

## DIVIDENDS AND INSTITUTIONAL INVESTORS ACTIVISM: PRESSURE RESISTANT OR PRESSURE SENSITIVE?

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### Abstract

This paper provides new international evidence on the relationship between dividend policy and institutional ownership by analysing a sample of US and UK and Irish firms characterised by an Anglo-Saxon tradition and a matching sample of other EU companies from Civil Law legal systems. We hypothesize that, due to the different characteristics of both the legal system and the nature of agency conflicts in firms from those countries, the type of institutional investors and their role in corporate governance is different and so the use of dividend policy to solve the conflict of corporate governance problem differs in each legal system. We find that while in firms from Anglo-Saxon tradition the relation between dividends and institutional investors, pension and investment funds, is positive, in Civil Law countries the relation is negative where investors are banks or insurance companies with other private interest inside the firm. These results are consistent with our hypotheses and breed new insights into the role of dividend policy as a disciplining mechanism in firms from different legal system with an important presence of institutional investors.

**Keywords:** dividend policy, corporate governance, institutional investor activism, pressure and pressure insensitive, international financial markets

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### 1. Introduction

Financial institutions' aggregate investments have grown substantially across world equity markets, and they have incentives to monitor managers when institutions are large shareholders. So, institutions may demand more dividends to avoid managerial discretion in the use of free cash flow ( Jensen; 1986) and to force firms to obtain external funds and be subject to monitoring by external capital markets (Short et al., 2002). In anglosaxon countries, institutional investors as pension and investment funds pension are frequent owners of important shareholdings and they can use the payout policies to play an active role in the corporate governance problems.

But activities of institutional investors differs both across types of investors and across countries. Recent studies have focused on the different objectives of different institutional investors in corporate governance such as pension funds, banks; or insurance companies. Pound (1988) and Bhattacharya and Graham ( 2007) distinguish two types of institutional holdings: pressure sensitive investors when they are more sensitive to pressure from corporate management and pressure insensitive when they are not sensitive to pressure from corporate

management. Pressure sensitive investors are banks and insurance companies because they have frequently other business relations with companies. This type of investors is more frequent in countries where investors protection are weaker, the ownership concentration is higher and firms use more debt to finance their investments. It is the case of civil law countries where investors as banks and insurance companies with other private interest in firms try to reduce dividends to get their private interests inside firms contrary to the attitude of pressure resistant investors, pension and investment funds, which are more frequent in anglosaxon firms.

The objective of our paper is to demonstrate that, due to the distinct characteristics of anglosaxon and civil law firms, the type of institutional investors and their role in corporate governance is different and so, the use of dividend policy to solve the agency problems differs in each legal system.

Our results suggest that while in firms from Anglo-Saxon tradition the relation between dividends and institutional investors, pension and investment funds, is positive, in Civil Law countries the relation is negative where investors are banks or insurance companies with other private interest inside the firm. So, different institutional investors can have a distinct impact on dividend policies according to the

particularities of corporate governance environments of each legal system.

The paper proceeds as follows. Section 2 provides the arguments to link dividends and institutional shareholders in different legal system with the hypotheses to be tested, while the following section describes the data and methodology. Section 4 presents and discusses the major results. The final section summarizes and discusses the paper's contribution to the literature.

## 2. The Link Between Institutional Investors Activism and Dividend Policy in Each Legal System

The relation between dividends and institutional investor can be influenced by the nature of each institutional investor and by the particular corporate governance problem existing in firms from different legal system.

The so-called *law and finance* approach is based on the legal tradition of each country. According to which, the legal and institutional features are not unrelated to the agency problems within firms. There are two conflicts of interest to which most attention has been paid: the relationship between managers and firm owners and the relation between shareholders and creditors. Nevertheless, in recent years there is more concern with the conflict of interest between large and small minority shareholders. As stated by Becht and Röell (1999) and Bianco and Casavola (1999), in the Anglo-Saxon common law countries, the main agency problem arises from the dispersion of corporate ownership and from a certain lack of shareholder activism. On the contrary, the main problem in civil law countries is the too high concentration of ownership and, consequently, large shareholders may use their voting power to extract private benefits from small shareholders. These aspects have an influence on the participation and the nature of institutional investors in corporate governance.

