



PENSION NOTES

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PENSION FUNDS PROMOTE HIGHER CORPORATE GOVERNANCE STANDARDS¹

- Corporate Governance (CG) refers to a series of standards, practices and procedures that determine and regulate actions within companies, setting out the rights and obligations of the different parties involved and contemplating incentives in order to protect the interests of the company and its shareholders, thus maximizing its long term value.
- The OECD, among others, is the institution that has most advanced in encouraging the application of better practices in CG matters. Hence, the [OECD Corporate Governance Principles](#) of 2004 set out non-binding standards and better practices, with guidelines for their implementation that can be adapted to the particular circumstances of each country or region.
- Good CG practices are essential for the integrity of companies, financial institutions and markets and are key to the health and stability of economies. As the 2009 BBVA publication [Pension Trends](#) points out, companies that adopt such practices increase their efficiency, reduce costs, limit risks and are acknowledged by society and markets, giving rise to increased competitiveness and reduction in capital costs, thus increasing the value of companies and favoring the economic growth of the country.
- The [Practical Guide to Corporate Governance: Experiences of the Companies Circle of the South American Round Table](#), published in 2009 and sponsored by the OECD, showed that between 2005 and 2007 companies that are part of this Circle (promoting better CG practices) had Equity Performance Indices (net income over accountable equity value) of 21.7%, 5 percentage points higher than companies listed on South American stock exchanges (the comparison group). Furthermore, between 2005 and 2007, the companies in this Circle had a Price to Book Ratio (price of the share against its book value) 61% higher than the companies in the comparison group.
- The best CG practices also have a positive effect on leadership in times of financial crisis. In fact, the evidence shows that the Price to Book Ratio of the aforementioned companies was 133% higher than that of companies in the comparison group in the midst of the 2008 economic crisis. In turn, share prices of the companies in the Circle dropped less than those of companies in the comparison group.
- It is also noteworthy that an average increase of 8% in share prices occurred in companies in the Circle after announcing CG improvements through the communications media.
- As Alejandro Ferreiro points out ("[The Regulation of Corporate Governance Good Practices in Emerging Capital Markets](#)," in the 2006 FIAP book "[Pension Fund Investment Perspectives](#)"), in Latin America and Eastern Europe, mandatory pension funds currently play an important role in the development of capital markets and the improvement of corporate governance quality in

¹ Document drawn up by FIAP.



the companies in which they invest the resources saved by workers in their individually funded accounts.

- According to [Ferreiro \(2006\)](#), pension fund managers (AFPs) must ensure the CG quality of the companies they invest in, in order to assure adequate profitability and the safety of their members. For example, article 45 of Decree Law 3.500 – the Chilean pension law – states that “the sole purpose of the investments performed with the resources of a pension fund shall be the obtainment of adequate profitability and safety.” Furthermore, article 147 of the same law states that “the fund managers must take all necessary measures to ensure the obtainment of adequate profitability and safety in the investments of the funds they manage.” Consequently, the AFPs are indirectly obligated, by law, to promote improvements in CG practices, since given the existence of a “market prize” for these companies, this would have a positive impact on their investments, with the consequent positive effect on the accumulated balance of members’ individual accounts, and ultimately, on the pension amount.
- As [Ferreiro \(2006\)](#) says, promoting best CG practices is also a policy requirement of the pension funds. Any problem in any company they invest in that is a consequence of CG failure and generates losses for investors, however small they may be, will most probably be considered by public opinion to be the result of the AFP’s failure to comply with its trustee role. This situation could give rise to different types of questioning of the legal status of the pension funds and possibly regulatory amendments that negatively affect their future profitability.
- The case of Chile and other countries that have implemented reforms based on individual funding is a clear example of how institutional investors have improved corporate governance standards. The pension funds have channeled enormous amounts of resources to the capital market, particularly in Chile. In 2009, the pension funds had invested US\$ 66,287 million in the domestic market, equivalent to approximately 37% of that year’s GDP. The increased volume of transactions has deepened the financial market, generating more information and lower monitoring costs. On the other hand, the AFPs assume the role of minority shareholders with a high degree of knowledge and information regarding the controlling groups of the companies in which they invest the pension funds, contributing to the appointment of a significant number of independent directors and preventing withdrawals of income that are detrimental to the interests of the minority shareholders (for example, in 1997, the Chilean AFPs opposed the purchase of the electrical company Enersis by Endesa Spain, since they considered that the benefits of the operation were unequally distributed among the shareholders).

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