



Bad company. The indirect effect of differences in corporate governance in the pension plan industry



I. Abinzano, L. Muga, R. Santamaria*

Public University of Navarre and Institute for Advanced Research in Business and Economics (INARBE), Spain

ARTICLE INFO

Keywords:

Pension plan governance
Bargaining power
Fees
Performance

ABSTRACT

This paper analyses the role played by pension plan governance structure and how it impacts on plan fees and plan performance. The results clearly show that fees decrease significantly and performance improves when pension plan governance structures permit full alignment of interests and allow greater capacity for the decision-makers to monitor and discipline the managers. It is also observed that companies managing both employee and individual funds, tend to exploit differences in the internal corporate governance mechanisms of each type of plan in order to nurture employer-sponsored plans at the expense of individual plans. These results suggest that internal corporate governance mechanisms allowing closer alignment with the interests of participants would be preferable to focusing exclusively on setting the minimum proportion of independent directors.

1. Introduction

Fund governance can be exercised through internal mechanisms (the board) or external mechanisms (fund inflows) (see [Khorana, 1996](#)). Analysis of the role of internal mechanisms has focused primarily on the impact of regulations to ensure a minimum percentage of independent directors and on the independence of the board chair, and, while the empirical evidence on the subject tends to be favourable, it is not entirely unanimous (see, among others, [Tufano & Sevick, 1997](#); [Mahoney, 2004](#); [Ingley & Van der Walt, 2004](#), [Palmiter, 2006](#); [Hoffman, Neill, & Stovall, 2008](#), [Ferris & Yan, 2007](#); [Chen & Huang, 2011](#); [Ding & Wermers, 2012](#); or [Tan & Cam, 2015](#)).

The literature also casts some doubt on the importance of the role played by external mechanisms, having shown that it depends, among other variables, on investor type. There is, indeed, evidence to show that institutional investors exercise market governance by withdrawing assets under management ([Del Guercio & Tkac, 2002](#); or [Goyal & Wahal, 2008](#)), whereas retail mutual fund flows are much less responsive ([Evans & Fahlenbrach, 2012](#)). [James and Karceski \(2006\)](#), placing the emphasis on differences in investor monitoring capacity, show that retail funds perform significantly worse than institutional funds, before and after adjusting for risk and expenses. In a study dealing with the analysis of individual investment funds, [Ivković and Weisbenner \(2009\)](#) demonstrate

the influence of tax issues on investment decisions, and show that individuals' fund-level inflows and outflows are performance sensitive, but in different ways. In short, this body of work reveals that certain elements, particularly those linked to investor type, can have a clear impact on the effectiveness of external factors as fund governance mechanisms.

It is worth considering whether the driving forces behind investors as a fund governance mechanism may be not just performance sensitivity, and motivation or sophistication in monitoring, but also the power to bargain¹ with the management and custody firm, which varies with, among other things, supply- and demand-market structures. Let us emphasize, at this point, however, that the demand pattern may be heavily determined by the pension plan governance structure, thus linking internal and external plan governance mechanisms.

The existence of corporate governance mechanisms that enable the alignment of investor and fund manager interests and facilitate collective decision-making can result in a de facto increase in demand concentration which helps to protect investors' interests. The absence of such mechanisms leaves investors with no alternative except to exercise their individual exit rights.

The Spanish pension plan industry provides an excellent framework for the empirical analysis of this interesting issue because of its unique institutional environment, which accommodates two main pension plan types² (individual and employer-sponsored) which contrast sharply in

* Corresponding author.

E-mail address: rafael@unavarra.es (R. Santamaria).

¹ The importance of bargaining power has come to light in the analysis of various service costs (see, among others, [Casterella, Francis, Lewis, & Walker, 2004](#), [Roth, 2006](#), [Kwak, Kim, & Moon, 2006](#) and [Wu & Wu, 2007](#)).

² In Spain there are two types of private pension plans: personal and occupational (employer-sponsored). Personal pension plans can be individual or associated. An associated pension plan is one that is founded by an association or union, where all participants must be associates, members, or affiliates of the promoting body. For these specific characteristics, in this study we focus on individual and occupational plans only. The associated pension plans most often found in Spain are those promoted by trade unions.

terms of governance structure. In employer-sponsored plans, the fund oversight committee (“Control Committee”) has the competence not only to determine fund characteristics, but also to select the management firm and custody firm. The promoter (which is the employer firm) has 50% of the votes on the fund Control Committee, while the remainder is shared among participants and beneficiaries.³ Thus, investors’ disperse individual interests are represented collectively by a single decision-making body (Control Committee) with interests aligned to their own, which substantially increases their concentration in practical terms. This clearly boosts the decision-maker’s power to bargain with the management firm, when laying out the terms of the contract, monitoring performance, and negotiating fees and other expenses associated with the plan.

In the case of individual plans, however, it is the promoter, which is a financial institution, that selects a management firm and custody firm, without any direct representation of the participants or beneficiaries in any of the governing bodies. In fact, there is generally no Control Committee.⁴ The only option open to a participant who is unhappy with plan performance or the levels of fees or other expenses, is to exercise the right of exit, that is, to withdraw the money invested in the plan and transfer it to another.⁵ These individual decision-makers, of course, have considerably less bargaining power and monitoring capacity than is held by investors in employer-sponsored pension plans. Note, finally, that management firms do not specialize in individual or in employer-sponsored pension plans, but tend to manage both plan types.⁶ Thus, any differences in performance, fees or expenses cannot reasonably be attributed to differences between management firms.