Bhattacharya and Graham (2007) suggest that an institutional investor with other profitable business relationships with the firm such as banks as lenders or insurance companies that act as primary insurers, can create conflicts of interest while other institutional investors can exert an effective monitoring on managers. Li and others (2007) find evidence that banks and insurance companies are frequent investors in civil law firms while pension funds are frequent owners of important shareholdings in anglosaxon countries. It is due to differences in the legal framework of civil law with a bank orientation of firms and anglosaxon firms with a market orientation to obtain funds respectively (Rajan and Zingales, 1995 and La Porta et al., 1998, 2000ab and 2002). As we mentioned, the authors distinguish pressure resistant versus pressure sensitive institutional investors according to whether these can reduce or increase corporate governance problems so that the

impact of these investors on dividends policy could be negative or positive. Therefore, we set two different hypotheses for firms from anglo and civil law system respectively.

Hypothesis 1: *In anglosaxon firms, dividends increase when the ownership of institutional investor is higher.*

Hypothesis 2: *In civil law firms, dividends decrease when the ownership of institutional investor is higher.*

## 3. Methodology

### 3.1. Sample and Variables

The information required to test the two hypotheses that were advanced in the previous section has been gathered from different sources. The *Compustat Database* was used to obtain firm financial data. Information on US company ownership over the period 1996-2000, during which the research was conducted, was collected from *Deloitte and Touch's Peerscope* and *Investor Insight's Market Guide* databases. *Amadeus*, provided by the *Bureau van Dijk*, was used for ownership data on European companies. La Porta et al.'s (1997) international data on Shareholders and Creditors rights was also used.

The final sample is shown in table 1. As can be seen from the table, the sample is composed of 931 companies over the period 1996-2000 and involves a total of 4,092 firm-year observations. Of the total number of companies, 462 are from the US and 469 are European.

### INSERT TABLE 1

### 3.2. Empirical Model

The extended model that we use in our empirical analysis is as follows:

$$DIV_{it} = \beta_0 + \beta_1 DIV_{i(t-1)} + (\beta_2 + \alpha_2 ANGLO_i) INSTI_{it} + (\beta_3 + \alpha_3 ANGLO_i) INSI_{it} + (\beta_4 + \alpha_4 ANGLO_i) DR_{it} + (\beta_5 + \alpha_5 ANGLO_i) MB_{it} + \delta_1 SR_{it} + \delta_2 CR_{it} + (\beta_6 + \alpha_6 ANGLO_i) LOGACT_{it} + \eta_{it} + v_{it} \quad (1)$$

$DIV_{it}$  is defined as dividend yield (dividends divided by market capitalization of equity), or as dividend payout (dividends divided by earnings) or the ratio between dividends and total assets. This variable was previously censored using a TOBIT model given that one cannot directly include such in a Generalized Method of Moments (GMM) panel without it being censored, as referred by Arellano and Bover (1997);  $INSTI_{it}$  is the degree of institutional ownership;  $INSI_{it}$  is the ownership by insider shareholders as a percentage of total shares;  $DR_{it}$  represents the level of debt defined as the ratio between the book value of debt and total assets;  $MB_{it}$  is the market-to book ratio;  $SR$  and  $CR$  are indexes for shareholders and creditors rights, respectively, as taken from La Porta et al. (1997);  $LOGACT$  measures size, defined as the log of the book value of the assets.

ANGLO is a dummy variable where a value of 1 is assigned for firms from the US, United Kingdom or Ireland (Common Law countries), and a 0 for all other firms (Civil Law firms).

