

**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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September 2009*

Presented at: PRI Academic Network Conference, Ottawa, Canada, October 1-3, 2009

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Comments welcomed

Background and Context

My colleague Andrew Williams and I ended our book suggesting a critical element in corporate governance was 'who will watch the watchers?', and who will monitor the monitors? We might have added, '*what will they monitor?*' This paper and the research agenda it outlines, argues that overwhelmingly large institutional investors (most of which are universal owners--UOs) failed to implement well-established corporate governance principles in most alternative investments (especially those directly and indirectly in the financial sector), and did not integrate governance with risk analysis, the latter itself being inadequately conceived.¹

During the 1990's and especially since the Internet bubble and Enron type collapses at the turn of the century, various alternative responsible investment trends (SRI,

* Many thanks, as always, to Andy Williams for his helpful suggestions and criticisms, offered in the timeliest manner.

¹ James P. Hawley and Andrew T. Williams, *The Rise of Fiduciary Capitalism* (University of Pennsylvania Press, 2000), pp. 175-77.

ESG, RI, sustainable investment) have paid inadequate or no attention, prior to the 2007-08 meltdown, to financial stability issues generally, and none to my knowledge about the relation between governance and potential financial instability. Much discussion within RI circles has been primarily focused on E and S, with G being mostly seen as a means to an E and S end, although long-time governance activists (e.g. CalPERS, CalSTRS, Hermes, USS, TIAA-CREF) continued to pursue an active governance agenda. (The important exception regarding financial issues has been the Network for Sustainable Financial Markets.²) In governance circles (which long predate the terms and programs of ESG, RI and sustainable investment), academic and practitioner governance literature has been too little concerned with financial risk, in spite of its long-established focus on economic and financial performance of firms. Indeed, the *raison d'être* of corporate governance is long-term performance. There were exceptions, but on the whole RI/PRI developments did not consider issues of financial crisis much more than their heretofore-mainstream counterparts. In short, there has been a black hole in theory and practice regarding governance actions and engagement by end asset owners in relation to financial risk. (There is a long-standing focus on internal firm governance and financial risk, primarily focusing on the role and structure of the board of directors in relation to top managers. In the risk literature there is little discussion of the role, if any, of end owners of financial institutions, primarily UOs.)

² <http://www.sustainablefinancialmarkets.net>

A similar conclusion is reached regarding institutional investors in general by the U.K. Treasury's "Walker Review": There was "...widespread acquiescence by institutional investors and the market for hearing up of banks' balance sheets as a means of boosting returns on equity." The Report states that institutional were "slow to act where issues of concern were identified in banks in which they were investors, and of limited effectiveness in seeking to address it either individually or collectively."³

The purpose of my research agenda is to understand how large institutional end asset owners (mostly universal owners) saw risk and practiced analysis prior to the crisis; what role, if any, corporate governance played (or might have played); and, most importantly, looking forward, to suggest directions for change. I believe the next generation of responsible investment, and of corporate governance in particular, should focus on the relatively unexplored relation between established corporate governance standards and practices on the one hand, and on the other, universal owner *investment strategy*, and risk analysis, metrics and their parameters.⁴

In an oft-cited work Frank Knight in the 1920's made the distinction between risk and uncertainty. Risk was calculable; uncertainty was not. The growth of highly sophisticated mathematics when combined with near real time massive computer

³ A review of corporate governance in UK banks and other financial industry entities, July 16, 2009. Not paginated, section 5.9. See Section 5 for a discussion of engagement, stewardship, collective action and governance at: http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf

⁴ I had hoped by this writing to have access to a number of large UOs, but for a variety of reasons such access has been extremely slow in materializing. Thus, this paper focuses on some background issues and concepts as it currently lacks much data. This is very much a in-process project.

power (beginning in the 1980's) tended in the minds of theoreticians and practitioners to obliterate this important distinction, whether by omission or commission.⁵ One important practical implication is that as the all that could be quantified view came to dominate; systemic risk was not and could not have been built into risk models and mindsets.⁶ This paper outlines the beginnings of a conceptual framework for this research, and attempts to suggest how one might begin to put empirical meat on these initial conceptual bones.

