THE AGENCY CHALLENGE AND STEWARDSHIP OPPORTUNITY

(Address to the International Forum of Sovereign Wealth Funds in Beijing, 11th May, 2011)

1. It is a privilege to be invited to speak at this Forum. My first reflection on the creation and short life of the International Forum is that, despite inevitable differences in asset allocation priorities and preferences, it signifies substantial commonality of purpose among Sovereign Wealth Funds (SWFs) and provides opportunity to share experience and to review emerging issues that are themselves probably common to most Funds. Given the aggregate scale of assets for which SWFs are responsible, the insights and understandings that develop in sessions such as this are of potentially great significance for the functioning of the global economy. So it is a considerable positive that, despite the parameters of discretion and sensitivity within which many Funds operate, this sharing of interests takes place. I hope that these sessions in Beijing will prove to be very constructive. In using this term, I want to suggest in particular that the outcome of your discussions could provide critical impetus to raising standards of corporate governance over time in both the developing and developed countries in which you invest.

2. Three years ago, one topic of concern was that the rapid growth of equity holdings within SWFs might encounter protectionist resistance in some parts of the developed world. Some protectionist instincts no doubt persist and may flare up from time to time, but my sense is that, overall, they have abated. This is no doubt attributable in part to the emphasis in the Santiago Principles on the distinction between the strategic interests of the sovereign state and the commercial, asset management objectives of the SWF and to the proposed high standards of governance arrangements for SWFs themselves; and also to what is widely seen as the moderation and responsibility of SWF investment strategies in practice. There was also a different but related concern that the substitution of significant ownership by SWFs for stakes in former government-owned entities could vitiate improvements in efficiency and operating performance that privatisations were intended to deliver. Here also such concerns appear to have diminished in the face of the professionalism of investment approach displayed by SWFs. While these two past concerns were linked to the perceived interests of developed country recipients of SWF equity investment, my focus in these remarks is on how stewardship rights and obligations in relation to SWF equity holdings might best be identified and exercised to the long-term mutual advantage of both SWFs and the companies in which they invest.

3. Despite big improvements in transparency, data on SWF investments are still limited. On conventional definitions it seems likely that SWFs currently hold between $4 and 5 trillion of assets, of which probably more than 40 per cent is held in listed equities. While these totals are still a small proportion of global market capitalisation, SWF holdings seem certain to increase substantially both absolutely and in their relative significance, in particular as oil and other commodity-linked surpluses persist. And the relatively long-term investment horizons of most SWFs give this prospective growth in the scale of their equity holdings a critical additional dimension.

4. Market-based capitalism comprises dispersed share ownership through the capital market as the cheapest and most flexible way of linking capital to management skills and technology. This model has served the developed world generally very well. Against the competition of complete state control of the means of production, it has been triumphant. Against family ownership, private equity and state capitalism as we see it today on so large a scale in China and India, its direct advantages are somewhat less clearcut. But for all these three business models, exit via a market IPO is, or may become, a critically important option. And it is important to acknowledge the key role of the equity market and of major investors, prominently including SWFs, in the recapitalisation of financial institutions when the credit markets dried up and public sector support of these entities was stretched to its limit. This contribution, through support of a very substantial total of rights issues, was crucial in preventing contagion of the financial crisis to non-financial business. It will continue to be of vital relevance in circumstances in which many major bank balance sheets continue to be stretched.

5. But I want to comment on two troublesome strains on the performance of the market capitalism model in the developed world that have emerged over the past two decades and which prompt serious questions as to just how much reliance can be placed on it as a core ingredient in global economic performance and growth. As increasingly significant long-term holders of publicly-listed equities, SWFs have a substantial interest in the way in which these strains are addressed.

6. The first relates to the agency gap. This sounds arcane but the core issue is simply that the gap between the shareholder (the principal) who owns a stake in an investee company and the board of the company (the agent) has widened substantially, in particular over the past two decades. There are many reasons for this. Communication between owner and agent is increasingly constrained as an unintended consequence of regulatory