We test this model with panel data to allow the values taken over time by a series of variables to be known on an individual basis (The panel data used is characterized as being incomplete or unbalanced. In particular, the variant chosen for this work is referred to a micropanel data, which is to say, a data group in which the dominant dimension corresponds to the number of individuals while the number of periods is significantly lower). The use of this methodology has a number of advantages when compared with a cross sectional data. The first is the so-called control of constant unobserved heterogeneity. In our case, the particular singularities of the firms can affect their dividend payment policies, as already stated, and such features can persist for long periods of time. The second is the dynamic dimension of our data panel that allows dividend policies to vary according to the proposed explanatory variables over a period of time and furthermore considers the impact on dividends in the light of changes in the model's other variables.

The existence of individual as well as endogenous effects leads us to consider the variables in first differences and to estimate the parameters of the model using the *generalized method of moments* (The endogenous character of the ownership structure has been considered in recent studies as Villalonga and Amit (2006) for US firms, Short and Keasey (2002) for UK firms, De Miguel et al. (2002) and Alonso-Bonis and De Andrés-Alonso (2007) for Spanish firms and López Iturriaga, and Saona Hoffman (2005) for Chilean firms among others).

## 4. Results

### Descriptive Results

The results are shown in tables 2 and 3. In table 2, descriptive statistics on the most significant variables used in firms within each legal and institutional framework reveal the existence of important and significant differences between the two sets of firms.

#### INSERT TABLE 2

Table 2 reveals that Anglo-Saxon firms on average pay out more dividends, carry less of a debt burden - with levels of debt that do not reach 30% of total liabilities, against 50% in firms from Civil Law countries -, display an ownership structure that is characterized by a much higher participation of institutional investors - reaching 40% of total ownership against a mere 7% for firms within the Civil Law tradition - and have greater opportunities for growth than firms in continental Europe (as measured by the market-to-book ratio). If a greater degree of shareholder protection is added to this already dissimilar model of financial architecture, a picture emerges of the different scope of agency problems in companies within the two legal and

institutional frameworks and, consequently, of the different dividend policies that are adopted.

### Regression Results

Table 3 shows the estimated coefficients for the variables in our model, first for Anglo Saxon firms and then for Civil Law firms, followed by the coefficients for the institutional variables and the results of the statistic tests<sup>31</sup>.

#### INSERT TABLE 2

We observe an important difference between our Anglo-Saxon and Continental European samples, which is the sign and magnitude of the coefficient estimate for INSTI. This coefficient is positive and significant for the Anglo-Saxon. So, we obtain evidence to confirm the hypothesis 1 of our study. In these firms, institutional investors as pension and investment funds are pressure sensitive to corporate governance problem and they are interested in increasing dividends to effective monitoring on managers. While the coefficient is negative and significant in the Civil Law sample (although not when we use the dividend payout ratio as the dependent variable). We also evidence to confirm the hypothesis 2 of our study. In this case, banks as lenders or insurance companies that act as primary insurers, can create conflicts of interest and they prefer reduce dividends to get their private interest in firms.

From Table 3 one can also observe a statistically significant negative impact of the DIV variable from the previous period. Although, as referred earlier, one would expect, instead, a positive impact (Lintner, 1956), it should be kept in mind that the 1996-2000 sample period a dramatic fall in dividend payments was observed in many countries, as observed by Fama and French (2001), although in later years, particularly after 2003, this phenomena has somewhat reversed. Thus, it may be the case that the negative sign observed in Table 3 for the DIV variable may well reflect this particular feature of recent aggregate dividend behaviour.

The values obtained by the Wald test, the Sargan test and the second order serial correlation allow us to confirm the validity of the instruments used and the absence of second order correlation.

