Democratisation and corporate governance

The relations of financial institutions to individual investors

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Pension funds are a major force in the economy, swollen by the demographic changes of an ageing population. More and more people are receiving pensions or are investing for their retirement. 'Grey Power' is firmly on the political agenda. What are the conditions for a true investor democracy of empowered citizens in a renewed system of corporate governance?

Debate on this issue is hampered by the poor understanding most people have of the financial environment in which they live, and on which their future depends. The democratisation of corporate governance requires an understanding of how business ownership and control has developed and of the potentials that have been created by the trends of change over the last half century or more.

Ownership and Control

The joint stock company

The standard view of business ownership and investment centres on the image of the entrepreneur as the owner and controller of the firm. The founder of the firm is seen as the legal owner and active manager of the enterprise, controlling all its operations and acting as the employer for its workforce. This model still applies for many small and medium-sized businesses, but it no longer corresponds to the situation of the majority of large firms in the UK.

The joint stock company and the principle of limited liability, especially important from the second half of the nineteenth century, changed the whole basis of ownership. In the company form, individuals own shares in the company rather than directly owning its assets. The shareholders have legal entitlements to control the assets and to earn an income from them (in the form of a dividend), but it is the company itself that owns the assets and employs the labour force.

The introduction and widespread adoption of this model made possible more effective inheritance practices for the founders of businesses. Second and subsequent generations could inherit shares from the founder without having to be immediately involved in the management of the company.

More importantly, the company form made it far easier for businesses to mobilise capital for expansion and investment. Because company shares could be bought and sold on the stock exchange, companies could issue new shares for sale to investors who had no previous association with the company or its founders. The company was able to draw on the resources of the growing number of middle class investors who were seeking profitable outlets for their savings. It was a win-win situation. Companies could draw on ever larger pools of capital — raising sums that would be impossible for their founders to provide from their own resources or from their immediate family — and investors could spread their risk by allocating their savings in small blocks to a number of different companies.

The key consequence of this legal change was a gradual dilution of the original controlling shareholding. The original owner of the business now had to share ownership with outsiders. The owner could still generally rely on the ownership of a majority of the shares to give him or her the kind of control that was possible with full ownership of the business. Even a minority shareholding, if sufficiently large, could be sufficient for effective control if the remaining shares were widely dispersed among a very large number of individual shareholders.

If the proportion of shares held by the founder or by his or her heirs fell too low, however, control could be lost and ownership could become, effectively, anonymous — indeed, French, Italian, and some other systems of company law describe the joint stock company as an 'anonymous society'.

From the 1920s, business commentators began to suggest that owner control would gradually disappear in large enterprises. As they grew in size, so the original controlling block would eventually become merged into the large pool of small investors.

US company lawyer Adolph Berle and economist Gardiner Means were the most compelling advocates of this view. They held that it would presage a 'managerial revolution'. The anonymisation of ownership inherent in the dispersal of shareholdings would create a vacuum of power, into which would rise a cadre of professional managers. Internal career managers with no significant ownership stake would be able to wrest control from the shareholders and exercise effective control without any interference from the outside shareholders.

Institutional investment

The vision of the rise of the sovereign managerial corporation, liberated from external control, was widely influential and seemed to fit the situation of many of the large enterprises emerging in the inter-war period. Changes in patterns of shareholding, however, were already beginning to undermine it as a description of business reality. It was in this period that individual shareholders themselves began to be replaced in significant number by 'institutional' shareholders.

The holding of company shares by other companies has a long history, but the crucial change has been the emergence of companies that hold shares as pure investors or trustees, acting on behalf of other investors who are the ultimate beneficiaries of the ownership. These companies have come to be known as financial institutions.

The earliest forms of financial institution to have any significance were the many investment trusts created in the last decades of the nineteenth century. These were formed as a means of pooling the savings of a number of people — generally business associates — so that these savings could be spread across a large number of companies and so made more secure.

The investment trust principle spreads the risk of investment, enlarging the principle inherent in the company form of shareholding. An investment trust holds shares in its own name but passes on the benefits of these shareholdings to its own individual shareholders.

Investment trusts rapidly expanded to pool the savings of larger groups of individuals, who benefited from the provision of expert financial advice, and the trusts became major shareholders in many large undertakings.

