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Investor Stewardship and the UK Stewardship Code

The Role of Institutional Investors in Corporate Governance

Daniel Cash
Robert Goddard

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ISBN 978-3-030-87151-2 ISBN 978-3-030-87152-9 (eBook)
<https://doi.org/10.1007/978-3-030-87152-9>

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This Palgrave Macmillan imprint is published by the registered company Springer Nature Switzerland AG

The registered company address is: Gewerbestrasse 11, 6330 Cham, Switzerland

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Introduction

Effective and sustainable shareholder engagement is one of the cornerstones of the corporate governance model of listed companies, which depends on checks and balances between the different organs and different stakeholders. Greater involvement of shareholders in corporate governance is one of the levers that can help improve the financial and non-financial performance of companies, including as regards environmental, social, and governance factors...¹

The term ‘stewardship’ can mean different things in different contexts. More generally, the concept relates to certain characteristics like long-term thinking, care, consciousness, purpose, and contribution.² It is almost thirty years since the Committee chaired by Sir Adrian Cadbury said almost the same thing as the quote leading this introduction: ‘given the weight of their votes, the way in which institutional shareholders use their power to influence the standards of corporate governance is of fundamental performance’.³ Therefore, in this book, we focus on the financial arena and the attachment of the concept of stewardship to the act of engagement from ‘institutional investors’ with the companies that they invest in. This is not an entirely new phenomena, but it is central to the modern business environment and has grown to become ‘mainstream’. With the changing nature of the economic environment over recent decades, and the structural constitution of how capital moves around the financial system, the focus is now on making systemically important

investors both more responsible, and also key watchdogs over the financial system. Yet, we question throughout the model of involving shareholders more and whether the need to encourage is a sign that, ultimately, it is not achievable.

With regard to the financial arena and the role played by institutional investors specifically, the concept of engagement by these shareholders has long been acknowledged and encouraged.⁴ It is worth noting here, very briefly, that the term ‘institutional investor’ is a ‘catch-all’ term that in reality describes a diverse set of organised and ‘sophisticated’ investors. We shall look at these complexities in much more detail as we go through, because that diversity is critically important with regard to understanding both the potential success of any ‘Code’ seeking to encourage stewardship and engagement, and also the potential limitations to any Code. For the uninitiated, there is a simple (but very crude) way of understanding the ‘institutional investor’ moniker. We can think of the term as encompassing two particular ‘classes’: asset owners, and asset managers. An example of an asset owner could be a pension fund, who collect the pension contributions of employees or savers, and seek to build the pot so that the value increases to meet the demands of the pension holders throughout the lifetime of the fund. Asset owners can and do invest those funds themselves, but they also often employ others to do it for them, which can be relatively cheaper than conducting the analysis and paying for investment services. Those organisations are called asset managers, and exist to invest others’ monies, usually from within an ‘investment mandate’ that is set by the asset owner. There are, naturally, complications with this crude dualised understanding. For instance, organisations may be employed to conduct stewardship activities for the asset owner; for example, proxy voting organisations will conduct voting responsibilities on one’s behalf, for a fee. The underlying sentiment to all of this is cost efficiency.

To return, there has been a traditional understanding of investor-based stewardship in that investors, once invested in an entity, will monitor the performance of that entity, exercise the rights associated with their shareholding, engage with the management of the company, and generally seek to provide an internal oversight position within the confines of the legally created corporate structure. That is the *theorised* model, when in reality an institutional investor will usually ‘walk’ away from an investment rather than voice their concerns etc., again under the umbrella of cost efficiency. If there is cause to do so, the concept of investor stewardship can entail

more direct and impactful action, with an example being the coordination of other shareholders to force through a particular action within the company (say, voting to change remuneration policies, for example). This role has been steadily increasing in importance over the past 50 years as the landscape of what an investor is has rapidly changed. Although the trend is not universal—as some cultures have adapted differently to the changing financial and technological landscape—some countries have seen a tremendous shift in their investor make up. In the UK for example, the proportion of household assets held by pension funds, insurance companies, mutual funds and other institutional investors increased from 36% in 1995 to 44% in 2005.⁵ This concentration has declined somewhat in recent years (particularly from pension funds),⁶ but the analysis of the picture in 2005 is relevant because of what was to happen two years later.

The Financial Crisis was a generation-defining moment that caused several investigations from around the world to conclude that more needed to be done. One element amongst many that was revealed was that the new investor environment, particularly in the UK and the US, involved a number of inherent dynamics that lent itself to a lack of monitoring and engagement within some of the world's largest and societally important companies. With the distance between the investor (by which we mean 'retail' investor or those that invest in much larger investing vehicles) or saver (for pension funds) and the company growing ever wider—and in truth the distance between the institutional investor and the company itself growing ever wider because of the rise of financial intermediaries—it became clear that this particular investor dynamic had spun out of control. The incentives to monitor, and to push for longer-term strategies, were outweighed by many other factors that all concluded with a system centred in short-term thinking, yield chasing, and disintermediation. The rise of 'investor capitalism'⁷ coincided with one of the most impact financial collapses in human history, and the result was catastrophic and is still being felt heavily today.

In response to these developments, a number of initiatives and ideas were actioned. One of them, which is the focus of this book, was to develop specific codes of practice for investors so that the stewardship role that many thought the investor ought to play, was systemically realised. Our focus is on the development of the UK Stewardship Code and its iterations. The development and rationale of each, the successes and limitations of the Code, as well as the future for the concept of stewardship