Risk Management, Governance and Value Creation

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David R. Koenig

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THE GOVERNANCE FUND

Welcome

Events of the past two years have yielded several surprises, including the rapid and dramatic downfall of financial services firms thought of as household names, even AAA credits. We seek to answer some key questions:

- What does the risk to a dramatic decline say about the governance and risk management at these firms?
- Is there any evidence that well-governed companies are or should be worth more to investors than poorly governed companies?
- Where do governance and risk management intersect? Are they one and the same or are they misaligned?

Quick Review

- April, 2008 presentation
  - Key Themes:
    - Ductility and Resilience in Corporations
      - » Contrast with Brittleness
    - The Emergence of Psychology and Complexity
      - » Changing finance and economic theory
      - » Social Amplification of Risk and Tipping Points
    - Complex Adaptive Systems
      - » Nearly everything in the world is a system, many are complex, not as many are complex and adaptive

Definitions

- *Risk* is the unknown change in the future value of an asset or system (e.g. company)
- A *Risk Event* is the realization of risk that alters the value of an asset or system, up or down
- *Risk Management* is the process of shaping future risk events to maximize the present value of an asset or system
- *Governance* is the framework of the system within which business objectives are pursued and risk management operates

Governance is Usually Discussed in Two Frameworks

- Legal Framework
  - Legislation / Regulation
  - Listing requirements
  - Case law
  - Duty of Care / Duty of Loyalty
- Operational Framework
  - How decisions are made
  - How information is gathered
  - How decisions and information are validated and reported
  - Prudent business decisions

Ultimate Objective of Corporate Governance

- Maximize the “value” of an organization
  - Defining, measuring and communicating corporate “value”
  - Effective use of scarce resources
    - Intersection of Governance and Risk Management
    - ERM as part of the Operational Framework of Governance
  - Give resources and guidance that allows risk-takers and innovators to effectively pursue corporate objectives, within the policies and risk appetite as determined by the governing body of the investors/owners
  - Give the governing body the information it needs to know it is effectively fulfilling its Duty of Care
  - Give investors and other key stakeholders confidence in the organization and its ability to pursue its objectives knowledgably

Good Governance Brings About Increased Value

- Gompers, Ishii and Metrick (2003)
  - During the 1990s, an investment strategy that bought firms with the strongest rights and short firms with the weakest rights would have earned excess annualized returns of 8.5% during that period
  - 24 Governance Factors: Dictatorship or Democracy
- Cremers and Nair (2005)
  - Based on equity prices from 1990 to 2001, they found that a portfolio with strong internal and external governance produced excess annualized returns of 8%.
  - Buy firms with highest level of takeover vulnerability and sell firms with lowest level of takeover vulnerability

What is measured?

Typical factors included in governance evaluations

- Gompers type analysis
  - Democracy vs. Dictatorship structures, 24 factors
  - Bebchuk, Cohen and Ferrell (2004) found only 6 of the 24 GIM metrics mattered
    - » Staggered boards, limits to bylaw amendments, poison pills, golden parachutes and supermajority requirements for mergers and charter amendments
- Governance factors
  - Chair/CEO separation, officer turnover, director turnover, independence of directors, auditor changes, insider trading…
- Forensic Accounting
  - Accrued expenses, reserves, pension assumptions, deferred expenses, restatements, receivables, share repurchases…

Governance and Value

- Studies have shown correlation, but not causation

- Can we come up with a reasonable theory as to why there might be causation?

The Value of an Asset

$$V_0 = \sum_{t=0\ldots n} \left(\frac{C_t}{(1 + r_t + p_t)^t} \right)$$

C_t = cash flow in period t
r_t = risk free interest rate to time t
p_t = risk premium to time t

Or,

$$V_0 = C_0 + \left(\frac{C_1}{(1 + r_1 + p_1)^1} \right) + \left(\frac{C_2}{(1 + r_2 + p_2)^2} \right) + \left(\frac{C_3}{(1 + r_3 + p_3)^3} \right) \ldots$$

Governance and Value

- How might governance affect firm value?
  - Cash flows improved
    - Better decision making?
  - Dittmar and Mahrt-Smith (2005)
    - The markets value cash at well-governed companies more highly than at poorly governed companies (approximately double the value)