Specifically the paper hypothesizes that the search for “alpha” (perhaps confused with what one large institutional investor official called ‘yield’, but which is more likely ‘alternative beta’) contributed to the financial crisis.⁷ This includes examining how various alternative investments, which increasingly grew as a proportion of portfolios during this period, were vetted of risk, as well as how investment in equities of the financial sector (both official and shadow) were examined in terms of risk. For example, the U.S. Washington State Investment Board in mid-2009 had 28% of its assets in private

⁵ This is captured somewhat differently between a Keynesian and a Bayesian view. The former argued that uncertainty could not be quantified, while the latter believed it could. Amar Bhidé, “In praise of primitive finance”, *The Economists’ Voice*, Vol 6: Iss.3, article 8, available at: www.bepress.com/ev/vol6/iss3/art8. Feb 2009, p. 1. See Nassim Nicholas Taleb, *The Black Swan* (New York 2007) and Richard Bookstaber, *A Demon of Our Own Design* (Hoboken, New Jersey, 2007) for more detailed discussions of uncertainty, risk, ‘fat tails’, and computational computing power in relation to financial theory and practices. Donald MacKenzie, *An Engine, Not a Camera: How Financial Models Shape Markets* (Cambridge, Mass: 2008), provides an excellent intellectual history of modern financial thought. Michel Crouhy, Dan Galai and Robert Mark, *The Essentials of Risk Management*, New York: 2006) warn of the dangers of fat tails in modeling risk, typically unrecognized and ‘not accounted for’ in theoretical distributions, including the Black-Scholes option pricing model. P. 350.

⁶ Bhidé *ibid.* p. 2; Frank Kinght, *Risk, Uncertainty and Profit* (Boston: 1921).

⁷ Alpha in common usage is above ‘market’ (or portfolio benchmarked) returns for a given level of (supposed) risk. Alternative beta suggests that the search for ‘alpha’/increased yield mostly took the form of alternative investments (e.g. commodities including various financial products; real estate; hedge funds; and private equity) but which actually returned market average (supposedly) risk adjusted rates in the alternative investment space. (For ‘alpha’ discussion see, Philip Augar, *Chasing Alpha: How reckless growth and unchecked ambition ruined the City’s golden decade* London, 2009. See Crouhy et al, p. 113 for a discussion of beta and firm specific risk.

equity, 'innovation' and real estate.⁸ Brull suggests that the Board is developing a new risk and benchmarking system for its alternative investments in terms of net return but, as far as can be gathered, there is no discussion of the systemic relation of various types of alternative investments to overall portfolio or macro-economic risk.

The three types of risk are that I focus on from an institutional investor's perspective are: 1-Systemic risk; 2-Sector risk; and 3-Firm specific risk.⁹ My hypothesis is that none of these three risk foci were examined, or in many cases, were even conceived of in the case of system and sector risk, and were thus not given due diligence. Risk was conceived narrowly in terms of volatility and firm/security risk.¹⁰ For a variety of reasons this proved neither adequate to the task, nor wide enough in scope to even formulate as a possible scenario of what was to happen. To take one important and obvious example: To what extent, if any, did UOs and others invested in the financial sector broadly (and in specific bank and shadow-bank firms individually) examine derivative risk, and what did they did conclude and what did they do about those conclusions if they undertook such due diligence?¹¹

⁸ Steve Brull, "Pensions: Washington State's Doubling Down", *Institutional Investor Magazine*, February 28, 2008; <http://www.sib.wa.gov/financial/io.html>

⁹ Crouhy et al, among others notes at least seven general types of risk (e.g. market, credit, legal/regulatory) and at least 13 specific types of financial risks (e.g. FX, interest rate, counterparty, transaction). Ibid., p.26.

¹⁰ Crouhy et al note regarding firm/security risk that: "...an asset's beta represents that portion of an asset's total risk that cannot be neutralized by diversification in a portfolio of risky assets, and for which some compensation must be demanded...by investing in higher-beta securities, the higher risk and also the higher expected future return of the portfolio [is expected]. Ibid.

¹¹ See Crouhy et al, op. cit., pp. 323-24, who in 2006 and previously in other writings concluded, as many others had as well, that credit derivatives create massive opportunities as "...they bring for both transferring and assuming credit risk. [A]...disaster will surely come, particularly if the boards and senior managers of banks do not invest time to understand exactly how these...work." (324)

Even robust risk monitoring is no panacea. Crouhy et al note that, "...risk management has not consistently been able to prevent market disruptions or to prevent business accounting scandals resulting from breakdowns in [internal] corporate governance. In the case of the former problem, there are serious concerns that derivative markets make it easier to take on large amounts of risk, and that the 'herd behavior' of risk managers after a crisis gets underway...actually increases market volatility."¹²

Additionally, while portfolio risk in terms of beta was modeled and monitored by many if not most universal owners, it was in general not coordinated or integrated with corporate governance, which has as a main task the monitoring of how individual firms (or perhaps all firms within a sector) conduct their own internal risk assessment. Thus, the massive failures by CEO's, CIO's and boards of directors in the financial sector to adequately assess risk to their own firms are primarily a corporate governance issue on two levels. The first is the adequacy of firm level internal (board and top management) risk assessment. The second, and a critical failure, is the adequacy of monitoring the internal firm governance by end asset owners.

