Institutional Investors, Risk/Return and Corporate Governance Failures: Practical Lessons from the Global Financial Crisis

A Conference for Institutional Investors, Practitioners, Professionals and Academics*

Venue: Saint Mary's College of California
Moraga, CA 94575
(San Francisco Bay area)

Dates:
October 5-7, 2009
(Begins October 5th at 6:00 pm dinner, Ends October 7th at 12:00 noon)

Conveners:

The Elfenworks Center for the Study of Fiduciary Capitalism
School of Economics and Business
Saint Mary's College of California
(www.fidcap.org)

The Principles for Responsible Investment
(www.unpri.org)

Millstein Center for Corporate Governance and Performance
Yale School of Management
Yale University
(http://millstein.som.yale.edu)

Sponsor:
Hermes Equity Ownership Services, Ltd
(www.hermes.co.uk/eos.aspx)

Papers and reporting supported by the
Investor Responsibility Research Center Institute
(www.irrcinstitute.org)

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***By invitation**

Background: The current financial crisis has, as part of its origins, a variety of corporate governance failures. Most obvious are misaligned compensation arrangements that incentivized extreme risk (typically short-term) while not punishing failure nor aligning with the longer-term nature of risk. These misalignments involve traders to CEOs, to other top level executives to board of director members**.**

Less examined to date is the role of large, supposedly sophisticated institutional investors (universal owners) in this crisis. The role is likely one of unconscious commission as well as of omission. Commission includes, for example, both direct and indirect exposure to extremely complex financial instruments (e.g. credit default swaps) through investments in hedge and private equity funds, as well as more traditional equity investments in large financial institutions. In particular, the pursuit of alpha and portable alpha often coupled with leverage to magnify returns may have led institutional investors to pursue financial products or investment strategies that proved to be particularly risky, and significantly contributed to the growth of these risky (and many have come to believe, illusory) goals of outperforming the market(s). Omission includes, for example, neither having nor considered having a risk monitoring system in place to monitor such investments based on what are now relatively well established corporate governance principles and best practices.

Here, the problem may have been that institutional investors accepted high returns in the financial sector without adequately investigating the basis for the returns and asking the question about whether they were sustainable and/or might pose systemic risk. There may be an important parallel to the over performers of the late 1990's, Enron, World Com, etc., that were much admired for their performance, but where performance was built on an unsustainable business model, often not adequately transparent. Additionally, there has not typically been concern for systemic risk, which has resulted from the piling on of multiple firm, sector and financial instrument risk.

Thus, the apparent acceptance of a significant degree of lack of transparency, especially in the financial sector and among the majority of alternative investments violated a core concept of corporate governance advocated by universal owners and others: that transparency is critical to accountability which in turn is critical to a well governed firm in relation to its owners. Transparency, accountability and good governance generally add value. Lack of these has been toxic.

For large (and smaller) institutional owners there should have been, and going forward should be, both conceptual and operational links between corporate governance, on the one hand, and investment activities and strategies, on the other. These functions are typically separated, operating along different (and potentially conflicting) trajectories within most institutional investors' organizations. This conference will examine whether in the past this was typically the case (and with what consequences), and going forward, what alternative forms of analysis and organization might better serve universal owners and their beneficiaries and investors.

Conference Objective: To investigate the role of corporate governance failures, gaps, oversights and missed opportunities leading up to and in the current global financial crisis; and, to consider and develop proposals to mitigate or eliminate these failures in the future. In particular, we are interested in what role corporate governance concepts, standards and activities should play in

relation to investment decisions and strategy. We believe this is a critical yet to date relatively unexplored area.

The conference especially seeks as participants top level executive and senior staff representation *from both the governance and investment sides of institutional owners* in order to examine retrospectively what lessons can be learned and prospectively what forms these lessons might take going forward.

Specific Topics/Questions to Investigate: The following questions will be explored through papers, discussion and presentations at the conference. This is not an exhaustive list. The organizers of the conference encourage suggestions for elaboration of the following topics as well as additional related topics.

1. **Corporate Governance**: How did corporate governance failures (oversights, failure of risk analysis, etc) contribute to the current global financial crisis? How much can realistically be expected from a robust form and execution of "good investment governance?" What specifically was and should be the role of large institutional, universal owner type institutions in such governance?