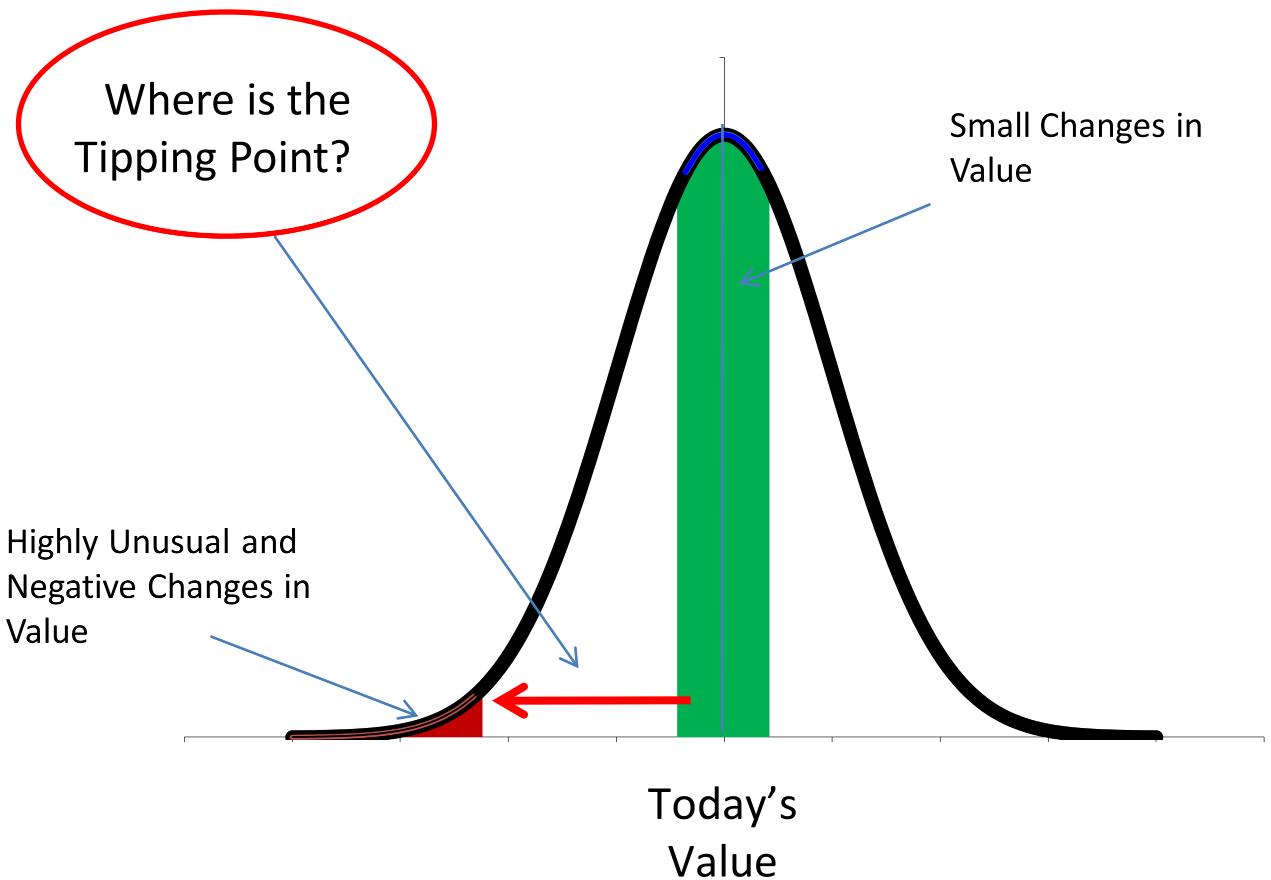
$$V_0 = C_0 + \left(\frac{C_1}{(1+r_1+p_1)^1}\right) + \left(\frac{C_2}{(1+r_2+p_2)^2}\right) + \left(\frac{C_3}{(1+r_3+p_3)^3}\right) \ldots$$

Governance and Value

- How might governance affect firm value?
  - Cash flows extended
    - Skaife, Collins and LaFond (2004)
      - Well-governed companies have better credit ratings
      - Positively related to accrual quality, earnings timeliness, board independence, board stock ownership, board expertise and takeover defenses
      - Negatively related to large block ownership and CEO power on the board

$$V_0 = C_0 + \left(\frac{C_1}{(1+r_1+p_1)^1}\right) + \left(\frac{C_2}{(1+r_2+p_2)^2}\right) + \left(\frac{C_3}{(1+r_3+p_3)^3}\right) \ldots$$

Good Governance Brings About Better Resiliency



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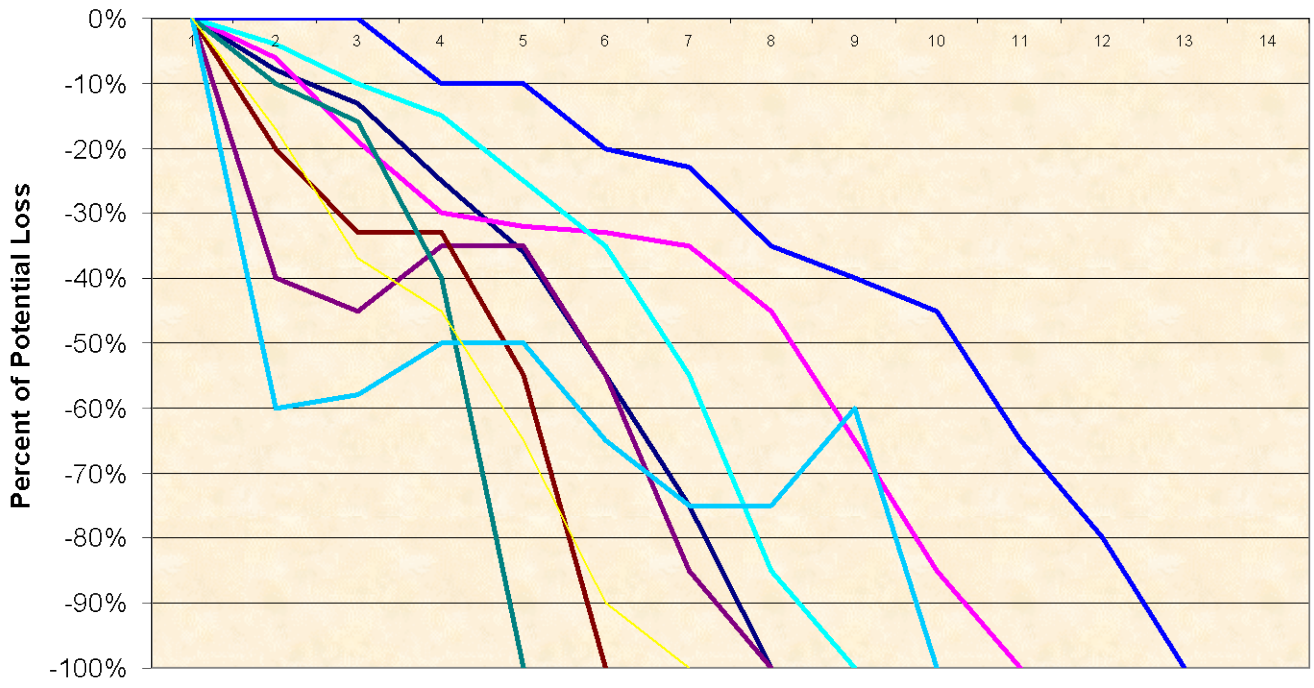
Cash Flows Extended