Thus, on the one hand, there were relatively well developed corporate governance practices, strategies and philosophies, and on the other hand, there was the absence of applying those practices, strategies and beliefs to the public equity and to the alternative investment side of portfolios.

¹² Ibid, p. 3. They add: "There is no single solution to the problem of how we measure credit risk—no Holy Grail of credit modeling...there are a variety of approaches...modelers have not found any easy way to integrate market risk and credit risk...[because each disregard the other.] p. 287

To this end, the research suggests a conceptual model of universal owner risk management that stresses monitoring of both under and hyper-performance for firms individually, but also for sectors (in this crisis, the growth of the financial sector relative to all others specifically.) Governance activities (engagement, proxy actions, etc) directed at under-performers have been well established over the last two decades, and have been quite effective. Governance activities that focus on apparent hyper performers (e.g. Enron, Citigroup) have been extremely rare. Additionally, the research also raises the question of whether even the largest UOs acting collectively (a generous assumption) are capable of effectively minimizing and mitigating firm, sector and systemic risk. That is, can governance actions force ‘self-regulation’? If they cannot, what are the implications for UO governance and investment activities in relation to public policy advocacy and actions?¹³

We hypothesizes that these gaps and failures to adequately monitor occurred because institutions did not take into account and apply across the investment spectrum basic corporate governance principles: specifically transparency, monitoring and accountability. In turn, this contributed, albeit unknowingly, to the financial crisis when combined with the large institutional capital flows into (some or many, depending on the specific institutional investor) alternative investment vehicles, along with the indirect investment in various structured investment products by (equity investment in) the financial sector itself (e.g. Citigroup, GE).

¹³ See, for example, Carlos Joly, “Responsible Investment: Can it Regulate Capitalism”, forthcoming in *Corporate Governance*.

The research concerns itself with how various alternative investments, which increasingly grew as a proportion of portfolios during this period, were vetted in terms of three types of risk (see above), as well as how investment in equities of the financial sector (both official and shadow) were examined in terms of risk. To state the obvious, many alternative assets (hedge funds and private equity in particular, but some commodity investment as well) are far less transparent (and accountable) to owners than is even public equity. How do governance principles on the public equity side apply on the alternative investment side? What are the implications for risk and monitoring?

Corporate Governance and Financial Market Instability¹⁴

Rodney Sullivan, an official of the CFA Institute, in a *Financial Times* article argued that a distinction should be made between corporate governance failures (especially compensation alignment issues in the financial sector), and more general issues of market failures and financial instability. He and others have argued that the two are not linked, and further the failure of governance does not prove inherent market financial instability. He concludes: “The current crisis can be best understood as a crisis of governance rather than an inherent failure of markets or of capitalism itself.”¹⁵ Pursuing the theme of internal (that is, firm specific) governance failure, Kirkpatrick in an OECD paper examines in more and convincing detail widespread

¹⁴ This paper does not develop and discuss the large literature on financial market instability and crises, but is strongly influenced by, for example, Hyman P. Minsky *Stabilizing an Unstable Economy* (New York 2008); and George A. Akerlof and Robert J. Shiller’s recent, *Animal Spirits* (Princeton 2009). See also Keith Ambachtsheer, “Pension Management”, in *The Finance Crisis and Rescue* (Toronto: 2009), pp 139-48).

¹⁵ Rodney Sullivan, head of publications for the CFA Institute, *Financial Times*, Aug 3, 2009 p. 11

financial failures of internal governance, from boards, to top executives to inadequate monitoring of top traders.¹⁶ He argues that OECD guidelines and other (e.g. Treadway Commission) standards were not followed by boards and top executives. The OECD guidelines are quite abstract. For example, principle VI.D 2 states that a board function should “...monitoring the effectiveness of the company’s management practices and making changes as needed”. This includes “monitoring of governance by the board and also includes continuous review of the internal structure of the company to ensure that there are clear lines of accountability for management throughout the organization.” Kirkpatrick makes the important point that such monitoring should have occurred given the warnings issued in 2006-07 by the IMF, BIS, OECD, Bank of England, FSA, and others “...with mixed reactions by financial institutions.”¹⁷

This is context for Chuck Prince, CEO Citigroup, famously saying with regard to ‘froth’ in the leveraged home loan market, that ‘while the music is playing, you have to dance’, that is, in order to maintain at least short term market share. Here, then, is the link between internal firm governance failures, and market failures and instability. Internal governance was, on the whole and with some exceptions, shown to be inadequately robust when confronted with the music of the market. The repeated tendency of most financial institutions to follow the herd (‘dance to the music’) is due to the commodity-like nature of most financial products. Kirkpatrick’s

¹⁶ Grant Kirkpatrick, “The Corporate Governance Lessons from the Financial Crisis”, Financial Market Trends, OECD, 2009, February 11 2009, OECD website.