The investment trust principle was extended during the 1920s with the invention of the unit trust, which operates as an 'open-ended' investment vehicle. Unit trusts issue certificates ('units') to savers, giving them a stake in the underlying assets represented by the shares held in the name of the trust. Unit trusts have remained a major area of savings and company investment, expanding considerably during the 1960s and again during the 1980s.

A further early form of institutional investment was that of the life insurance companies who used the premium income paid by those they insured to buy company shares. The income earned on these shares — as dividends and capital gains — was to be used to pay out the life claims made against the company. As life insurance became a more general form of savings, through endowment policies, this sector grew considerably.

Endowment life insurance backed by company shareholdings became a key means of retirement provision. Insurance companies increasingly linked up with investment trusts and unit trusts in complex patterns of cross-shareholdings and accumulating savings and pension schemes.

This form of institutional investment was most significantly increased through the dedicated pensions schemes that invested in shares in order to generate the income that would pay retirement pensions. The large railway companies and public utilities set up in-house pension funds in the 1920s, but the number of funds grew massively from the 1960s with the development of the pension industry. Large companies and public sector undertakings set up in-house funded schemes, and many of them recruited banks and specialist companies to manage the funds. Large sections of the labour force were drawn into funded pension schemes, thus becoming dependent on the stock market investments of the companies that managed their schemes.

These developments meant that the managers of the large companies could no longer be seen as the sovereign controllers of the enterprise. Institutions became the dominant shareholders in large companies and were able to limit the autonomy of the internal managers in ways that were not possible for the small individual shareholders.

Well above half of all shares in large companies are now owned by financial institutions. For the larger and more profitable ones the proportion is often greater. Individual institutions now hold substantial stakes in particular companies, and groups of associated institutions often have significant blocks of shares.

These institutions were, for a long time, rather passive investors who were willing to leave the managers with a great deal of autonomy. Institutions that were dissatisfied with the way in which a company was run would sell their shares on the stock market and invest elsewhere. Managers were not tied down to particular policies.

As institutional holdings became larger, however, selling became less attractive. An institution that wished to sell a large block of shares in a company would need to find a willing buyer, but the potential buyers were other institutions, equally dissatisfied with their investments in the company. Institutions became 'locked-in' to the companies in which they invested. Denied the possibility of 'exit', they were forced to give 'voice': to intervene in company affairs and to make their preferences known to the managers.

Institutions began to establish regular liaison meetings with companies in which they invested. They took a far greater interest in any issues that came to a vote. Issues of executive remuneration were a frequent area of conflict. The major pension funds became the most active investors, simply because of the scale of their holdings.

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Thus, owner-control of the classical type has largely become financial control — control by financial institutions operating through the financial system.

Instead of the managers of the separate companies exercising power in the business sector unchallenged, it is the managers of the huge financial undertakings that take the leading role.

Investor Democracy

Ownership has been concentrated —oligarchic, even — in the hands of the financial institutions and their controllers. These financial institutions are the trustees and guardians for a large number of individual savers — especially for the individual pensioners and prospective pensioners who contribute their savings to the funds.

In theory, this should give the ultimate beneficiaries the opportunity to participate more fully in a properly democratised system of corporate governance. Yet the individuals who are the ultimate beneficiaries of institutional investment are rarely aware of the issues at stake and the power that lies in their hands. On all sides, there is a failure to recognise or understand what exactly their role should be. This raises a number of issues.

Knowledge, understanding and availability of the information

Most people know very little about the legal rights and responsibilities they have as investors in a pension scheme, life insurance policy, or ISA-based unit trust. Many do not even know that their pension and other benefits are secured through shareholdings and so are tied to the profitability of companies on the stock market. Those who recognise that they depend on the operations of the stock market generally have little understanding of how companies operate, who owns them, and what rights they have as the ultimate providers of capital.

For example, there is very little understanding of the voting rights and entitlements a beneficiary has in his or her scheme or in the affairs of the companies in which it invests. Savers have, in effect, delegated investment responsibility to institutions and managers and allow the system to operate as an oligarchy rather than a democracy.

Institutional managers often connive to maintain this situation, seeing greater investor involvement as a problem to be managed. They limit the flow of knowledge and information in ways that effectively exclude from participation those for whom they are the trustees and custodians. It is often said in jest that hospitals would be run more efficiently without the patients: do financial institutions, perhaps, feel that their institutions could run more efficiently without their beneficiaries?

