The Actuarial Profession
making financial sense of the future

Corporate Governance and Risk Management: Ticking Boxes or Creating Value?

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Overview

- Is corporate governance effective?
  - An academic overview
- The problem with focussing on outputs
- Positive risk management
- Can actuaries be trusted with this?

Corporate Governance Research

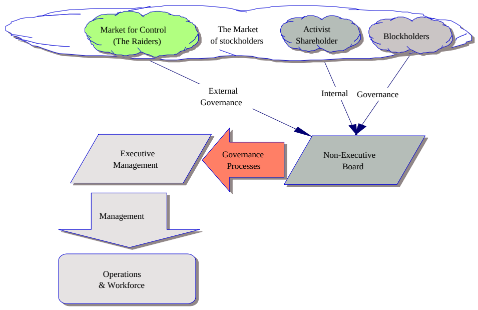
- 2004 business research project for CASS Business School, with academic peer review
- Goal – to create a product that measures and communicates efficiency of corporate governance spending for different stakeholders, creating a "governance performance curve" and model for translating input to output
- Failed to create product
- But …

The Corporate Governance Assumption

- Premise - good governance leads to superior performance
- Governance costs
  - "Corporate governance is about reducing the cost of capital, it is not a moral crusade"[#1]
  - Too much of a good thing? Law of diminishing returns.
- Governance is about volatility reduction (Beta), or downside risk protection (asymmetric volatility)?
  - So governance value differs as market risk premium change
  - Greater impact with reduced equity risk premium

#1 - ICGN Annual Conference 2003 - Alistair Ross-Goobey
2003 – Gompers, Ishii & Metrick

The Market Only Model



Structural Indicators

- Board accountability
- Financial disclosures and internal controls
- Shareholder rights
- Remuneration
- Market for control
- Corporate behaviour

#1 – **Gompers, Ishii & Metrick, 2003.**

Academic Studies

US Firms
- Shareholder rights = strength of governance
- Divide firms into percentiles on an "output" basis
- 1990's strongest quartile beat weakest by 8.5% pa [#1]
- Governance correlates to operational perf' metrics [#1]
- Following 2 years, only 2%pa, a diminishing return[#2]
- Russell 3000 index 1999-2003, poor governance firms outperformed [#3]!

Germany [#4]
- 90^{th} v 10^{th} percentile, 12% pa excess return over 1990's

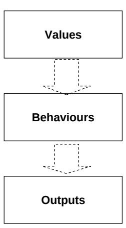
#1 – **Gompers, Ishii & Metrick, 2003.** Like many studies, equalises returns using Tobin Q methodologies
#2 – Cremers & Nair, 2003. #3 – Financial Times, 2004
#4 - Drobetz, Schillhofer, Zimmerman, 2003

The Costs

- Link governance cost to Beta
  - Impact on Beta for a given spend, free cashflow to equity (FCFE)
  - 1% reduction in FCFE requires a 2.5-3.5% reduction in Beta[#1]
- 2004 - Aegon, AIG, GE stated compliance with corporate governance initiatives, including Sarbanes-Oxley, cost 1% of revenues in 2004. Impact on FCFE?
- Poor governance leads to increased acquisition premia of 20-25% (e.g. poison pills, staggered Boards)[#2].

#1 – Grodon Growth model, "market assumptions". Risk value assumed symmetric – it is not.
#2 – Bertrand & Mullainathan / Core, Holthausen & Larker / Bebchuk, Coates & Subramanian / Garvey & Hanka / Danielson & Karpoff … etc

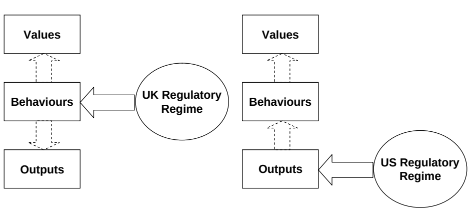
Governance Framework



- Most studies focused on outputs
- Implies static "adopt best practice" then stop - one off event focus
- Not long-term
- Miss governance as risk mng't & operational value generation
- Need ongoing, evolving, flexible processes

Corporate governance is focused by regulation

- Regulatory regimes differ in approach and focus



Sub-atomic particles

- “Boards are like sub-atomic particles, they behave differently when they are observed[#1]”…

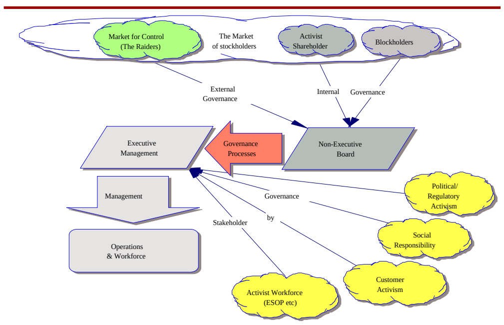
#1 – Roberts & Minnow, 1996

Value Creation

- Value creation depends on interaction of multiple stakeholders[#1]
- Firms are contractual frameworks between different stakeholders, so need to manage all the links[#2].
- Stakeholders remunerated at opportunity cost, only shareholders receive rent from the firm [#3].
- Aligns with European model [#4]
- Executive now “central actor”