¹⁷ Ibid, p. 2, 4-5.

analysis of internal financial institutional governance failures is good, but limited as he assumes that governance is solely an internal affair. He does not look at who's monitoring the (failed) board monitoring, or who should have been. He does not look at governance from an owners' perspective.¹⁸

Bebchuk and Spamann convincingly show that the risks taken by top management (and top traders) that might reasonably threaten the firm's existence and have previously benefited shareowners are a rational if long odds bet given past (hyper) performance. Self-preservation (along with 'reputational risk' of the firm in the financial sector) do not mitigate risk. Yet failure and collapse comes at the expense of debt holders specifically, and with systemic implications. Since UOs own both debt and equity, as well as face massive systemic losses by definition given broadly invested portfolios, their failure to be adequate external monitors of the internal monitors (boards, top executive) was critically important. The restricted and immediately self-interested rationality of boards and top management could not be relied upon to preserve the institution. Too much had already been earned by these individuals to offset future increasingly risky behavior. Individual risk/reward calculations skewed toward ever-higher risk as past high earnings offset future risky rewards, of both top management *and* for shareowners.¹⁹

¹⁸ Ibid. pp. 12-14.

¹⁹ Lucian A. Bebchuk and Holger Spamann, "Regulating Bankers' Pay", Harvard, John M. Olin Center for Law, Economics and Business. Downloaded from: <http://ssrn.com/abstract=1410072>. Shareowner alignment with top management in six large banks is argued as well in "Governance in Crisis: A Comparative case study of six U.S. investment banks", Nestoradvisors research note April 2009. (London, 2009) For a more traditional analysis see, *Final Report of the IFF Committee on Market Best Practices* (Institute of International Finance, 2008, available at: <http://www.iif.com/events/article+193.php>)

The corporate governance implications of this for financial institutions, *and for them alone*, are profound. No longer is shareowner/top manager alignment the goal; indeed, as the two studies cited suggest, it became perverse in terms of systemic sector and firm risk (as only financial institutions have the ability by themselves to cause systemic risk), and thereby for a UO, a risk to its entire portfolio. Bebchuk and Spamann argue that in order to reward top financial managers (and board members) their compensation should not be tied solely to firm share price (or bank holding company share price) even over the long-term but rather to a basket instruments including equity and debt. For institutional owners, financial sector risk and rewards therefore must also be calculated in terms of a basket of holdings on the debt *and* equity side, in addition to the possibility of system failure devaluing other non-financial sector holdings. This means that governance is not simply the governance based on equity ownership, but must be more inclusive across the investment portfolio.²⁰

A number of empirical questions arise from this. Were any UOs tracking financial institutional and financial sector risk from this perspective? If so, which ones, how and what actions were taken? If not, looking forward, how can and should this perspective be integrated into risk assessment. Clear VAR (value at risk) models

²⁰ This is parallel to the problem many institutional owners had with stock options in the 1990's, which were seen by many as a means to align owner and manager interests, but ignored the downside risk to debt holders of massive leveraged option issues. (Unpublished author's interviews with large institutional owners, 1997.)

cannot do this. What should be the role of the governance side?²¹ For example, should share owners engage with financial firms to radically restructure compensation package benchmarks, not only for long(er) term, but in order to align compensation with UO financial interests, which are broader than just their share ownership interests? That is, to include debt and other assets, particularly alternative assets.

