

An Exploration into Corporate Governance, Risk  
Analysis and the Financial Crisis:  
What Did Universal Owners Do, and Not Do, to  
Contribute to the Crisis?

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# Universal Owners and Monitoring

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- Who will watch the watchers
  - What will they watch for? What will they monitor?
- Failure to watch and monitor financial crisis indicators
  - Did not apply corporate governance principles to the financial sector and to alternative investments (commodities, real estate, hedge funds, private equity)
  - Contributed unwittingly to bubbles and unsustainable leverage
- Failure to consider consequences of investment decisions *and* lack of governance monitoring:
  - systemic risks increase and therefore portfolio risk
    - But not captured by traditional risk conceptions or metrics
      - E.g. VaR
  - Created financial negative externalities
    - Internalized within portfolio (and beyond)

# ESG and Responsible Investment

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- Did not learn from 1987 LTCM failure; Internet and Enron type bubbles
- Responsible investment (RI) was not adequately conceived: ESG is conceived narrowly. Especially the G.
  - Some exceptions
- There was a major hole in governance, both PRI/RI governance, and among other governance activists (e.g. ICGN) and individual institutional investors (e.g. CalPERS)

# Governance and Risk

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- Long established focus on internal/firm risk
  - Board of directors, top management, traders
  - Internal governance mostly failed massively prior to crisis
- But almost no discussion in academic or practitioner literature of role of end asset owners as monitors of risk as a function of governance:
  - Firm level
  - Sector level
  - Systemic
- Risk was typically conceived narrowly in terms of volatility and confined to portfolio risk alone (and how to hedge it)

# U.K. Treasury “Walker Review”

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- Institutional investors were “slow to act where issues of concern were identified in banks in which they were investors, and [they were] of limited effectiveness in seeking to address it either individually or collectively”.
- The research agenda:
  - How did UO’s see and practice risk analysis prior to the crisis?
  - What role, if any, did corporate governance play?
  - Looking forward, what role could/should it play and how should risks be conceived?
  - What could/should be the relation of governance to investment strategy?

# The Conceptual Frame in Brief

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- Alpha, yield, alternative Beta and the financial crisis—  
or
  - Be careful what you wish for....How collective investment strategies of UO's unwittingly contributed to the crisis
  - Un-risk adjusted benchmarking (institutions and individuals)
    - absolute/relative returns
- UO's Investment chain (consultants, money mangers) caught up in seeking alpha, and risking the market as a whole
  - Forgetting the distinction between risk and uncertainty
  - The fetish of numbers/quantification and of efficient markets
  - The limits of modern portfolio theory

# Themes Informing the Project

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- The financial instability hypothesis: Minsky
- “Animal Spirits”: Keynes, Kindleberger, Akerloff/Schiller

# Holistic UO Monitoring and Its Limits

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- Under *and* hyper-performance
- 3 levels:
  - Firm
  - Sector
  - Systemic
- Risk and governance beyond equity: must include debt and alternative investments
- Governance principles (transparency, accountability, monitoring) should apply to *all* investments
- Governance in the financial sector *is different*

# Financial Sector Governance: It Is Different

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- Shareholder alignment with top management may be perverse (Bebchuk/Spamann)
  - Need for a more complex standard of performance
    - A basket of long-term indicators including debt
    - For U.S., take account of bank holding companies
- The limits of non-governmental 'self-regulation'
  - The need for public policy to do what UO's cannot themselves do
    - Limits of gatekeepers (e.g. rating agencies, banks as self-invested monitors, trading counter-parties)

# The 'Sophisticated' Investor?

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- The 'Sophisticated' Investor?
  - Re-think the U.S. 1940 Investment Company Act under which defines large institutions as 'sophisticated' investors
  - UO's failed the monitoring test: either not sophisticated, or if sophisticated, not capable of necessary monitoring
    - A. If the former, necessitates new regulatory regime
    - B. If the latter, a radical reconsideration of *both* investment strategy and corporate governance is called for
  - Likely both A and B are necessary

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