In this context, the first issue for analysis is whether these differences in pension plan governance structures have a relevant impact on fee setting, given the importance of the latter in the ultimate return on the investment not only for the participants, but also, of course, for the management (and custody) firm, whose main source of income it is. The second is whether the two plan types differ significantly in performance terms. As noted previously, the literature has already analysed the role of investor typology in these issues. The first novelty of this paper is that we analyse two pension plan governance structures, each offering participants a very different degree of monitoring capacity and bargaining power with which to discipline managers.

Since some management firms handle pension plans of both types (individual and employer-sponsored), we are also able to test whether this simultaneous management of plans with such different governance structures has positive or negative consequences for participants or plays no role at all, either in the fee setting process or the performance of the funds under management. There exists empirical evidence, albeit not related with the impact of corporate governance structure on pension plans, supporting either a positive or a negative impact. Note, however, that this literature addresses several distinct issues and that the various studies it includes do not offer alternative explanations for

³ This percentage is established at plan level, given that every plan has a Control Committee. If the fund has only one plan, the plan Control Committee becomes the fund Control Committee and the described situation ensues. Otherwise, the fund Control Committee will maintain the representational distribution of the various plans under its administration. Note also, however, that the shares can be adjusted upon a collective bargaining agreement, albeit within certain legal limits.

⁴ A Control Committee is necessary only when there is more than one promoter, which is very rare in practice, given that the only promoters of this type of plan are financial institutions (banks, savings banks, insurance companies, etc.) which also usually own the management firms.

⁵ There also exists a type of “ombudsman” or investor advocate (“*Defensor del Partícipe*”), whom investors can consult if they wish to appeal against pension plan decisions.

⁶ The overall average percentage of management firms managing both individual and employer-sponsored plans, over the sample period (2008–2014), is 47.08%, among which are the largest. Indeed, for the year 2014, average total assets for firms managing both types of plan is 1.6 times greater than for those specializing in one type only. When calculated in terms of the financial group to which the managing company is affiliated, the percentage reaches 64%, with average fund size 1.53 greater.

the phenomenon in hand, nor are their findings strictly incompatible with each other.

Findings that might support the existence of a positive effect are those reported by [Evans and Fahlenbrach \(2012\)](#) in an analysis of retail-institutional mutual fund twins. According to these authors, monitoring by institutional investors results in higher yields for funds with institutional and retail class shares at the same time as for those with retail class shares only, thus providing support for a positive synergy effect on performance from sharing governance with more sophisticated investors. Given that, by virtue of the Control Committee, there is a more sophisticated decision-maker in employer-sponsored plans ([Abinzano, Muga, & Santamaria, 2016](#)), the implication of the findings of [Evans and Fahlenbrach \(2012\)](#) for the case in hand might suggest a positive effect on individual plans managed by firms handling both types of plans.

The theory of a negative effect could be supported by the findings of [Gaspar, Massa, and Matos \(2006\)](#) who report cross-fund subsidization in mutual fund families benefiting those with higher fees and higher yield and potentially attracting more cash inflow to the fund family. In the case that concerns us, the stronger pressure coming from employer-sponsored plans could lead management firms to engage in strategic behaviour and protect the interests of these plans at the expense of individual ones.

This paper makes two main contributions to the literature. Firstly, it finds significantly lower fees and better before- and after-fee performance in pension plan governance structures that permit full alignment of interests. Secondly, and more innovatively, our study finds that firms managing employer-sponsored and individual plans, each with its own governance characteristics, are incentivized to take advantage of their existing differences by engaging in cross-fund subsidization.

The rest of the paper is organized as follows: Section 2 presents a brief description of the Spanish pension plan framework. Section 3 presents the testable hypotheses. Section 4 describes the database used in the study. Section 5 describes the methodology. Section 6 reports the main results and robustness checks and the seventh and final section discusses the main conclusions.

2. Spanish pension plan framework

The legal and governance structure of pension plans varies across countries. As shown in [Stewart and Yermo \(2009\)](#), there are two types of autonomous pension funds: the institutional type (which has its own internal governing board) and the contractual type (where the governing body is usually the board of directors of the management firm). There are also mixed types. In particular, the trust, which is the legal form in Anglo-Saxon countries, has characteristics of both types.

Spanish pension funds are of the contractual type, although governance is shared with a separate oversight committee (“Control Committee”). The differences in governance structure between individual and employer-sponsored plans in Spain are inherent in their very creation. As we have already mentioned, the promoter in the case of employer-sponsored plans is the employer firm, which holds 50% of the votes in the Plan Control Committee, while the rest are shared among the participants and beneficiaries. When the plan is the only one in the pension fund,⁷ the Plan Control Committee is the Fund Control Committee, which has the decision-making power in issues as important as determining fund characteristics and hiring (and/or firing) firms to manage and take custody of the assets of all the fund’s pension plans. The objectives of this committee are very closely aligned with those of the participants, assuming, as is reasonable, that the firm’s

⁷ A pension fund comprises the combined assets of one or more pension plans. It is managed by a single company and held in custody by another. Employee pension funds contain only employer-sponsored pension plans, while personal pension funds contain only individual or associated pension plans. A given pension plan may invest in more than one pension fund.

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