The unique governance aspects of financial institutions raise a host of questions. Among some important ones: Are there examples of UOs and other institutional owners who treated financial institutions' risk differently than other sectors' risk? If so, how? If such analysis resulted in governance or investment decisions recommendations, were they followed? If so, by which investors? More specifically, which types of financial risk were tracked? E.g. Liquidity, solvency, counter-party, sector (e.g. sub prime), operational, and systemic risk.²² On a broader level, it is worth considering the difficult question of whether institutional owners are actually able to know how well (of even if) financial firms are understanding their own risks and if so, can this be tracked, how, and by whom? Can close to real time information be made available (for example, by regulators), and if so, under what conditions? What is or should be the role of regulators and regulatory regimes? To ask these questions is to immediately suggest that 'self-governance' governance, at least in the

²¹ VAR time frame is far too short, often extending no more than a few years, and often far less. Additionally, VAR assumes a multivariate normal distribution. Crouhy et al conclude that VAR "...must be supplemented by [other] methodologies...stress testing and worst-case scenarios." Michel Crouhy, San Galai and Robert Mark, *The Essentials of Risk Management* (New York: 2006), pp. 163, 173. Internal VAR usage by banks permitted them to reduce capital by between 20-50%. (Ibid., p. 67)

²² See Crouhy et al for an extended discussion of various types of financial risk.

financial sector, cannot occur. It necessitates a robust governmental (and inter-governmental) regulatory regime.²³

Financial crises are fundamentally about asset inflations of one sort or another (historically from tulips to housing to oil and energy to land speculation). This raises an important issue of what role UOs should take upon themselves if and when they and others see asset bubbles forming. This falls in the areas of both risk analysis and corporate governance, as UOs likely own a significant proportion (indeed, collectively often a majority) of many players in 'frothy' markets. But it also calls into question whether, absent a significant regulatory regime change, they are able to do this.

A Case in Point: Can and Should a UO Try to 'Prick a Commodity Bubble'?

Lord Desai in a 2008 *Financial Times* article²⁴ argued that the price of oil during that year's oil run up does not reflect end-use underlying supply and demand factors (however much those have changed in a secular manner in the last 5-10 years), but rather to some debated but significant degree reflects speculation. The exact nature of this speculation is as well debated (e.g. hedge against global inflation, hedge against the declining dollar, simply placing a bet on rising oil and commodity prices themselves, the move by large institutional investors in 'alternative' assets since the

²³ More fundamentally as Wolfe wrote in the *Financial Times*: "A business that is too big to fail cannot be run in the interests of the shareholders, since it is no longer part of the market [since it is de facto insured by the state]" ("Reform of regulation has to start by altering incentives", June 24, 2009.)

²⁴ *Financial Times*, June 6, 2008

Enron scandals using commodity indexes).²⁵ He argues that speculation is responsible for commodity markets bubbles in the oil (and commodities' markets generally), posing a systemic risk financially, as well as causing damage to the real economy. Specifically, commodity index funds treat oil as an asset to be bought and sold, as would be the case with non-index speculators. This is what Michael Masters call physical commodity traders contrasted with index commodity traders.²⁶ Deasi's proposed requiring from 'regular' 'physical' traders a lower margin, while raising the margin for index traders to nearly 50% (from its current 7%).

Whether this (and numerous other proposals) are adequate, or indeed, whether the analysis underlying various restrictive proposals is in fact correct in whole or part is beyond the present scope. Rather my purpose (being a non-expert in the areas of commodity trading and investment generally, and oil in particular) is to raise a question for institutional investors who compose the vast majority of what Masters calls index speculators. By this he means large institutional investors in the commodity markets who allocate a proportion of their portfolio (alternative investments) to the futures and derivatives markets and in his view behave very

²⁵ Michael Mackenzie, Gillian Tess, Aline van Duyn, "As consumer prices climb, derivatives find new favor", *Financial Times*, June 18, 2008, p.7. The article makes the point that commodities are a major focus of an inflation hedge. Ironically, if too many act on this, it feeds the very inflation to be hedged against, in addition to creating a potential (actual?) bubble in the very asset that is seen as a hedge. Especially important contributors are insurance companies and pension funds, but generally hundreds of billions of dollars have flowed into the commodities markets in the last five years, and with the expanding sources of funds have also come financial instruments and indexes previously absent from those markets. E.g. exchange traded funds. (Diana B. Henriques, "Lieberman seeks limits to reduce speculation", *The New York Times*, June 12, 2008, p. C4)

²⁶ Masters' testimony before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, United States Senate, May 20, 2008. Downloaded version of testimony not paginated.

differently than 'traditional speculators'. They are typically indexed distributing their investment using indexes such as S&P, DJ-AIG commodity index and the like. The major investors are sovereign wealth funds, corporate and government pension funds, university endowments and institutions, most of which are UOs. Additionally, index investments aimed at the retail market are using exchange-traded funds. (For example, Masters calculated that index speculators held long 47% in the heating oil market; 39% in gasoline; 28% natural gas; 31% WTI crude oil, etc. in mid 2009.) These investments have occurred mostly since 2001.

