Aligning governance and risk

Coping with greater public scrutiny

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Designing and implementing mandates of public sector investment institutions to meet to twin challenges of greater market uncertainty and higher public scrutiny has become a major task. Institutions that align governance and risk tend to perform better in extreme market environments. This has big implications for corporate governance and the structure of boards.

Do public investors face common corporate governance challenges.

The general answer is Yes. In many countries, especially in western countries where public investors such as pension funds originated, those types of institutions have faced significant governance problems as a result of lack of clarity about the relationship between the client, the government, and the beneficiary. It has been a long-standing problem over the past 25 years. Each new generation of investment institutions has attempted to solve some of these governance problems. Yet some institutions, particularly state or local pension funds in the US, simply do not have an opportunity to redefine or rebuild themselves. It is very difficult to go to the state legislator and turn a representative board into being an expertise-based board.

What can be done to help clarify that relationship?

Consider some of the older state and local government sponsored pension funds in the US. They were built around a representative board model, which then employed an executive board. There were – and remain – many tensions between these two boards. The current debate in Australia is instructive. The new government is considering having independent directors on superannuation fund boards as another step towards clarifying the relationship between the sponsor and the beneficiary. Ultimately, these are long-lived institutions. They always carry with them that institutional heritage.

You have called for a 'tailored principle approach' to investment decision-making in public investment funds. What does such an approach entail?

Our research has benefited from analysing specific institutions around the world. We came to three fundamental conclusions. The first concerns the conception and design of the institution. It is fundamental to get it right. This allows you to define the mandate, how the board is organised, and identify the return target and performance benchmarks.

The second conclusion is that, within the framework of the form of the institution, how well the entity functions depends a great deal on linking up the investment strategy with the risk budget and governance budget. Thus, you need to do the things that you can afford to do within an appropriate risk framework. In practical terms, this means getting out of geographies or sectors that you don't understand or can't respond to adequately. The third is that financial markets are sometimes extreme environments. We operate in a world of risk and uncertainty. In these very complex and challenging environments, we need to be responsive, to understand the world in which we live, and take actions and decisions around those moments of greater or less uncertainty. Institutions with aligned governance and risk budgets do better, on average, in these circumstances.

What corporate governance lessons can we learn from the financial crisis?

One of the lessons is that many funds are simply market followers, because of their size and inability to manage themselves in real time, as opposed to the statutory or administrative time environment, where investment horizons and return targets are dictated by regulators. If you are going to be a market follower, you accept the costs and consequences. That's a big problem for many institutions, particularly those that went into the financial crisis already relatively underfunded. You see this in both the public as well as private sector fund space. Some of those institutions that went in relatively underfunded are now so underfunded that their capacity to respond may be fatally damaged. These public and private funds are surviving on the inflow of contributions, rather than prospering from an investment machine. You only have to go to the US public sector space to witness that.

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What are the implications for governance?

This class of institution needs a governance overhaul. Another class of institution is represented by market anticipators. These more or less succeeded depending on their faith in the efficient–market hypothesis and all that follows from that theory. Some institutions that signed up to that credo were disappointed in the results. Finally, there is a set of large institutions that came out of the financial crisis relatively unscathed. This was partly due to their size, but also because some of these institutions framed future-looking strategies that were more conscious of the possible turmoil in financial markets. Many of these had formed beliefs about the future after the tech bubble in the US. They had built their own internal expertise and their own assumptions and models about market reforms. Where these strategies paid off, they produced relatively lower losses, and experienced quicker recoveries and higher rates of return. In these institutions, it is hard to see the effect of the global financial crisis.

Many public investors, particularly among the sovereign funds, defensively retreated to in-house fund management after the crisis. Was that wise?

Many institutions have started to look more carefully at insourcing and outsourcing, looking at the mix of production of risk-adjusted returns between their own teams and their external fund managers. Today we see more scrutiny of the provider-side and a much harsher critique of their capacity to respond to risk and uncertainty. This has required funds to build their own capacity to interrogate outside providers. This strategy demands a huge investment in capacity and resources.

How applicable are these observations to central banks? While they fall within the public investor universe, they are a distinct actor within this category because of their short-term horizons and high liquidity needs.

Central banks, mainly in the west, have learnt some fairly harsh lessons through the financial crisis. Through the 1990s and the first decade of the 2000s, central banks were preoccupied by questions of macroeconomic stability, inflation and unemployment. They were staffed by macroeconomists schooled in that tradition. A number of leading central banks didn't have the depth of resources properly to understand financial market performance.

Can you give an example?

I can recall a conversation in late 2006 or early 2007 with a member of the Monetary Policy Committee of the Bank of England. I suggested that there was a house price bubble. He told me in no uncertain terms that did not seem plausible or likely. The bank's expertise was macroeconomic, and conventional instruments of planning and policy-making had dominated thinking. So it is not fair to be too critical. But, in the aftermath of the crisis, central banks have had to educate themselves in a much deeper way about financial markets and performance and structures. You see a real effort to build that capacity internally in a way they might not have done 10 or 15 years ago.

What then are the priority issues for central bank reform?

A major issue is who should sit on the boards of central banks. They need to be experts in their field, to have sufficient breadth of experience and understanding to understand financial issues. And they need to be able to interrogate their own staff in a meaningful way. The second question about central bank governance is to ascertain what is their goal. Some central banks have an array of goals.

Their goal-setting process is not necessarily dominated by macroeconomics as it is for others. After the financial crisis, financial stability became one of the key goals of any central bank. This requires a new skill-set, and new ideas. The third point concerns the expertise of internal staff. Some central banks came out of the crisis exposed as rather thin on key variables. There has been substantial restaffing and considerable effort to developing in-house capabilities. This has meant, however, competing with investment banks for expertise. Not all central banks are able to get the best people because of the marked differences in salary and so on.

How crucial are transparency and accountability to effective corporate governance in public investors?

Transparency and accountability are easy words to voice, yet there are important variations in the level to which they are appropriate for individual institutions. For example, the Fed publishes minutes of their meetings, while the European Central Bank does not – although it plans to do so. The ECB's country representatives may face scrutiny in their national media about voting in certain ways. This is not something Fed members face. So different approaches are necessary for different institutions. ▪

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