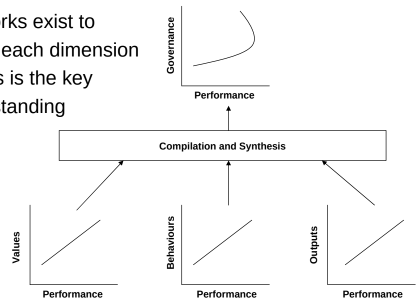
#1 – Phillips 2003
#2 – Freeman 2001 / Aoki 1984
#3 - Becht, Bolton & Roell 2002 / Shliefer & Vishny 1997
#4 – Charreaux & Desbrieres

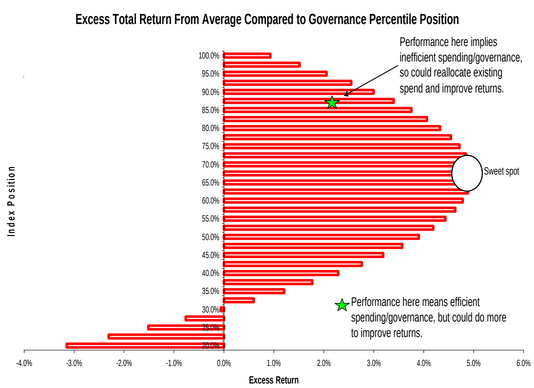
The Stakeholder Model



If you value it, or want to manage it, measure it!

Frameworks exist to measure each dimension
Synthesis is the key to understanding





Concludes

- Excess returns maximised in 65-75 percentile
  - Average structural governance not optimal
- Long-term difference between good and bad
  - Supports studies, but investors wised up
- Strong downside protection
  - See costs as a put option on company specific risk
- Big firms have poorer governance than small firms [#1]
- Excess governance has a cost
- Dominance potential of compliance frameworks[#2].
- **Lies, damn lies and statistics**
- **Garbage in – Garbage out**

#1 – **Gompers, Ishii & Metrick, 2003.**
#2 - Collins 1998 / Porras & Collins 2002

It's All In The Timing

- June 2004 – Larker, Richardson, Tuna
- Does Corporate Governance Really Matter
- Corporate Governance Structures, Managerial Behaviours & Organisational Performance
- "Structural indicators of corporate governance have very limited explanatory value for management behaviour and organisational performance"
- Correlation is not causality
- 3 years to end 2002, good governance group had poorer total return performance[#3] than average
- Outperform over 1 and 10 years

#1 – Larker, Richardson, Tuna, June 2004
#3 – GMI Governance rating service

Government

- "That government is best which governs the least, because its people discipline themselves."
  Thomas Jefferson

Focussing on outputs

- Visible structures e.g. Board/committee structures
- Non-executive directors
- Segregation of duties
- Financial reporting
- Performance management systems
- Risk registers
- ICAs

Focussing on outputs – the problem

- All of these are important
- Evidencing risk management
- There is nothing wrong in ticking boxes, but….
- Outputs are a necessary but not a sufficient condition for achieving effective risk management

Getting the inputs right

- Values - culture
- Behaviours - leading by example
- Articulation of risk appetite
- Substance and not style

Risk Management Cultures

- Uncontrolled
- Compliant
- Controlling
- Positive risk management

Positive risk management

- Clear organisational purpose
- Objectives – what does this mean for me?
- Understanding risk – not minimising
- Improve benefits from positive variances
- Improve benefits from negatives too
- Can organisations be risk aware?
- Everybody is a risk manager because….

Risk appetite

- Stated variance tolerances
- Absolute boundaries of action
- Degree of prescriptiveness
- Situation specific
- Transparency and information
- Required actions
- Accountabilities and authorities
- Outcomes from good and bad variances
- Common understanding

Understanding risk

- Clarity of purpose
- Acceptance that plans never deliver - exactly
- Reducing scope for the unexpected
- Awareness of possibilities and impacts
- A formal structure helps
- Consistent communication also helps

Where it breaks down

- Belief that the structures alone are sufficient
- Disjoint between top and bottom
- No connection with day job
- “Do what I say, not what I do”
- Silos
- Opacity – leave it to the techies

The purpose of an actuarial department?

- Completing regulatory returns
- Providing figures for Board/management
- Proactive advice on strategy, risk and capital

Actuaries leading the way?

- Clarity
- Comprehension – Board level downward
- Transparency
- Process management
- Knowledge sharing
- Documentation
- Systems robustness
- Do ICAs help actuaries get into the business?

Actuaries leading the way

- Do your objectives get you out in the business?
- Are you an example of good risk management?
- Are you helping others understand risk?
- Are you concerned about the “how” and “why”?
- Is this a hard or soft science?
- Creating internal cultural transparency

Summary

- It is easy to be cynical about governance procedures
- Formal structures alone will never be sufficient
- Good governance depends on culture
- Good risk managers will lead by example
- Actuaries may have some things to learn here