- What is the role of governance in executive remuneration and compensation? Specifically, what are incentives for failure and short-term risk taking? How can misaligned compensation plans be corrected?
- What is the role of 'good investment governance' in the investment decision and allocation process?
- What forms might 'good investment governance' take?
- How might governance monitoring interact with investment decisions? Should they?

2. **Financial Institutions**: Some financial institutions were deeply affected by the crisis (i.e. Citigroup and AIG) and others were less affected. Are their lessons to be learned by looking at their governance structures prior to the crisis and investigating their board and management responses to the crisis?

3. **Systemic Risk:** Can and should institutional investors effectively identify and monitor for systemic risk?

- Can this role be played by institutional investors individually or is there need for some industry-wide entity that analyzes potential sources of systemic risk? What might entrepreneurial activity look like to provide value added analysis? Is there a potential market for this? Is the early 1990's market in the US for corporate governance analysis a parallel here?

4. **Alternative Investments, Alpha**: What role did the search for alpha and portable alpha play in the crisis and what role did institutional investors play in the pursuit of alpha? Did the governance side of organizations monitor these investments on the same basis as they did on the equity side? Should they? Can they?

- Were risks analyzed for various forms of securitization and CDOs? What information was known, and what was asked for? What models were used to evaluate borrower specific, sector specific and systemic risks?

- Were there failures in the governance structure of institutional investors themselves that might have prevented them from perceiving the housing and other credit bubbles or that prevented them from acting on their perceptions?

- Were 'out performing' investment sectors and specific investment entities subject to the same corporate governance standards as 'under-performing' firms and sectors have been? (In other words, was there a double corporate governance standard in effect?)

- What was the role, if any, of endowments (e.g. Yale, Harvard) in pushing the envelope on returns? Are there different fiduciary standards and obligations between endowments on the one hand, and pension funds and investment retirement accounts, on the other? Should there be?

5. **Alternative Investments: Real Estate, Infra-structure and Commodities:** What role did the expansion of real estate, infra-structure and commodity investment by large institutional owners play in the crisis? (See also #4, above)

6. **Role of Gate Keepers**: What was the role of accounting, financial reporting, rating agencies, consultants and regulation in the global financial crisis? What should have been the role of universal owners in relation to these gate-keeping functions? What should be changed going forward? Who watches the watchers remains a central focus.

- How much can be expected from institutional investors and corporate governance practices compared with governmental regulation? What should be the role of public policy advocacy on the part of institutional investors and owners?

- Can this advocacy role be played by individual institutional investors or should industry wide entities take on this task? Both?

7. **Responsible Investment, What Potentials?** Do the perspectives of the movement for 'responsible investment' (RI) with its emphasis on corporate governance have a role to play in mitigating and minimizing the next crisis or in assisting the recovery from this one? How can effective alignment of the long-term interests of most institutional investors and financial institutions be achieved? What should be the role of governmental regulation in this alignment and the prevention of such crises?

- What is or should be the role of ultimate beneficiaries and investors vis a vis universal owners and other institutional investors? How is or should this role be related to RI? What role could or should legal and/or regulatory changes have?
- Do the 'S' (social) and 'E' (environmental) factors in RI play a role in risk re-orientation? If so, how and what does or might that look like?

Format: Between 40 and 60 leading theorists and practitioners in the field of corporate governance, finance/economics, financial markets and responsible investment will be invited to a two-day conference at Saint Mary's College of California. Short presentations and paper summaries, some with a discussant, will structure discussions among all the participants. As with two prior very successful conferences the Elfenworks center has organized using this format, *an emphasis will be on cross discussion among all participants, rather than a formal question/answer format with presenters/commentators.*

Schedule: The conference will begin on Monday, October 5th with an early evening reception and dinner with keynote speaker; Tuesday, conference sessions all day with, lunch; Wednesday, a morning session, with the conference ending at noon on October 7th.

There will be an open public session Tuesday evening, to which the College and Bay area communities will be invited. The rest of the sessions will be closed and Chatham house rules will apply in the closed sessions.

Hosts: The Elfenworks Center or the Study of Fiduciary Capitalism and the School of Economics and Business Administration, Saint Mary's College of California.

Outcome: Either a book useful to practitioners and scholars about corporate governance, responsible investment and the global financial crisis, based on papers presented as chapters, with additional material possible, or a special issue of a journal. Publishers will be sought in advance, with commitment if possible.

Participants: Academics, professionals and practitioners from pension funds, sovereign wealth funds and sovereign pension funds and other universal owners.

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