The Path of a "Problem" in a Brittle System



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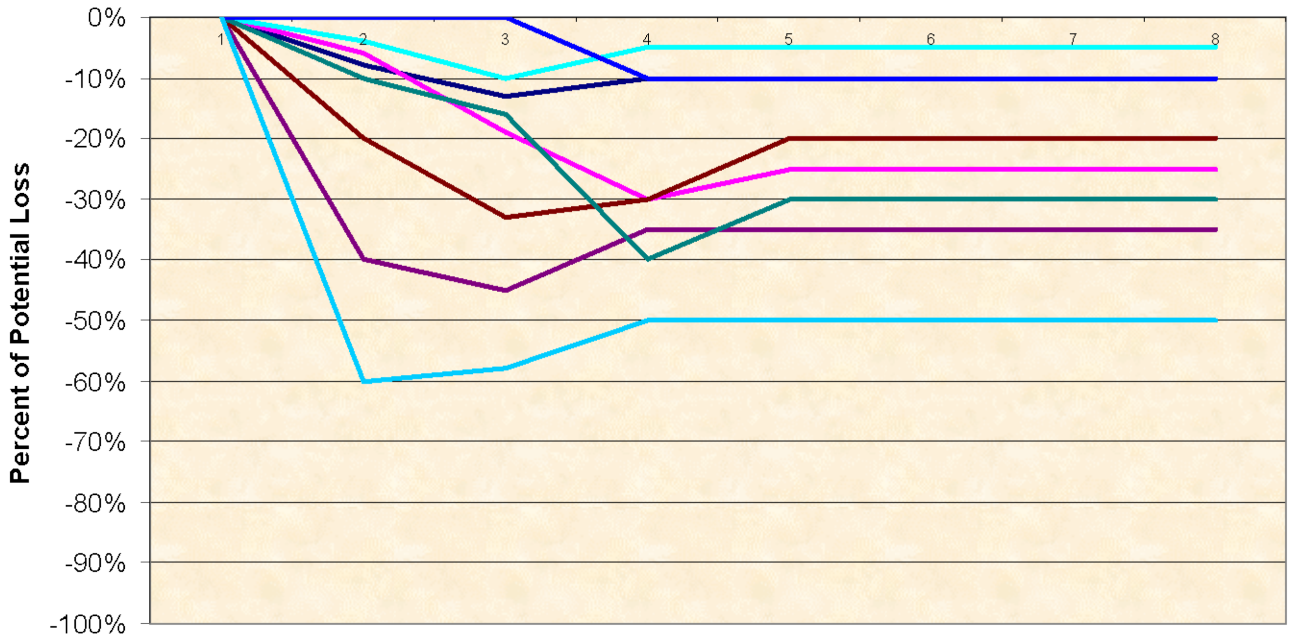
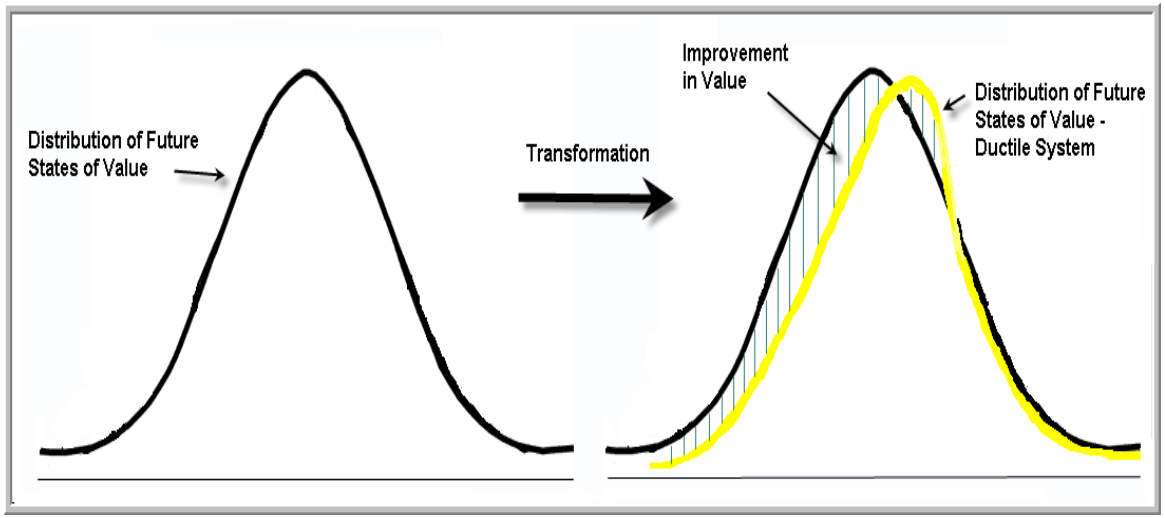
Cash Flows Extended