arrangements designed to prevent market abuse; the population of owners is dramatically less stable than, 40 years ago – in the 1960s and 1970s, the average holding period for US equities traded on the Big Board was around 7 years, now it is less than a year; we have seen very recently the rapid growth in high frequency trading, where the holding period may often be less than a second; and there has been a steep decline in some developed economies in the relative weight of "natural" long-term equity investors such as life assurance and pension funds as their portfolios have increasingly been driven by concerns such as ALM into the fixed income space. A consequence is that ensuring the alignment of interests between major investors and the boards of their investee companies (which the market capitalism model was supposed to ensure) has become much more difficult. There has been clear evidence of this, for example in the unsatisfactory nature of even major shareholder influence on boards in situations where their concerns have tended to be disregarded in knowledge that their stake is so big that they cannot readily sell. We all know that failures of corporate governance in financial institutions did not cause the financial crisis. But governance failures contributed to its severity because boards of banks in particular failed to challenge managements when they were pursuing what proved, in some cases, to be reckless business models and shareholders failed to hold their boards to account for not doing so. This inevitably means that public policy-makers are obliged to be attentive to governance issues when considering how to respond.

7. These developments have led to very different approaches on the two sides of the Atlantic. In the US, there has been a strong attempt to address the agency gap by giving shareholders more rights, for example through say on pay or access to the proxy. By contrast in Europe, where shareholders have long enjoyed critical rights, notably the ability to dismiss directors, the debate has gone in the other direction. It has been about whether the rights of shareholders as providers of capital should be in part replaced by regulation. Thus there has been the comment in the UK and elsewhere in the European Union that many listed companies now "float ownerless in a vacuum" and that it should not be axiomatic that shareholders have control rights.

8. For completeness, I should acknowledge that the agency gap problem is greatly reduced where an SWF invests as a limited partner in private equity. In this situation the general partner, acting on behalf of the limited partners within the clear framework of the partnership agreement, has a very short line of communication to the board and executive of an investee company. The general partner has clear responsibility, acting effectively as principal, for guidance and decision-taking in the interests of the limited partners vis à vis the investee company as agent. As a consequence, the agency gap is

narrow and, while the private equity model always envisages disposal of an investee company, the time period for such exit strategy tends to be much longer than the average holding period for asset managers in listed equity. The private equity model has been and remains attractive to many SWFs precisely because it provides an effective means of accessing and drawing benefit from improved operating performance. But while the scale of SWF investment in private equity is probably set to increase, it will remain small in total in relation to SWF holdings of listed equities, and is not therefore a "solution" to the agency problem, which thus remains to be bridged.

9. These strains associated with the attenuated agency gap are serious enough. But at least equally serious are the related pressures that have foreshortened time horizons for decision-taking in boardrooms – the problem of short-termism or myopia. Prominent among these are the massive changes in technology which both facilitate and require much faster decision-taking; the greater liquidity and volatility of financial markets; and increasing obligations of disclosure of short-term performance through quarterly earnings statements. These factors together have distorted the time dimension of the principal/agent relationship as evidenced by the weight placed by boards, investors and market commentators on short-term earnings as against long-term prospects. In particular, pressures on fund managers to generate performance for their clients have brought sharper buyside focus on short-term results which have, in turn, intensified board and executive focus on quarterly disclosures and, as an inevitable corollary, made them less attentive to the pricing of risks and to the longer-term. Clear evidence of all this is that, in the phase before the financial crisis, several major financial institutions that encountered severe difficulty were heavily influenced by the market to leverage up to achieve what was seen as enhanced balance sheet efficiency and to boost short-term returns on equity – in the event, as we now know, involving serious mispricing of risks.

10. There is an unfortunate paradox here. Whereas the high inflation rates of two decades and more ago in the developed world justified a skew of business decision-taking in the direction of relatively fast payback projects, the very welcome global decline in inflation rates has been accompanied by these other pressures toward myopia. The overall systemic and structural benefits of lower inflation are in consequence much less than they should have been. The negative result of all these developments taken together is regression into a model of capitalism that exhibits an inadequate relationship between owners and agents and where the time dimension of decision-taking is inconsistently skewed to the short-term. A shift is needed from short-term capitalism to long-term capitalism to escape, as one commentator put it, from the "tyranny of short-termism".

11. I mentioned earlier the separate and different challenge to the working of the market capitalism model in developing countries. As an important and positive ingredient in a global rebalancing of capital flows, SWF equity investments are no longer so exclusively focussed on the developed world but increasingly seek opportunity in emerging economies. Here the challenge is less that of the agency gap or of myopia as encountered in developed markets but, rather, weakness in the basic legislative and regulatory framework for market conduct and corporate governance. If such environments tolerate market abuse, disregard for minority interests and inadequate or misleading disclosure, they are unlikely to generate sustainable returns or to be commercially attractive to professional investors such as members of the SWF community.