These are large numbers that, if correct, impact the price of 'real' goods and commodities as the futures markets sets the world price for commodities. Two key elements distinguished index speculators from traditional ones: the former tends to be price insensitive, thereby augmenting the impact on commodity markets. That is, an investor will allocate a given amount to invest in a commodity index, regardless of price. Additionally, they tend to hold long term.²⁷ (Masters suggests that due to a regulatory loophole, index speculators are not subject to position limits if they use commodity index swaps with banks, as most do).

The point of this all too brief summary is that these markets have immediate and long- term impact on all sectors of the economy. As institutional investors search for

²⁷ In our book, Andrew Williams and I pointed out that when UOs hold equity long term in index or index-like portfolios, which drives corporate governance engagement (voice being the only option if exit is blocked). In turn, this led to a concern for portfolio-wide externalities and in some circumstances to public policy actions. It would appear that UO actions in commodity markets turn this on its head. (Thanks to Andy Williams for this point.)

'alpha' (e.g. through alternative investments directly in commodity markets, but indirectly as well in some of their hedge fund and private equity investments) the collective impact of individual institutional decisions may well have had and continues to have impact on all sectors of the economy. This is perhaps another example in which the search for 'alpha' may harm absolute market returns in the longer-run.

As large institutional investors are mostly universal owners, it seems it would be a reasonable and prudent action to consider whether this collective 'rush to alpha' is in fact hurting market values as a whole, thereby making alpha a temporary (bubble?) phenomenon, and rendering the search for alpha at best somewhat illusory, and at worst significantly destructive of the value of the whole portfolio.²⁸ If there were a significant possibility that this might be the case, would it not be prudent to find ways to evaluate whether this is in fact a risk. If it is or might reasonably be, then the question becomes whether it is possible, given the huge collective action problem endemic to this situation, to contain or minimize the negative impact (call them intra-portfolio negative externalities) of a bubble or potentially bubble market.

²⁸ Based on a few anecdotal pieces of evidence, even some of the most committed sustainable institutional investors have not considered undertaking such an analysis. It would be interesting and important to know if any have taken such an analysis, and if so, how it has influenced their investment strategy.

This is why Desai (and some others) have called for pricking the bubble or other actions.²⁹ Could the search for alpha in commodities be its own worst enemy when considered systemically and holistically (that is, inclusive of feedback loops).

It is likely well be beyond the collective agreement capacity of institutional investors to solve this collective action problem. This includes those interested in or committed to sustainable finance. If this is the case, then various public policies (regulatory, listing, legislative) may well be considered as a part of fiduciary duty, much as adequate climate change legislation is now considered within the legitimate purview of fiduciary duty. In this case, the sustainable institutional investor might well consider developing a public policy position and considering what actions might promote it. This in effect asks the state to save us from ourselves as competitive dynamics lead to herd-like behavior. One critical element in this dynamic is benchmarking to peers which ultimately drives herd-behavior when done *absent a holistic (interactive) portfolio risk analysis*, as noted above.

Conceptual Underpinnings of Failure: Collectively Creating One's Own Negative Financial Externalities

Along similar lines Steve Lydenberg in a recent paper argues that the main techniques for improving portfolio returns (e.g. diversification, securitization, hedging) '...when widely adopted can actually increase market risk.' Modern

²⁹ In separate actions, U.S. Senators Leiberman and Feinstein proposed various restrictions (Feinstein) or the banning (Leiberman) of institutional investors from commodity markets. (Henriques *ibid*; Zachary Coile, "Bill would limit trading in energy markets", *San Francisco Chronicle*, June 14, 2008, p A3; Joanna Chung, "Limits imposed on overseas oil trading", *Financial Times*, June 18, 2008, p. 4.

portfolio theory (MPT) limits risk to the single portfolio, rather than looking at possible contribution to cumulative and systemic effects if widely adopted. Single portfolio 'risk' is measured in terms of how much returns vary around an average/mean rate of return.³⁰ While it is well understood that MPT cannot deal with market-wide risk, Lydenberg suggests that under certain conditions widespread adoption of MPT contributes to, rather than is a passive recipient of, market-systemic disruption or failure.³¹

A UO perspective on ESG, in particular a focus on externalities (E and sometimes S) necessitates what I have called holistic portfolio monitoring. That is, analyzing the interactive effects of the behavior of one firm or sector on other firms and sectors held in the portfolio.³² Previously I have argued that this is and should be a prudent and indeed fiduciary duty for a universal owner. This holds true not just for public equity, but also for activities in all asset classes. To the degree that UOs invested in, for example, hedge funds, private equity and real estate entities, which facilitated and drove financial risk³³, the systemic result was to massively increase both individual portfolio risk and systemic risk. MPT simply does not examine such

³⁰ Crouhy et al, op. cit., p. 110.