The Path of a "Problem" in a Ductile/Resilient System



Changing the Shape of the Future



Ductile/Resilient Systems Shift the Distributions of Changes of Value

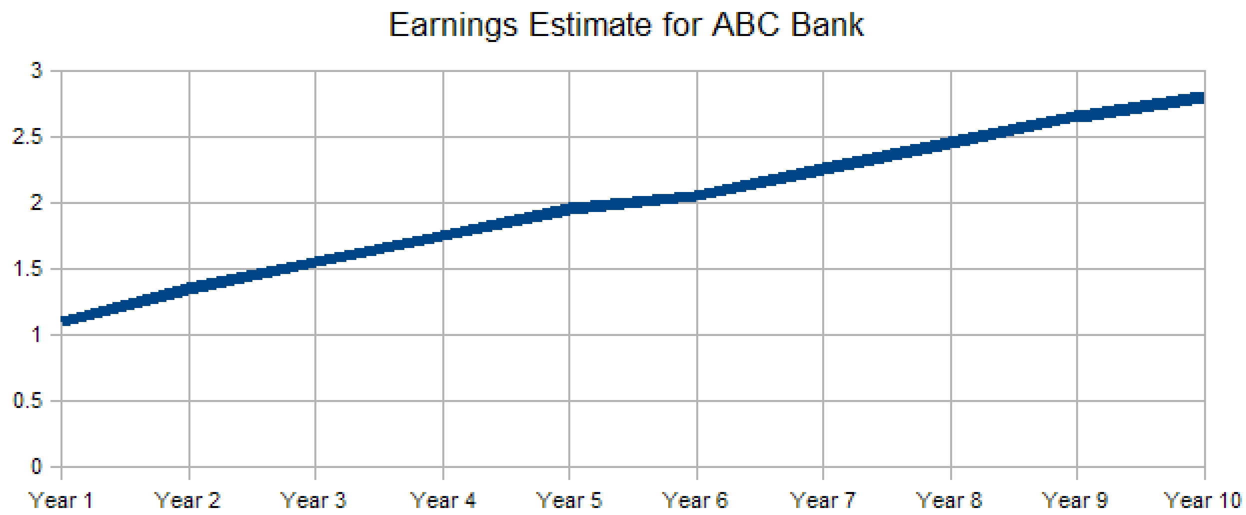
- Reduced probability of “Tipping Point” risk
- Left tail (extreme loss) reduced

Governance and Value

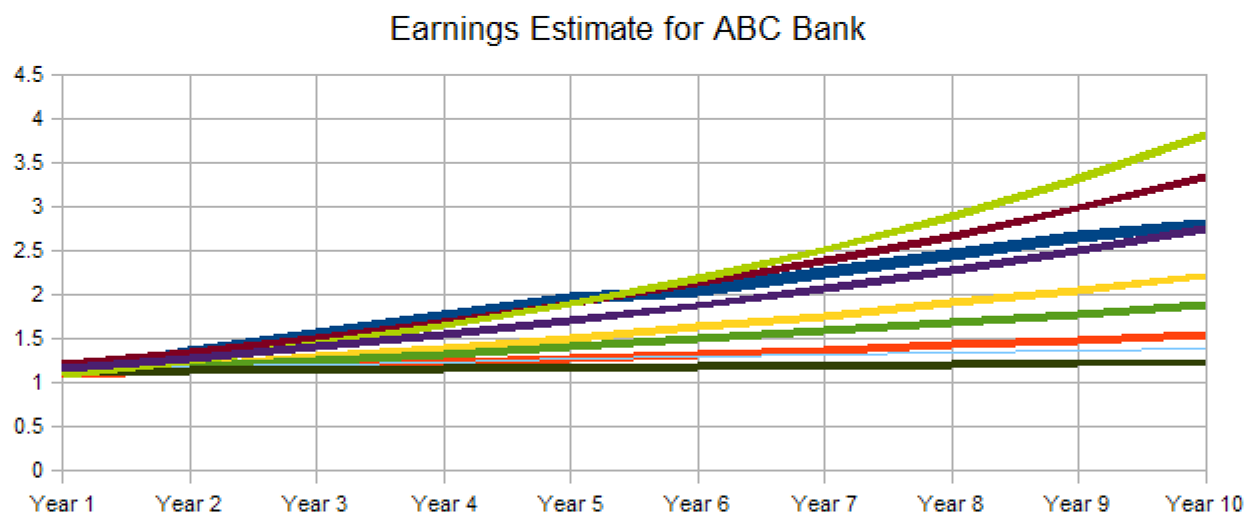
- How might governance affect firm value?
  - Risk perceptions and discounting
  - Loss Avoidance
    - Impact of Possible Large Losses vs. Possible Large Gains
  - Risk Processing or "Risk as Feeling"
    - Lowenstein, Weber, Hsee and Welch (2001)
    - Evolutionary and reactive
    - Thinking and rational

$$V_0 = C_0 + \left(\frac{C_1}{(1+r_1+p_1)^1}\right) + \left(\frac{C_2}{(1+r_2+p_2)^2}\right) + \left(\frac{C_3}{(1+r_3+p_3)^3}\right)\ldots$$

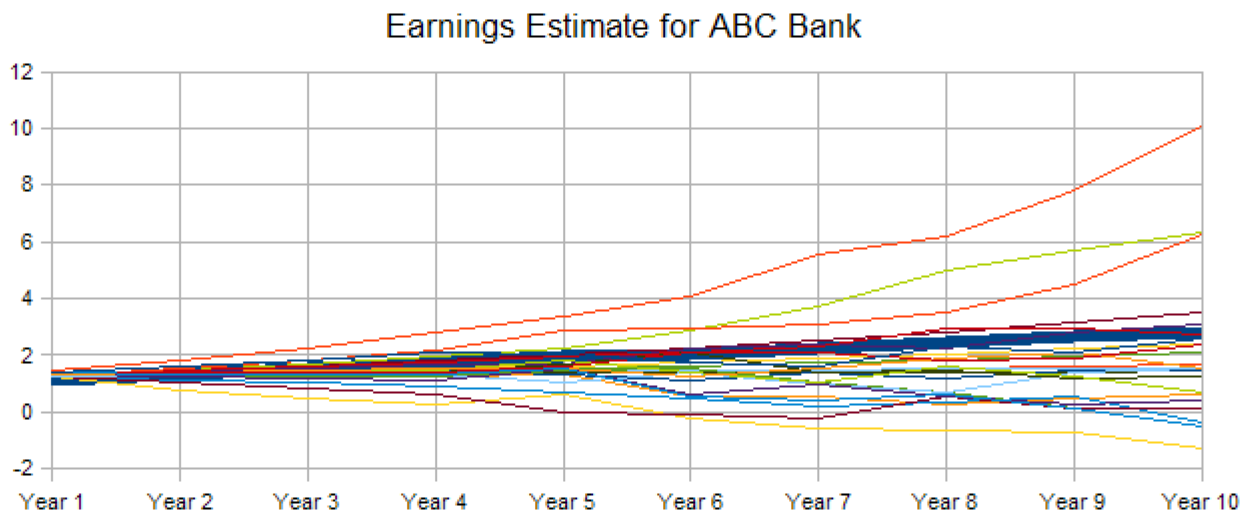
Perceived Risk: One analyst's view of a bank's earnings