12. You would be entitled to observe that these remarks have been long on diagnosis of problems but short on proposed remedies. I want to offer suggestions but also to emphasise that, as in medical and so many other situations, prescription without adequate diagnosis may yield outcomes worse than the disease. While there is need for better legislative and regulatory provision in relation to market conduct and corporate governance in some developing economies, I have doubts about the capacity of coercive legislative or regulatory provision (as for example favoured by some in the European Union) to mitigate the problems of agency gap and short-termism in the developed world as I have described them here. But I believe that, in particular given the combination of the naturally and, to some extent, constitutionally long-term horizons of most SWFs and rapidly growing scale of SWF listed equity holdings, there are initiatives that you might consider, and influence that you might bring to bear, that would be beneficial in terms of outcomes for both investee companies and for performance secured by SWFs as shareholders.

13. The core of my suggestion is that SWFs should recognise the potential importance of stewardship in relation to companies in which they have material stakes. I have no illusion that exercise of a stewardship role is easy or costless and should emphasise that, despite the typically long-term horizons of SWF equity investors, commitment to stewardship does not mean that an SWF, or its mandated asset manager, should be precluded from buying or selling the stock of an investee company subject to normal market rules. But I do want to suggest that, in the quite common situation where an SWF is unlikely to be, or unlikely to be able to be, an active short-term trader in a stock, the SWF should consider indicating directly to an investee company, or indirectly through the relevant asset manager, that it attaches importance to its stewardship role.

14. Let me be more specific. In the UK we have developed a Stewardship Code with which many of you will be familiar. It has three objectives. The first is to improve the quality of the relationship between companies and their shareholders. This should better equip major shareholders to assess the capability, functioning and core strategic approach of the boards of their investee companies and should enable boards to better understand what major shareholders want and insulate them from predatory speculation and the short-term knee-jerk responses to which it can give rise. The second objective is to build a critical mass of committed shareholders who recognise that the control rights that accompany share ownership make a share more than just a trading instrument and are thus willing to behave as owners. The proposition is that the rights of ownership are complemented by obligations that are the reciprocal of the accountability of boards to shareholders. Unless such responsibilities are recognised by major shareholders, companies will indeed increasingly risk floating "ownerless in a vacuum" and, because they are not effectively accountable to shareholders, more prescriptive regulation would appear to be unavoidable over time. Hence the third objective: to satisfy public policy-makers that owners and boards are on top of the situation.

15. The Stewardship Code sets out good practice on engagement with investee companies to which it is recommended that long-term investors should aspire. The aim, not least given that non-UK investors now account for some 40 per cent of investment in UK equities, is to build a critical mass of UK and overseas investors committed to the orderly, high quality dialogue with companies needed to underpin good governance. Of course much SWF investment in equities, in the UK and elsewhere, is undertaken through asset managers. The Stewardship Code proposes here that the SWF or other beneficial shareholder should specify its expectations as to the exercise of stewardship responsibility, including voting policy and readiness to participate in collective action, as part of the terms of the asset management mandate.

16. This Stewardship Code is a UK initiative, designed for the UK environment. But I believe that it has much wider geographic relevance; that increasing conformity with it will over time be greatly to the advantage of SWF and institutional investors; and that, accordingly, SWFs, both on an individual basis and as a group, have a vested interest in promoting its observance as a model code beyond the UK. My invitation and suggestion is that the Forum should recognise more explicitly its potentially vital role as a change agent in promoting best practice.

17. In reflecting on ways in which the Forum and individual SWFs might do this, I have kept prominently in mind two key constraints that I know matter

greatly for the SWF community. First, as indicated earlier, a commitment to stewardship does not in any way preclude an SWF from buying or selling an investee company's stock subject to normal market rules. But, on the positive side, where an SWF has the intention and preference to be a long-term holder in a particular investee company, the board should as far as possible be made aware, thus opening up the possibility of mutually constructive engagement. The second constraint relates to an understandable concern in relation to confidentiality and discretion. It is no part of the stewardship proposition that an SWF should engage directly with the board of an investee company in a potentially contentious situation unless it freely chooses to do so. A major ingredient in the role of a mandated asset manager should be to engage appropriately with an investee company, attentively throughout to the need to do so with discretion in respect of its SWF client. On the positive side, however, the delivery of good stewardship will depend on clear guidance in the asset management mandate on the areas and ways in which the SWF expects an asset manager to act on its behalf, including voting and, possibly, participation in a collective action initiative where a number of shareholders find that they have common concerns in relation to an investee company.

