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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

THE ROLE OF THE INSTITUTIONAL INVESTOR

Note by the Secretaries

The attached note by the Central Policy Review Staff is relevant to the discussion of Item 4 of the meeting to be held on Tuesday, 24 July 1979.

Signed JOHN HUNT
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Cabinet Office
20 July 1979

THE ROLE OF THE INSTITUTIONAL INVESTOR

Note by the Central Policy Review Staff

1. In the position of the United Kingdom capital market today the pension funds and life offices and, to a lesser degree, the unit trusts and investment trusts cannot fulfil their fiduciary duties to their pensioners, policy-holders, etc. unless they keep their finger on the pulse of most of the companies in which they have large investments and unless they are prepared to take remedial action, e.g. replace some or all of the Board or the Chief Executive, if the company is performing unsatisfactorily for reasons which are remedial.

2. Such a proposition would not have been valid in the early 1960s, when the institutions only held some 25 per cent of the ordinary shares quoted on the Stock Exchange and if institutions did not like a company they could 'vote with their feet'. But it is valid today when the financial institutions hold more than 50 per cent of all ordinary shares - a proportion that is likely to increase ineluctably unless the Government decides to remove the great fiscal attractions of investing through intermediaries rather than directly, which still exist after the Budget. The large financial institutions cannot normally now 'vote with their feet'. They can only divert the flow of their <u>new</u> funds away from particular companies or try to sell their large blocks of shares to other institutions.

3. Many large public companies are likely to have a majority of their shares held by long-term institutional investors. The institutions are therefore in a position to exert pressure on companies if they so choose; individual private investors, on the other hand, are de facto powerless.

4. A number of arguments have in the past been advanced against great involvement by institutional investors, e.g. that it prevents them 'voting with their feet'; that institutions know about investment/insurance not abo managing industry; problems of inside knowledge: that shareholder powe will encourage Government regulation (perhaps nationalisation) of the financial institutions: that some interventions could result in closures/ redundancies which will give the institutions a bad image. There are good answers to all these points but to rebut them one by one here would take too long.

5. In 1972 the then Governor of the Bank of England, Lord O'Brien, launched his initiative for an Institutional Shareholders Committee (ISC) to to increase the involvement of the financial institutions with the companies in which they have had large investments. For some years the initiative seemed a failure but now there is considerable movement. This is clear from the actions of the institutions as well as from the evidence of such bodies as the British Insurance Association (BIA) to the Committee to Rev the Functioning of Financial Institutions (CFFI). Many of the large insti e.g. the Prudential and Commercial Union, the National Coal Board and P Office Pension Funds, M & G Unit Trusts, have regular contact with the managements of most of the companies in which they invest and this prac is spreading. The institutions have, on occasion, flexed their muscles publicly but more frequently and often more effectively they have exerted their pressure privately - they rightly do not want to undermine public confidence in the company they are trying to turn round. Sometimes the pressure is brought to bear through the Investment Protection Committee of the BIA, Unit Trusts Association, etc: in other cases by an ad hoc gro of institutions and more rarely through the Institutional Shareholders Committee. Somewhat similar work is done very effectively under Sir Henry Benson's leadership in the Bank of England.

6. Non-Executive Directors (NEDs) also have an important role in bringing outside influence and discipline to bear on management. Their use is also spreading. They should be seen as complementary to the role of the institutional investor not as an alternative. The task of an effective NED is a very difficult one. Boards with blue-riband NEDs did not prevent some major debacles in the 1970s. (To improve their effectiveness it is for consideration whether steps should not be taken to limit the number of NED directorships any individual should hold in listed companies on the Stock Exchange say a maximum of six. To take on more would normally mean they would have inadequate time to carry out their functions effectively, especially if they formed part of Audit Committees.)

7. While the CPRS believes a degree of institutional interest and, notably when things go wrong, of more active involvement in management is healthy and desirable, it is clearly necessary to avoid undue interference, particularly of well-run companies and certainly any attempt by the institutions to usurp the functions of management. When problems arise the institutions' normal approach should be to give management time to put its house in order and, failing that, to bring about changes in management.

8. On the other hand, as in the United States, modern and efficient managements are likely to welcome an informed dialogue both with their institutional investors and with their bankers. It can provide management with support and indeed the necessary confidence to weather the difficult period ahead and to plan for the upturn. The current President of the Engineering Employers' Association (who is also Chairman of two major British companies) recently told the CPRS how little interest his major institutional investors took in his companies' affairs and that he personally would welcome greater involvement.

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Possibilities for action by the Government

9. Ministers might consider the need -

(a) to make it clear in speeches that they are looking for an active interest by institutional investors in the companies in which they have large investments and that they support the work of the ISC and the various investment protection committees - the lack of overt Ministerial support was probably one of the reasons for the failure of Lord O'Brien's original initiative:

(b) to invite the Chancellor and the Secretary of State for Industry to make this clear personally to the current Chairman of the ISC and his three fellow members:

(c) to invite the Chancellor to instruct his officials to make similar points at the next in their series of meetings with the Investment Management Community, which were recently instituted following a proposal put forward by Mr P Moody, Investment Manager of the Prudential and President of the Institute of Actuaries:

(d) to advocate the wider use of NEDs and Audit Committees, but consider the possibility of limiting (perhaps via the Council of the Stock Exchange) the number of such directorships any one person can hold in large listed companies.