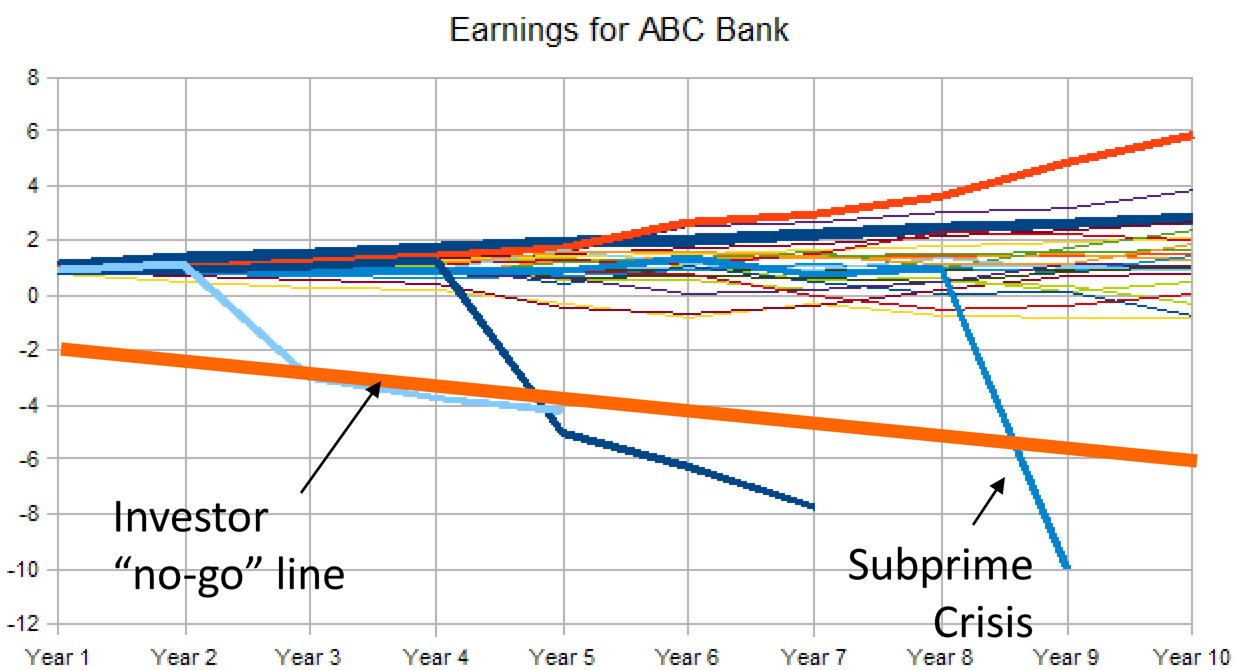
Perceived Risk: All analysts' views of a bank's earnings



Perceived Risk: Stochastic model outcomes for a bank's earnings



Realized Risk



Additional Academic Studies

- Padgett and Shabbir (2005)
  - The UK Code of Corporate Governance
    - Positive Link Between Compliance with the Code and Firm Performance
- Hoyt and Liebenberg (2009)
  - The Value of Enterprise Risk Management
    - Developed Enterprise Risk Management programs at insurance companies associated with higher value and a premium of 16.5%

Commercial Vendors

- Companies sell governance rankings
  - ISS/Risk Metrics
  - The Corporate Library
  - Governance Metrics International
  - Audit Integrity
  - CFRA Accounting Lens/Risk Metrics
- What does research show about these?
  - Daines, Gow and Larcker (2008)
    - Rating the Ratings: How Good Are Commercial Governance Ratings?
    - Finds very weak relationship in terms of predictive ability
    - May suffer from time frame chosen

Evidence from Recent Crisis

- Data from commercial vendor
- Chose top 10%, bottom 10%, P>10, NYSE, AMEX, NASDAQ
- <u>Static Portfolio</u> from Jan 2007 – Dec 2008
- Approximately 100 companies in each group
- Well-governed returned 14.2% more over period than poorly-governed
- Poorly-governed had 20% higher volatility

Notes

- Single-name governance/value relationship is still very difficult to predict
- Probabilistic assessments of classes of governance may offer more hope
  – Why?
    - Time to recognition of problems
    - Yield Chasing – Risk-sensitive foraging
    - Luck – good and bad
    - Large sample size

The Value Spectrum

Reacting to News
Shareholder Litigation
Regulatory attention and/or intervention
Rogue elements

Positive earnings surprises
Strong brand loyalty
Localized innovation
Aligned incentives