18. I have also had in mind that commitment to stewardship is not meant to be a merely box-ticking exercise. It calls for high quality human resource capability alongside but, as necessary, separate from the core investment capability of the SWF. Such a corporate governance capability within an SWF is unlikely to be effective unless it is established as a serious endeavour with strong leadership. Of course this will entail cost, but this cost should be marginal in relation to the prospective benefit through more effective stewardship –in particular the direction and oversight of the way in which it is exercised by mandated asset managers.

19. In the UK, the approach and philosophy throughout has been that effective stewardship is a voluntary activity. Because the Stewardship Code is voluntary, no-one is obliged to adhere to it and the desire to do so should come from within the market. But the risk is that, without some pressure, it will be seen as "motherhood and apple pie" and at risk of being disregarded. So the aim has been to encourage the support of asset owners, and UK fund managers are expected to commit to the new Code on a comply or explain basis. Some 150 have already undertaken to comply. In the spirit of Principle 15 of the Santiago Principles – involving commitment to operate within the applicable regulatory and disclosure requirements of the host countries in which SWFs invest – I hope that SWFs investing in the UK might over time come to commit to the Code, and that all SWFs will ensure that their mandated UK asset managers are fully committed in respect of their UK investments.

20. To be clear, such stewardship is not meant to involve anything close to intrusiveness on the part of shareholders or asset managers in the day-to-day operation and normal strategic development of their investee companies. This is unequivocally the role of board and management. But the major shareholder should, through appropriate dialogue and communication, have a basis for confidence that the board of its investee company is up to the job in terms of its leadership, composition and functioning.

21. Equity holdings in the UK represent only a small part of the SWF global total and so, beyond the commitment being expected of all asset managers in the UK, it would certainly be constructive, and I propose for your consideration, for the Forum to make a general statement in support of the concept of stewardship and recognising the UK Code as setting a possible international benchmark. If individual SWFs were to require their asset managers to apply the Code conscientiously with regard to their UK investments and the Forum were to give explicit support to the concept of stewardship in a general way, this would help to embed the Code as best practice and to secure benefits for the SWF community without incurring unwelcome attention.

22. Principle 21of the Santiago Principles refers to the responsible exercise of ownership rights and it may be that, if or when the Forum undertakes a triennial or other review of the Principles, the terms of this Principle might be amplified to give explicit support to stewardship codes where they exist. It may be relevant to acknowledge that the Principles were written at a time, although only some 3 years ago, when there was understandable concern about a negative reaction in host countries to any appearance of activism on the part of SWFs. But the exercise of stewardship as envisaged here, in an orderly and non-disruptive way, is far removed from, and very unlikely to lead to, the sort of activism engaged in by minority interests that sometimes deliberately seek high profile public focus as part of their campaigning against a board or specific board proposition. Additionally, and in any event, the atmosphere and the environment has changed and there is, I suggest, an opportunity for the Forum to transition from its initial principal focus on the governance of SWFs themselves to the standards of governance expected in companies in which SWFs invest.

23. I am doubtful how far new black letter legislative or regulatory provision in the developed world has the capacity to mitigate the agency gap and short-termism problems that I have described. But the position is different in at least some parts of the developing world where the legislative and regulatory infrastructure required to protect minority rights and to support

good standards of market conduct and corporate governance may need further development. Such development is plainly in the interest of SWFs which should, I suggest, do all that they can to signal appropriately to the authorities in individual countries where they are in principle ready to invest that their investment decisions will be influenced by the quality of infrastructure that is put in place. I note that the Santiago Principles do not include any guidance in this respect, and the Forum might wish to consider whether there is scope and would be support for a new Principle in this sensitive but important area.

24. The international or global dimension of many if not most of your investee companies signifies the extent to which the relevance and quality of corporate governance has become a global phenomenon. I mentioned earlier that whereas the policy inclination in the United States – not without a good deal of contention - has been to strengthen formal ownership rights in the wake of the financial crisis, the inclination in the European Union has been to question how far shareholders should be allowed to retain them. This is a cautionary tale which sets in perspective that the Forum has a unique and timely global capability to influence governance in a direction which is unequivocally in the interest of boosting underlying performance of your investee companies. I use the term "unique" advisedly because no other global grouping, not even the IMF, has the reach and potential capacity for effective influence that is available to the SWF community and through this Forum. I have no illusion that progress will be easy or that there will not be tensions on the way, but the desirable direction of travel seems clear.

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11th May, 2011