³¹ "Asset based investment: Notes toward an alternative theory and definition of success", paper presented at the Elfenworks Center for the Study of Fiduciary Capitalism conference, 'Institutional investors, risk/return and corporate governance failures', October 2009, p.1. It should also be added the MPT is based upon the assumptions of the efficient market hypothesis (EMH-in all its variants), one key assumption being that people are entirely rational actors and markets incorporate all available information, thereby making markets 'efficient.' See Akerloff and Schiller op cit, among others, for empirical and theoretical critiques of the EMH. See also Hawley and Williams, op cit., chapters 4-5 for critiques of the financial model in corporate governance (based on the EMH). For a nice discussion of behavioral finance, see Lisa Kramer, "Behaviorial Finance", in *The Finance Crisis and Rescue* (Toronto: 2009), pp. 125-35.

³² Trucost has contracted with the PRI (Principles for Responsible Investment) to conduct an initial quantitative analysis of selected environmental externalities on a portfolio from a holistic perspective.

³³ For example, through massively increased leverage, second and third degree securitization creating synthetic CDOs, etc.

interactive effects. The pursuit of alpha increased market-wide risk, although MPT would suggest the opposite. That is, MPT does not take into account possible market-wide consequences of its own adoption, either on systemic risk, or even on single portfolio risk. . Thus, for example, if everyone makes greater and greater use of CDO's as 'insurance' (or supplies funds for them, wittingly or not), the result is not more hedged risk but given leverage the greater possibility of systemic crisis. The consequence is a 'fat tail' event.³⁴

For a UO this is conceptually similar to the failure to conduct interactive monitoring for environmental externalities. What one sector or firm does is internalized in varying degrees within the portfolio as a whole. The same is true for financial products and firms. Monitoring is essential, but not (only) within the confines of a MPT perspective, but in terms of the interactive (and cumulative) effects of various financial products and entities. This is a major challenge for both risk analysis and corporate governance.

What can various forms of corporate governance do in these circumstances or is this beyond the effective reach of even highly coordinate governance coalitions?

Apparently little was done prior to the financial crisis using governance and engagement to attempt to minimize risk. For example, in the public equity space it would have been possible to raise in a variety of ways (including in public fora and the media) the risks that most firms in the financial sector were running, given

³⁴ See Talub, op cit, pp. 15-17.

leverage ratios, warnings of sub-prime problems and the like. With few exceptions to my knowledge, little was done. An important element, still unknown, is what occurred in private discussions on the governance or the investment or the risk operations sides in large UOs.³⁵ There is a legitimate question of what possible impact these activities might have had even had they been used. If this is so, that is, that corporate governance is inadequate to the task, then a UO has a fiduciary obligation to consider other means, the most obvious and important being public policy advocacy and mobilization.³⁶

Lydenberg suggests that a beginning point for an alternative theory to MPT is a UO perspective (which includes considerations of ESG and a sustainability approach). In part this implies that fiduciary obligation means not simply the risk adjusted beating benchmarks, but rather looking at the ‘prudent enhancement of asset-class opportunities’. (This gets into the meaning of the ‘exclusive benefit’ rule—ERISA in U.S.—which has been interpreted as meaning the financial benefit, even at the possible cost to other elements of retirement benefits, that is, well being (e.g. oil

³⁵ The U.S. trade union, SEIU, between May and September 2008, did raise a number of flags regarding increasing risk focused on Bank of America and taking proxy actions, and in calling for Congressional hearings on Washington Mutual. This was, to my knowledge, the exception, although it, too, was well into the crisis, although before September 2008 when Lehman collapsed. While proxy vote support was ultimately forthcoming from a large group of institutional investors, few publicly committed prior to voting. (Various SEIU press releases, 2008)

³⁶ In suggesting mobilization linked to advocacy (something quite rare among even the most self-conscious UOs), CalPERS’ actions in the 1990’s to amend the California state constitution to make itself more autonomous from the governor’s office in order to protect its assets comes to mind. If that was done in the defense of fiduciary obligation, as I believe it was, then other forms of legislative lobbying and mobilization on the most serious of matters would also be appropriate. See also Joly, *op. cit.* Hermes, the U.K. equity ownership services group, a leader in corporate governance, issued both an analysis of the crisis and a program, including significantly stepped up regulation and enforcement. But this was not until November 2008. (‘Imperatives arising out of the crisis’ and ‘The Way Ahead’ (November 2008).