Defending Value

Creating Value

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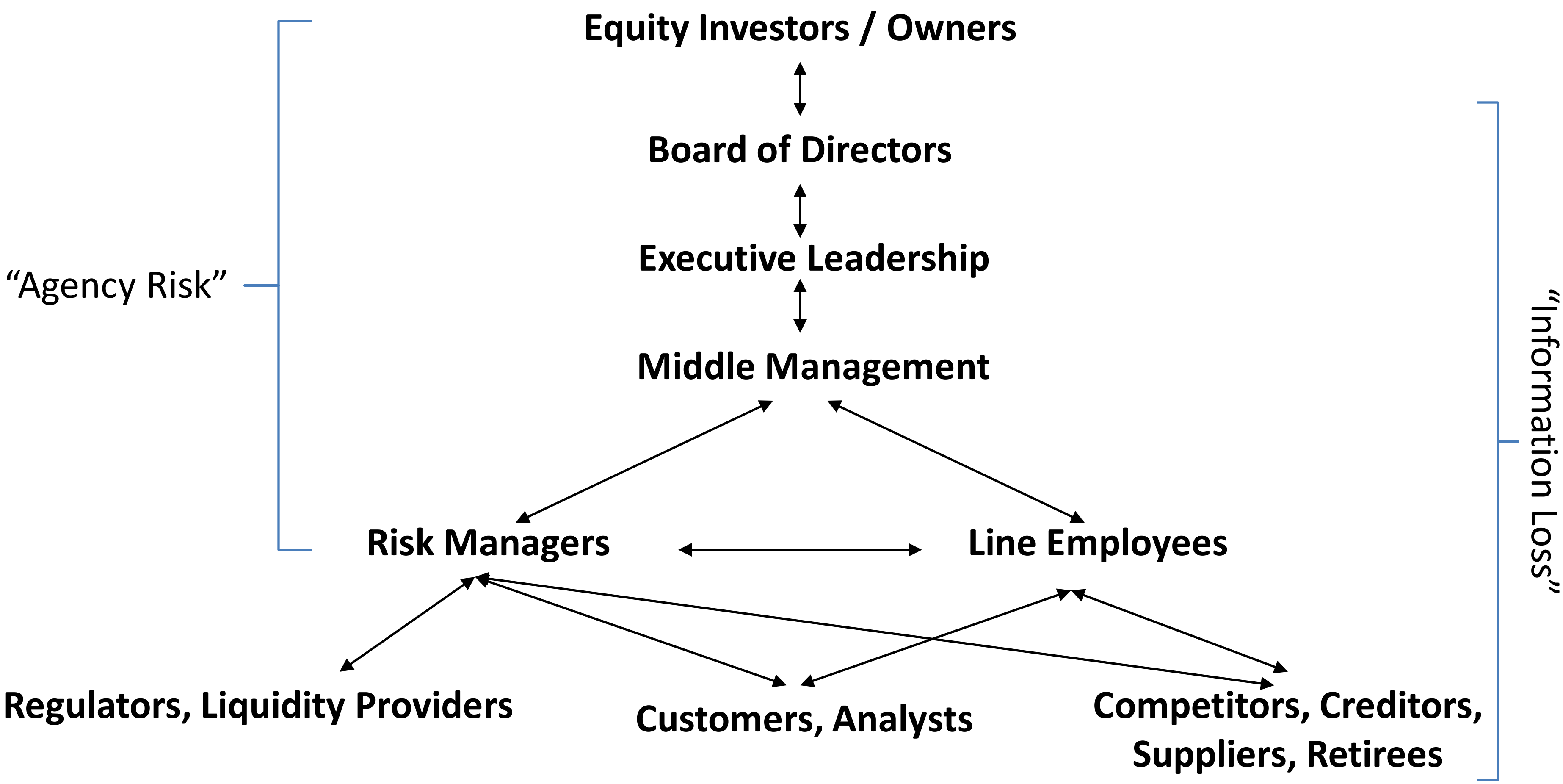
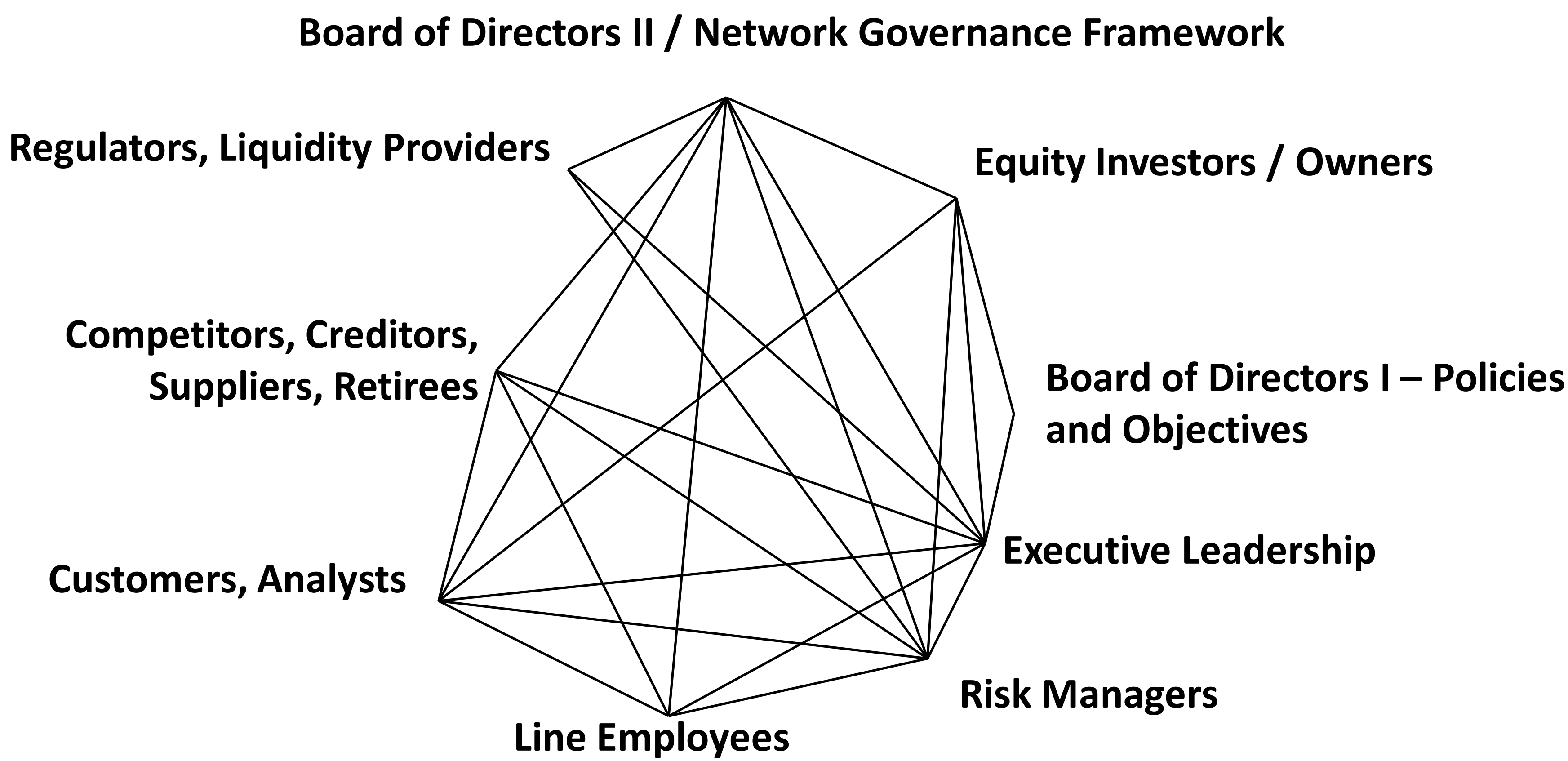
Hierarchical Governance Framework