Those beneficiaries who do have some knowledge about their general financial situation often do not know, and are rarely given, any clear understanding of how they can act in relation to the trustees and managers of their schemes. For example, they do not generally know if they are able to influence the choice of investments that are made in their name, and they may find it extremely difficult (and time-consuming) to obtain the information needed in order to make any effective choices and decisions.

Beneficiaries generally have very little involvement in the election or selection of trustees and institutional fund managers. And there is little agreement about what an appropriate level of involvement would be. There is a legal requirement to have 50% employee representation among pension fund trustees, but the significance of this depends on what is meant, in practice, by an 'employee representative'. Most employees have little or no involvement in the selection of their 'representative' — indeed, most do not know that there are employee representatives or who they are. In few cases are there open elections of employee representatives as trustees of pension funds, and few employees know whether they could themselves stand for election.

Elections are generally managed by the existing managers and trustees rather than being opened to full democratic participation. This raises the question of whether there should be a further changed relationship between trustees and beneficiaries so as to increase the *de facto* powers of the beneficiaries. What are the conditions that would make it possible to properly 'democratic' pensions funds?

Further key questions surround the provision of the information that would allow beneficiaries to make informed choices. How much information is provided to beneficiaries on the areas and companies in which their fund is investing? Do beneficiaries want, or need, more information? Institutional investors operate with professional intelligence and appraisal departments to collect and evaluate the information for them, but how can individual beneficiaries match these when they appraise and assess the information that they have? What should be the responsibility of fund managers to provide appropriate information to their beneficiaries?

In general, the information provided to beneficiaries is very limited, and is not provided on the timely basis needed for participation in decision-making. Beneficiaries generally get reports on decisions that have already been made, rather than information about decisions that are about to be made.

This raises issues around the role of the business press and other media in creating the conditions under which people can begin to rationally and effectively assess the information available to them. What kind of information should be made available to beneficiaries through the media, and how can this contribute to an effective public discourse on investment policy and practice?

Trade-offs and difficult choices

Information is not the whole answer. Once people have knowledge, understanding, and relevant information — and assuming they have the time to use this — they will still face the need to make difficult choices.

It is often argued that individual beneficiaries would like to see more socially responsible and ethical forms of investment; this may well be the case. They may desire more investment in hospitals, environmental projects, housing, and so on, and may be willing — even keen — to see their investments applied to these areas. Yet beneficiaries are generally unable to assess the financial returns available from this form of investment when compared with other types of investment.

Would ordinary investors be willing to forego a favourable personal financial return when a more socially responsible investment might earn them a lower pension? Do they understand the current legal requirement that funds seek the best return for their beneficiaries, regardless of wider social benefits?

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This balance between personal interest and social responsibility is not simply an abstract principle. If two or three years ago beneficiaries had been asked whether pension and insurance funds should seek to ensure that improved housing be made available to the poorer members of the community, many would no doubt have regarded this as a good thing, preferable to investment in many other sectors of the economy. They may have held very different views of such investment when the problems of massive investment in sub-prime mortgage provisions became apparent and large mortgage providers came under huge financial pressure. Which beneficiaries would then have been happy to see their pension fund supporting the activities of Northern Rock in the housing market?

Such conflicts and uncomfortable decisions are also apparent in issues around the future of pension schemes themselves. There is much argument over the closure of final salary pension schemes to new entrants. Many current and prospective pensioners argue in favour of keeping the schemes open. Are they also willing to support the rights of future entrants if this threatens their own pension because of falling stock market returns?

Participatory decision-making may be more democratic and ethically justifiable. It might also require a trade-off against profitability and, therefore, against future benefits. That may be the price of democracy.

The traditional model of the shareholder is inappropriate for the investors of the twenty-first century. The investor as an active citizen must become an empowered consumer of the various products of the financial services industry, capable of informed choices and able to make their views felt. This democratisation of investment depends on changes — often uncomfortable changes — in financial institutions, the business press, and beneficiaries themselves. The RSA's Tomorrow's Investor project is central to that task.

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The RSA is an Enlightenment organisation devoted to finding innovative practical solutions to today's pressing social problems. Through its 27,000-strong Fellowship it pursues its mission: to help people be the people they need to be to see the change they want in the world.

The citizens of the future will need to be self-reliant, engaged and other-regarding if they are to create a principled and prosperous society. This is nowhere more true than in financial matters. The Tomorrow's Investor project, the first stage of a prolonged RSA engagement with these issues, aims to facilitate this goal, both practically and intellectually.

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More information can be found at the RSA website: www.theRSA.org.uk