time when the real profitability of their companies on a realistic measure has been small or negative. This is reflected in a reduction in the level of cover for dividends, to the point where, in 1981, half of a sample of 250 listed companies had paid dividends which exceeded the available real profits on a current cost measure. Can it possibly be in the long-term interests of investors that so many companies have been paying dividends out of the funds of shareholders? Quite apart from, and in many ways more important than, the deception of boards and shareholders that can result from inadequate allowance for inflation in the published accounts, there is the distortion of decisions on key matters such as pricing and investment which is the result of inadequate adjustment for inflation in the internal management accounts. The fact that inflation has now abated to a much more moderate level greatly eases this distortion problem. Even inflation at 5 per cent per annum for which inadequate adjustment is made means that there will be distortion, and I would differ strongly from those who argue that, with inflation at its present reduced level, the accounting profession can afford to relax in its effort to identify generally acceptable standards for accounting for inflation.

But the very intractability of accounting for inflation is, of course a major part of the disease itself. The disease has done immense damage to the fabric of our economy through the past decade, and I do not believe that we will be able to feel satisfied that the capacity for further damage has been eradicated until inflation itself has been eradicated.

Winning the inflation battle will facilitate the task of companies in maintaining their efficiency gains and in becoming more efficient, but it will not of course solve problems that are internal to companies themselves and to their proprietors and others. From the Bank's observation of companies in difficulty in recent years, some consistently common threads are observable. In a very high proportion, the seeds of decline would have been apparent from analysis of the publicly available financial information several years before a critical stage was reached. The symptoms have typically included: declining profitability; a poor and deteriorating return on capital; a continued deterioration in the financial position shown by successive balance sheets with a progressive rise in indebtedness, mainly short term; below average productivity in terms of output per employee; and lack of control over working capital, manifesting itself in an excessive level of stocks or debtors in relation to turnover. These are of course only symptoms of potential or actual financial distress, and it is necessary to look behind them to identify the root causes. Boards and managements seem often to have been slow to perceive incipient problems and to recognise the need for retrenchment and rationalisation. Yet where action is needed and none is taken, the financial position of the company will deteriorate and the eventual decision is more expensive and painful than if action had been taken in a timely way.

Primary responsibility for the conduct of the affairs of a company, and thus for situations such as these, rests with its board, and difficulties are most likely to arise when the board is not up to the job—perhaps where the composition or structure of a board is inadequate or the directors are overly dominated by a strong chairman or chief executive. The board is responsible collectively for the adequacy of senior executive management, for approving investment plans, including acquisitions and diversifications, and for monitoring performance. The board, and in particular the non-executive members, must ensure that there is an adequate and well understood framework for decision-making. They should also inquire as to the reasons for deviations from plan and for any serious deterioration in the performance of any significant part of the business and ensure that weaknesses are identified and appropriate corrective action taken.

All of these propositions are familiar enough to investing institutions, but we need to be very clear about where they lead. Boards of directors do not have responsibilities of the kind that I have just described in, so to speak, a vacuum. They are accountable for discharging them, and this accountability is principally and very squarely in our system to the shareholders. The reciprocal of this obligation is the obligation of the shareholders to satisfy themselves about the competence of their boards and the way in which they are functioning. Where the shareholder is a significant individual holder, this reciprocal obligation is of course the same thing as his own direct self-interest, but the position is not substantively different when a large holding is that of an institution, acting for the interests of its own pension beneficiaries, policy-holders or shareholders. Just as it is the responsibility of the board to satisfy itself as to the competence of the management, so it is that of the shareholders to seek to ensure the quality of the board. To put it at its sharpest, just as it is unreasonable to assign to management the blame for errors of omission or commission which rest at least in part with the board, so shareholders cannot themselves avoid responsibility for the difficulties of companies to whose boards they have been insufficiently attentive.

I deliberately put the point in these terms because there is sometimes a supposition that effective action by institutional shareholders involves interference with management; and, separately, because the ability of shareholders to elect directors is under challenge. I do not suppose that many of you would want to claim competence to second-guess the management of the companies in which you invest, but I hope that it will become more generally understood and accepted that, apart from the influence exerted by market transactions in shares, the principal influence that the shareholder exerts is *vis-à-vis* the directors. If this influence has been exerted effectively, and shareholders are satisfied with the composition and competence of the board, they have no role to play *vis-à-vis* management: that role is quintessentially a matter for the board.

The potential challenge to the ability of shareholders to determine board composition comes principally from the draft European Community Directives, which would give employees the right to elect a minority of directors and would require the election of a specified proportion of non-executive directors. A substantial merit of our present structure is that directors are responsible for the performance and well-being of the company as a whole without particular responsibilities to sectional interest, and I am very doubtful whether the quality of direction overall would be improved by impairing the ability of boards to act in the interests of their company as a whole. Nor do I believe that coercion in the appointment of non-executive directors is likely to be the most constructive way forward; little is likely to be gained by the introduction of boards of non-executives who are there largely because statute prescribes that they should be.

All this underlines the importance of the initiatives that are increasingly being taken by institutional shareholders to seek to secure, as far as possible on an agreed basis with the present chairmen and members of boards, such strengthening of boards as seems necessary. I am conscious of the difficulties, sensitivities and consumption of time involved in efforts that are made to improve boards. There are no easy ways of avoiding the burdens of such initiatives. But if it is not taken, one or both of two consequences is in time likely. The first and most certain is that, in the absence of action to strengthen a board which is not up to the job, performance and the return on investment will be lower than they could otherwise have been. The second consequence, not the less serious for being a little more distant, is that if a combination of shareholding structures and of rights and duties of the kind that we now have is not seen to function effectively in terms of the overall business performance with which it is associated, then those shareholding structures, and rights and duties, will increasingly themselves come under criticism and challenge. In other words, if the present structures are to be retained, they must be seen to work.