Networked Governance



Best Model: Networked, Distributed Governance

- Nested Policies
  - Distributed Accountabilities
  - Short Communication Lines
- Independent Validation
  - Stakeholder Committee
  - Board CRO and other Independent Checks

Nested Policies Governance Framework

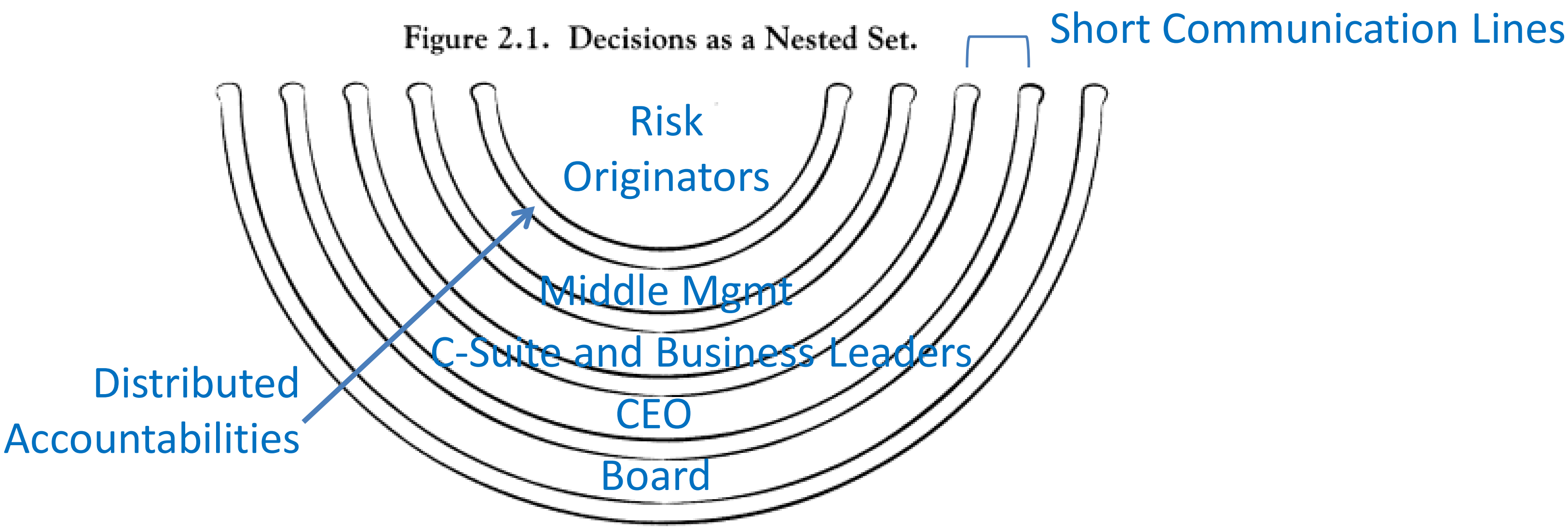
The board decides what to have policies about, and to what level of detail it will develop them. Its policies fit into four categories:

- ***ENDS*** — The board defines which human needs are to be met, for whom, and at what cost. Written with a long-term perspective, these mission-related policies embody the board's vision, and the organization's reason for being.
- ***EXECUTIVE LIMITATIONS*** —The board establishes the boundaries of acceptability within which staff methods and activities can responsibly be left to staff. These policies limit the means by which Ends shall be achieved.
- ***BOARD-STAFF LINKAGE*** —The board clarifies the manner in which it delegates authority and how it evaluates performance relative to ends and limitations.
- ***GOVERNANCE PROCESS*** —The board determines its philosophy, its accountability, and the specifics of its own job.

