INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE

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Abstract

In a an overall equilibrium in asset markets there will be different types of institutions that are fundamentally different in terms of the required skill sets of their key employees. These different skill sets are optimal for pursuing different types of policies regarding what assets the institution should invest in. Institutions with a large group of customers, whose money they manage on a continuous basis, are usually part of a many layered principal-agent relationship chain. This chain usually includes several intermediaries. The ultimate beneficiary is at one end of the chain, and the firm that runs the actual production of what consumers pay for at the other. To avoid moral hazard facilitated by weak control from ultimate beneficiaries such institutions normally focus on investments where there is little information asymmetry and performance thus relatively easy to measure. Such institutions are not designed for investments where performance is difficult to assess, where a conclusive assessment is feasible only after a considerable time period. Investments where performance is difficult to assess require strong personal financial interests for the key-decision makers of the investing institution. Firms that are in need of substantial restructuring belong to that category of investments. In such firms direct involvement by a private equity firm, run by knowledgeable persons who are driven by strong personal interests, may well be the only way to avoid costly liquidation. For firms with less serious problems, e.g. cases that can be remedied by applying stricter corporate governance standards, an activist hedge fund, run by persons with a more limited skill set, may be the appropriate kind of institution. Our paper highlights how previous empirical results concerning the impact of different types of institutions' ownership on corporate governance can be understood in terms of required skill sets and corresponding incentives.