## 5. Summary and Conclusions

In summary, the results obtained from our empirical model show a relation between institutional ownership and dividend policy which is remarkably

<sup>31</sup> Year dummies were included as explanatory variables but are not reported in Table 5 for simplicity. Only the coefficient for the 2000 year dummy showed some statistical significance at the 10% level.

different between the two legal and institutional environments (Civil or Common Law).

We evidence that the type of institutional investors and their role in corporate governance is different due to the different characteristics of both the legal system and the nature of agency conflicts in firms from those countries. And so, the use of dividend policy to solve the conflict of corporate governance problem differs in each legal system. We find that, in firms from Anglo-Saxon tradition, the relation between dividends and institutional investors as pension and investment funds is positive. In this case institutional investors try to force to increase dividend policy in order to reduce the agency problems between managers and shareholders. While, in Civil Law countries, the relation between dividends and institutional investors is negative due to the influence of banks or insurance companies with other private interest inside the firm.

Therefore, we breed new insights into the role of dividend policy as a disciplining mechanism in presence of institutional investors in ownership structure of firms from different legal systems and distinct agency problems. But there is a significant scope for further investigating the relationship between this type of investors and different methods of payout, dividends and/or share repurchases, in an international context.

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## Appendices

**Table 1.** International distribution of the sample of firms by different origin legal and country

| Civil Law tradition  |        |              |
|----------------------|--------|--------------|
|                      | Firms  | Observations |
| French origin        | 71     | 350          |
| France               | 44     | 212          |
| Spain                | 29     | 151          |
| Netherlands          | 12     | 63           |
| Belgium              | 6      | 33           |
| Greece               | 2      | 10           |
| Italy                | 2      | 10           |
| Luxemburg            | 1      | 5            |
| Portugal             | 167    | 834          |
| Total                |        |              |
| German origin        |        |              |
|                      | Firms  | Observations |
| Germany              | 71     | 341          |
| Austria              | 8      | 38           |
| Total                | 79     | 379          |
| Total                |        |              |
| Scandinavian origin  |        |              |
|                      | Firms  | Observations |
| Denmark              | 33     | 158          |
| Sweden               | 23     | 70           |
| Total                | 56     | 228          |
| Total                |        |              |
| Percentage           | 11,94% |              |
| Common Law tradition |        |              |
|                      | Firms  | Observations |
| USA                  | 462    | 1.830        |
| United Kingdom       | 165    | 811          |
| Ireland              | 2      | 10           |
| Total                | 167    | 821          |
| Total                |        |              |
| Percentage           | 35,61% |              |

**Table 2.** Summary statistics for Anglo Saxon firms and Civil Law firms

| Variable | Mean  |       |         | Median    |       | St. Desv. |        | Máximum |       | Mínimum |         |
|----------|-------|-------|---------|-----------|-------|-----------|--------|---------|-------|---------|---------|
|          | Anglo | Civil | p value | Anglo     | Civil | Anglo     | Civil  | Anglo   | Civil | Anglo   | Civil   |
| DIV      | 0.019 | 0.019 | 0.000   | *** 0.014 | 0.007 | 0.029     | 0.052  | 0.885   | 0.782 | 0.000   | 0.000   |
| INSI     | 0.309 | 0.524 | 0.000   | *** 0.284 | 0.562 | 0.207     | 0.235  | 0.793   | 0.875 | 0.000   | 0.000   |
| INSTI    | 0.469 | 0.079 | 0.000   | *** 0.493 | 0.024 | 0.232     | 0.120  | 0.870   | 0.849 | 0.000   | 0.000   |
| DR       | 0.277 | 0.492 | 0.000   | *** 0.277 | 0.499 | 0.189     | 0.189  | 0.884   | 0.962 | 0.000   | 0.000   |
| MB       | 1.866 | 1.022 | 0.000   | *** 1.113 | 0.569 | 2.236     | 1.873  | 13.360  | 6.220 | 0.016   | 0.551   |
| LOGACT   | 3.835 | 2.715 | 0.000   | *** 3.358 | 2.606 | 1.684     | 0.913  | 7.527   | 6.689 | 0.912   | 1.106   |
| ROE      | 0.146 | 0.142 | 0.427   | 0.137     | 0.129 | 0.120     | 0.2231 | 0.925   | 2.631 | -0.478  | -0.776  |
| ROA      | 0.073 | 0.069 | 0.019   | *** 0.066 | 0.060 | 0.068     | 0.841  | 0.366   | 0.755 | -0.262  | -0.2462 |