Except for what belongs in bylaws, these categories of board policy contain everything the board has to say about values and perspectives that underlie all organizational decisions, activities, practices, budgets, and goals.

Source: Carver Governance Model, (http://www.carvergovernance.com/)

Nested Policies Governance Framework



Smaller bowls fit within larger bowls as smaller issues fit within larger ones. Like a set of real bowls, the entire set can be controlled through the direct control of only the outermost, most inclusive bowl.

Source: Corporate Boards That Create Value, John Carver and Caroline Oliver (http://www.carvergovernance.com/)

The Role of Independent Validation

- Stakeholder Committee
- Board Chief Risk Officer / External Risk Director
- External and Internal Audit
- Short and Matrix Communication Lines

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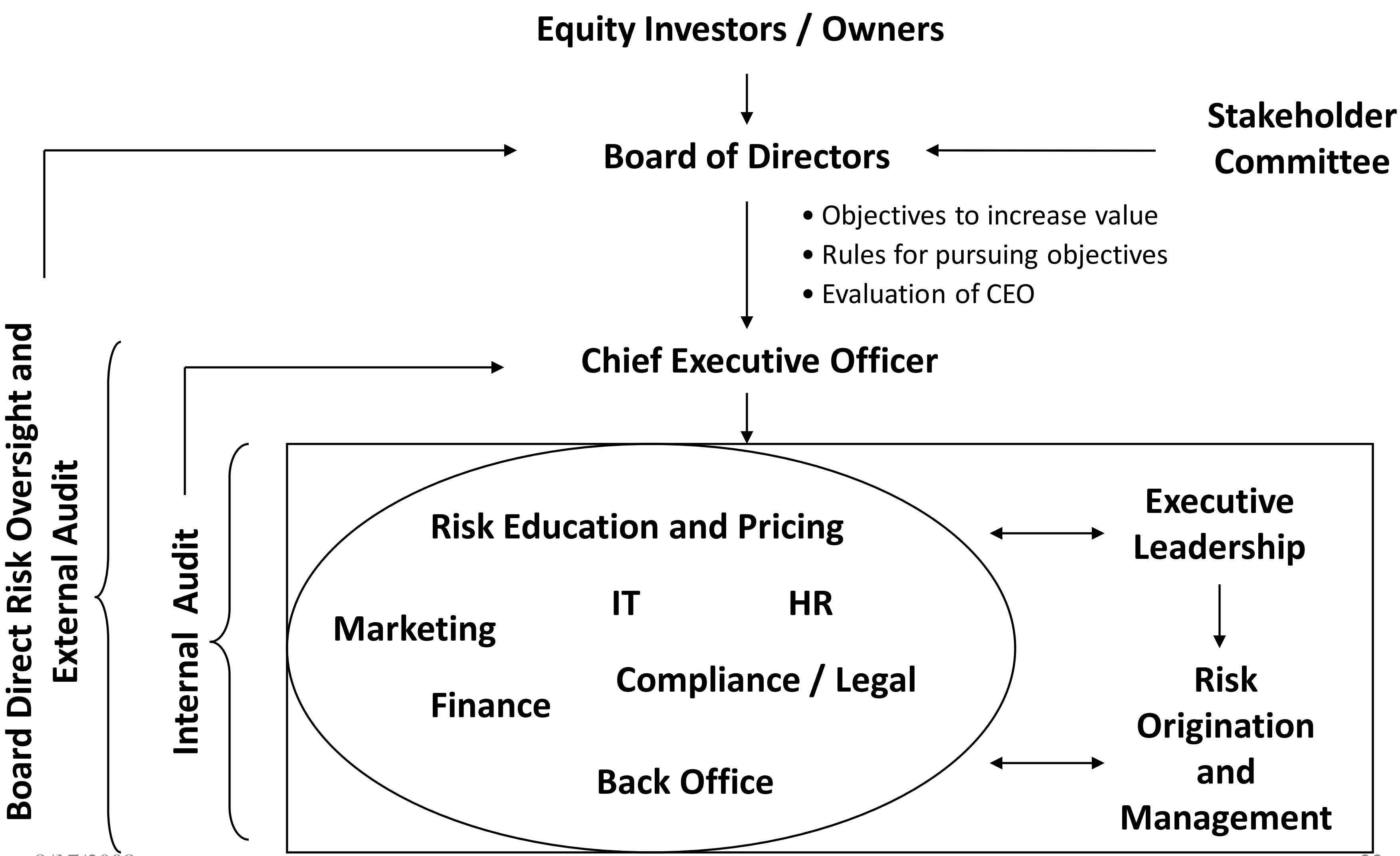
Distributed Governance Framework



Summary

- The way in which the organization pursues its objectives should:
  - Encourage a distribution of risk taking and the management of risk as close as is practical to where risk is originated
  - Nest policies in a manner to shorten communication lines and to encourage innovation within the establish rules for pursuing objectives
  - Ensure that parties external to each nested group have an input to their networks
  - Be transparent, open, accurate and honest in dealing with external stakeholders who may influence the value of the organization and who need to know that organization is pursuing its objectives knowledgeably
- Ultimate goal: maximize the “value” of the organization

Good Governance Brings About the Ability to Raise Capital More Easily and Less Expensively

– McKinsey and Company (2000)

- Surveyed over 200 institutional investors in 22 different countries with a combined $3.25 trillion of assets under management. They found that the large majority of investors were willing to pay a premium for companies with effective corporate governance practices. In the U.S., 84% of investors were willing to pay an average premium of 18.3%.

Thank you.

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| 401 Division Street South | Suite B | Northfield, Minnesota 55057 | *p* +1.507.301.3149 | *f* +1.480.247.4773 | *www.thegovernancefund.com* |