Financing new investment

I have talked about promoting better performance by existing businesses, but further and wider improvements in competitiveness than will be available from efficiency gains and cost reductions—important as these are—will be required to bring about the wealth generation needed in this country to meet the prospective claims on resources, not least in the provision of pensions. This means that companies and investors will need to pay much greater attention to the non-price aspects of competitiveness, such as innovation, design and development and marketing.

One factor in our relatively poor industrial performance has been the inadequate attention given to engineering, and the very word 'engineer' does not command the regard in this country which it carries in most other parts of the world. The Engineering Council was created some two years ago to help to remedy this situation, with one of your number—Ralph Quartano—as a founder member. I know that he played a prominent part in the preparation of a guide, now published by the Council, designed to help institutions to ask the right questions to obtain a well-informed view of the technological strength of companies in which they invest. As well as informing institutional investors themselves, such enquiries will also help to bring home to companies the importance which they need to attach to their technological resource. I commend to you this initiative by the Engineering Council and I am very pleased that one of my colleagues at the Bank—Kit Farrow—has been appointed to succeed Ralph Quartano as a Council member.

As output and profitability recover and the energies of boards and their managements are less preoccupied with mere survival, firms will bring forward more innovative projects, often with a significant research and development content and a relatively longer gestation period until a commercial return is shown. Much of the funding for innovation and expansion will of course come from internally-generated cash flow. But some external funding will also be needed in many cases in the form of equity or capital. Some of this will be provided conventionally through rights issues, but a growing proportion of new investment in high technology areas seems likely to be undertaken by relatively new smaller firms, and these will call for special consideration and treatment by providers of equity capital. In this situation, a number of investors have established a capability for meeting the needs of the smaller company, recognising that the provision of venture capital—one major form—is a specialised operation requiring techniques which differ markedly from conventional portfolio investment. Venture capital companies and funds are, of course, equipped principally to handle projects of a relatively modest overall size, although the hope, encouraged by American experience and increasing experience here, is that they will grow rapidly. Larger 'high-tech' ventures are normally within the competence of established companies but I do not doubt that, during the past recession, even many soundly-based companies have been driven by short-term financial constraints to shelve projects which have longer pay-back periods.

I draw this area of higher technology to your special attention because it is clear that our future wealth-generating capability, not least as the flow of benefit from the North Sea diminishes, will depend crucially on investment decisions to move in to higher value-added areas of activity. Important as conventional cost and price competitiveness is, it achieves little for a company to offer a very competitive price list and speedy delivery for products or services that the market, at home or abroad, no longer wants. Equally, our future economic success will depend not only on offering to the world market a competitive array of products but on our success in identifying areas of rapid market growth.

I bring no ready reckoner, still less alchemy, that will enable you to distil the essence of the investment projects that are most likely to be rewarded with such success. But I am clear that they will not all be rewarded with quick pay backs and will not invariably measure up well against conventional criteria of investment appraisal. What this means and requires, I suggest, is a readiness on the part of institutional investors and others deliberately to hypothecate part of their budgets for investment in new higher value-added areas of activity. What proportion of investable resources this should comprise is a matter for individual funds, and it would be quite mistaken to suggest that any general rule should be applied. The important point is that there should be a recognition of the need and a readiness to dedicate some part of the resources available to meeting it. Precisely how these are best deployed is also a matter for individual funds and, just as I believe it is important for fund managers to retain and exercise discretion in determining what approaches to investment in new 'high-tech' areas of activity suit them best, so also there is merit from the standpoint of aspirant new businesses themselves in having a variety of possible financing techniques available.

Collaboration between banks and investment institutions

My observations have been concentrated on the role of the investing institution, but it would be incomplete for a banker not to mention the complementary role of banks in this context. The banks of course have relationships with their corporate customers, untrammelled by insider dealing considerations, and for this reason, and still more the binding obligation of confidentiality in respect of the affairs of a bank's customer, bankers and shareholders have in the past had little contact in respect of companies in which both have interests. But the speed and extent of erosion in the position of some companies in recent years have led to some changes in practice. There have been several instances in which banks and institutional investors have found it in their mutual interest to participate side by side in the capital reconstruction of a company. I believe that this experience will be helpful in future cases because, while the immediately perceived and perhaps actual interests of major banker and major shareholder in a company may be divergent in the short term, they will usually be convergent in any longer-term situation, for both parties have an interest in seeing their companies flourish. It is for these reasons that I regard increased contact and communication between institutional investors and bankers as a generally welcome development in cases where the constraints of confidentiality and of 'insider' information can be satisfactorily met.

End-piece

The main problem that I have addressed is how institutional investors can make a larger contribution to improving the economic performance on which the well-being of their own shareholders and beneficiaries ultimately and directly depends. The task is to achieve this in a relatively liberal market environment in which, despite the weight of the institutions overall, the preferred approach to companies in which you invest is one of persuasion and agreement rather than overt friction and coercion. There is also a need for a high degree of discrimination in the appraisal and support of new areas for investment. All this constitutes a formidable assignment for fund boards, trustees and managers, and calls for exceptional standards of professionalism and competence. But the major position of trust and responsibility that you now occupy will be satisfied with nothing less.