DIV is the dividend yield, measured as dividends divided by market capitalization of equity; INSI is the variable that measures ownership by insider shareholders, calculated as the total percentage of all shares owned by the members of the managerial team, both executive and non-executive board members, in addition to those owned by shareholders whose stake is over 5% of the total shares of the company; INSTI measures the degree of institutional ownership; Lit represents the level of debt, measured as the ratio between the book value of debt and of total assets; MB is the market to book ratio (market capitalization of equity plus book value of total assets less book value of equity, divided by the book value of total assets); LOGACT measures firm size as the log of total assets; ROE is the ratio between Net Income and Shareholders Equity; ROA is the ratio between Net Operating Profits and Total assets.

**Table 3.** Results of a Tobit Regression estimated as a dynamic panel data analysis using GMM estimation

| Variable               | Anglo firms        |     | Civil law firms   |     |
|------------------------|--------------------|-----|-------------------|-----|
| Constant               | -0.044<br>(0.070)  |     | -0.044<br>(0.070) |     |
| DIV <sub>i</sub> (t-1) | -1.828<br>(0.208)  | *** | -1.828<br>(0.208) | *** |
| INSTI <sub>it</sub>    | 0.082<br>(0.027)   | *** | -0.197<br>(0.069) | **  |
| INSI <sub>it</sub>     | -0.235<br>(0.276)  |     | 0.484<br>(0.319)  | *   |
| DR <sub>it</sub>       | -0.4993<br>(0.459) | **  | 1.088<br>(0.589)  |     |
| MBit                   | -0.033<br>(0.010)  | *** | -0.002<br>(0.028) |     |
| LOGACT <sub>it</sub>   | 0.028<br>(0.014)   |     | -0.314<br>(0.814) |     |
| SR <sub>i</sub>        | 0.038<br>(0.011)   | **  | 0.038<br>(0.011)  | **  |
| CR <sub>i</sub>        | 0.015<br>(0.013)   |     | 0.015<br>(0.013)  |     |
| Wald test              | 4180.75 (20)       | *** |                   |     |
| m1                     | 3.67               |     |                   |     |
| m2                     | 0                  |     |                   |     |
| Hansen/Sargan test     | 13.67 (12)         |     |                   |     |

DIV is the dividend yield (dividends to market capitalization ratio); INSTI measures the degree of institutional ownership; INSI is the variable that measures ownership by insider shareholders, calculated as the total percentage of all shares owned by the members of the managerial team, both executive and non-executive board members, in addition to those owned by shareholders whose stake is over 5% of the total shares of the company; DR represents the level of debt, measured as the ratio between the book value of debt and of total assets; MB is the market to book ratio (market capitalization of equity plus book value of total assets less book value of equity, divided by the book value of total assets); LOGACT measures firm size as the log of total assets; SR and CR are indexes for shareholders and creditors rights, respectively, as taken from La Porta et al. (1998) ANGLO is a dummy variable where a value of 1 is assigned for firms from the US, the United Kingdom or Ireland (from Common Law countries), and a 0 for all remaining firms (from Civil Law countries). The results are presented in two columns: In first column we present the coefficients obtained for anglosaxon firms and, in second column, we present the results for civil law firms of our sample. The constant, the coefficients for dummy variables SR and CR and the coefficient for previous dividends are the same for both samples of firms. \*\*\* for 99% confidence level, \*\* for 95% and \* for 90%.