investment returns at the cost of global climate change; pharmaceuticals profits at the cost of higher medical care.)³⁷

As a consequence ‘out performance’ and benchmarks should not be the indicator of long-term investment success (chasing alpha/harming markets as a whole), but rather absolute returns based on real productivity increases (‘reasonably’ distributed across the socio-economic spectrum) needs to be the indicator of a UO’s success.³⁸ Such a profound change in investment philosophy, strategy and operations is a massive challenge. An obvious corollary is that a UO’s remuneration policies must aligning the incentives of its managers with those of beneficiaries and retirement investors whose well being depends on long-term return, not on quarterly or even annual returns. As Taub, quoting Coffee, argues fund managers tend to herd because they find it more damaging to their careers “...to be individually wrong than collectively wrong.” Benchmarking is thereby re-enforced and perpetuated.³⁹

³⁷ Lydenberg, op. cit, pp 21,23,40. For Lydenberg this means developing what he calls ‘asset based investment’, that is, defining and maintaining specific roles and tasks for various asset classes. See the section, above, on oil speculation for an example of seeking alpha while risking both beta (the larger market return) and sustainability. Robert Monks has for years also raised the issue of the scope of fiduciary duty, as have Johnson and Jan de Graff. (Keith L. Johnson and Frank Jan de Graff, “Modernizing Pension Fund Legal Standards for the 21st Century” , February 2009, Network for Sustainable Financial Markets (www.sustainablefinancialmarkets.net). See also, Claire Woods, “Funding Climate Change: how pension fund fiduciary duty masks trustee inertia and short-termism”, paper presented at the Elfenworks Center for the Study of Fiduciary Capitalism conference on Institutional Investors, Risk/Return and Corporate Governance, October 2009, who makes similar arguments focused on climate change.

³⁸ There are a variety of social justice and politically based arguments for considering the huge growth of income inequality as an issue, and arguable one that could have some fiduciary implications for pension plans. Additionally, there is a link between consumer spending and debt driven consumption that is heightened by stagnant or sinking real incomes. Absent debt some sectors would have been materially worse off. Further, how an economy supports its consumption sector (about 70% of GDP in the U.S.) is related to the issue of what is a sustainable economy.

³⁹ John C. Coffee (“Gatekeepers: The professions and corporate governance”) as quote by Jennifer Taub, “Enablers of Exuberance: Legal Act and Omissions that Facilitated the Global Financial Crisis”, a

Conclusion: The ‘Sophisticated Investor’?

Institutional investors, according to the U.S. 1940 Investment company Act are considered ‘sophisticated investors’. It is time to rethink this definition. For too long institutional investors, including UOs, have depended mostly on gatekeepers and the supposed checks and balances (e.g. credit rating agencies, banks as monitors, trading counterparties, self-preservation instincts of financial firms, assumptions of the rational actors, efficient markets and the investment chain of consultants and money managers) to ensure if not create ‘sophistication’. Few UOs and other large institutional investors actively sought out minority views on financial risk, built alternative scenarios that would consider the possibility that the financial system might be significant fragile and crisis prone. Even after the near systemic disaster that came with the 1987 collapse of LTCM (Long Term Capital Management) there was little concern with asset inflation and leverage built up. In addition to having learned too little from the Internet bubble and the subsequent Enron type collapses, one must question the ability and/or willingness of ‘sophisticated investors’ to protect their own interests. This is closely related to the benchmarking problem. If gatekeepers are necessary but not sufficient, as is increased disclosure and transparency, then the only prudential recourse would be what Taub calls

'substantive investment and operations restrictions' of various types and classes of investment.⁴⁰

Thus the network of non-governmental gatekeepers and the supposed monitoring of investment and corporate governance risk by end asset owners (including mostly likely the majority of those which have adopted RI principles) failed, for a complex matrix of reasons only alluded to in this paper. Sophisticated investors failed the monitoring test. Either they have not been particularly sophisticated; or if sophisticated apparently incapable of monitoring adequately and effectively. If the former, a new regulatory regime and standards are called for. If the latter, a radical reconsideration of the relation of corporate governance to investment strategies, and to risk analysis and monitoring is called for. Likely, important elements of each are necessary.

⁴⁰ Taub, op cit p. 24. Lydenberg (op cit) similarly suggests such restrictions. Taub notes an agency issue (p. 50) among institutional investors. They are not putting their own money at risk, but rather those of others. Williams and I point this out calling them 'professional investors'. Op. cit, Hawley and Williams.