J. of Multi. Fin. Manag. 20 (2010) 126–143

Contents lists available at ScienceDirect

Journal of Multinational Financial Management

journal homepage: www.elsevier.com/locate/econbase

The role of institutional investors in the inventory and cash management practices of firms in Asia

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ARTICLE INFO

Article history:
Received 6 May 2008
Accepted 19 July 2010
Available online 23 July 2010

Keywords:
Cash
Inventory
Emerging markets
Institutional investors
Asia

ABSTRACT

This paper examines the role of a particular class of institutional investors, domestic and foreign banks, in corporate decisions that have liquidity implications such as inventory and cash management. Using a sample of 256 non-financial listed firms in six Asian countries over the period of 2002–2005, this paper shows that foreign banks improve inventory and cash management practices, due to their superior monitoring of the managers. The disproportionate numbers of the institutional investors across industrial sectors in these Asian countries seem to suggest that some industrial sectors have stable demand of their products, such as in consumer goods sector, which is an attraction, for these institutional investors. Furthermore, the paper finds that forward-looking government policies are crucial to entry of these institutional investors in the developing countries. The research findings have implications for board structure and corporate governance standards.

1. Introduction

The opening of local stock markets to foreign investors has allowed diverse groups of foreign investors to move across borders in search of higher returns. One particular group of investors that has received continuous attention in the finance literature is institutional investors (Dong and Ozkan, 2007). The main motivation of this paper is to provide a new empirical assessment of the size of institutional investors' (or blockholders') shareholdings, specifically, of the influence of domestic and

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1042-444X/$ – see front matter
doi:10.1016/j.mulfin.2010.07.001

foreign banks on the inventory and cash holdings of non-financial listed firms in Japan, Singapore, Malaysia, Indonesia, South Korea, and Thailand.[1]

Our current knowledge about the role of these institutional investors in these countries is still limited. Previous studies have investigated the determinants of U.S. institutional investors' (such as mutual funds, pension funds, and hedge funds) investment in emerging markets (see Ko et al., 2007; Aggarwal et al., 2005; Kaminsky et al., 2001; Park and Song, 2001) and examined the role of domestic banks in influencing firms' investment and financing decisions (see Hoshi et al., 1990). Our study is different from other studies on East Asian countries, which focused almost exclusively on family and government ownership because we chose to study domestic and foreign banks as institutional blockholders in these economies. From previous studies, we know that institutional investors are more methodical and better at evaluation of managerial performance compared to ordinary investors.[2] While Seifert et al. (2005) argue that although these institutional blockholders have their own separate interests, these investors might cooperate with local managers to pursue strategies that may (or may not) maximize shareholders' wealth, and Patibandla (2006) further adds that agency costs are more problematic for foreign institutional blockholders compared to domestic blockholders because of different legal environments.

Government regulations affect the ways companies are owned, the manner in which they are controlled and the process by which changes in ownership and control take place. We selected six Asian countries – Japan, Korea, Indonesia, Malaysia, Singapore and Thailand – because the experience and the role of foreign vs. domestic banks as institutional investors vary across these countries, which, as we argue in this paper, have implications for the incumbent firms.[3] We excluded China because it has a completely separate market for foreigners. For instance, recent studies (see Ko et al., 2007; Kamesaka et al., 2003) show that the nature and development of institutional investors are different in Japan and Korea. In Japan, ownership is often concentrated within a small number of other directly related firms, banks, and families. Japanese banks (the biggest institutional investors) keep a closer relationship with industrial firms through mutual stock ownership; in other words, Japanese banks own stocks not for high investment returns but for the business relationship and control (see Aoki, 2002 for a comprehensive review of main banking system in Japan). By virtue of their closer involvement in the day-to-day activities of firms, commercial banks may have cheaper and better access than do other institutional investors to the information required to monitor a firm's investment policy (Li, 1994). A borrowing firm might face switching costs once this relationship is severed, therefore, firms commonly adhere to the policy suggestions of the banks and do not face investment constraints (Hoshi et al., 1990).

Secondly, previous Asian studies have mainly focused on the relatively developed East Asian countries such as Singapore (e.g. Chuanrommanee and Swierczek, 2007; Mak and Kusnadi, 2005) and there is a lack of evidence on the role of such investors in the less advanced corporate governance countries such as Indonesia and Thailand (Klapper and Love, 2002). Thailand and Indonesia set an upper limit (49%) for foreign institutional investors (which was subsequently relaxed in Indonesia). Recently, Indonesia introduced a Good Corporate Governance Code but it is not mandatory for all firms. The adoption of new codes of corporate governance takes into account the different characteristics of each company, such as the size of the share capital, for example.[4] In Thailand, domestic institutional investors, such as the banks, mutual funds and securities firms, lack good corporate governance (Nikomborirak and Tangkitvanich, 1999). Daouk et al. (2006) ranks Thailand at the bottom of the list of 22 developed and 10 developing countries according to the quality of their corporate governance. In Japan, because of the well-established convention of exclusive delegation of integrated monitoring

[1] Patibandla (2006) examined two types of the largest institutional investors in India, i.e., government public financial institutions and private financial institutions.

[2] See, for example, Stapledon (1996), Diamond (1984), and Cubin and Leech (1983).

[3] Prowse (1990) examined the role of institutional investors in the U.S. and Japan in resolving agency problems. They found that Japanese financial institutions take large equity stakes in firms to which they lend, particularly in firms more susceptible to agency problems.

[4] Other new measures include requiring at least 20 percent of the board members to be outside directors in order to increase the effectiveness of its management role and transparency, internal control systems, and audit committee.