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I focus on the intersection of government, Wall Street & main street.

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Freddie Mac and Norwegian Wealth Fund Past Executives Speak Out on Corporate Governance

Image via Wikipedia

This report is not another case study on Bear Stearns, Lehman Brothers and the markets crisis of 2008. Instead it is a fast forward to present day corporate governance and risk management reform practices.

A special thanks to David R. Koenig for providing the analytical framework outlined in his upcoming book and developed through his experience as an award winning risk management leader.

Also, a special thanks to Robert Bostrom for sharing his views on best practices from his work at Freddie Mac and in the financial sector and to Knut Kjaer for sharing his views as a pension fund expert and former founding CEO of the Norwegian Petroleum Fund, one of the world's most prominent sovereign wealth funds.

The first section entitled, ***Flashback to 2008****, is designed to reconnect us to the meltdown of the global markets as the impetus for the federal reform legislation. By-pass it if you prefer to move directly to the analysis on present practice.*

Flashback to 2008

In March 2008 Bear Stearns collapsed, igniting an unprecedented risk management meltdown and subsequent global financial crisis.

Bear's leveraged risk at 30 times its assets was at record-breaking levels. Following came a rash of news about mortgage failures and the devaluation of real estate. In turn, the value of securitization assets dropped, affecting the performance of pension funds, hedge funds and other institutional investors. Bear's clients experienced a "crisis of confidence" and stopped doing business with the firm

Bear could not be saved despite the Fed's attempt. It was sold to JP Morgan Chase for $10 a share—a price far below its pre-crisis 52-week high of $133.20 per share.

In September 2008, Lehman Brothers failed due to similar causes and following the government's decision not to bail out the embattled firm. This event marked Lehman as the largest bankruptcy in U.S. history. It provided the last punch needed for investors to flee the markets.

Government leadership underestimated systemic risk associated with Lehman. A main conduit of the U.S. financial system, it had a ripple effect on the economy and global markets. Removing it only made conditions worse as banks froze credit needed for businesses to function.

Although it could have been much worse without it, President Bush's $700 billion bailout could not stop the contagion from spreading through the financial system and the global economy.

Consequently, world markets unraveled in October 2008. In fact, October 2008 became the worst performance month in over 21 years. The Dow dropped 2,400 points in the first 8 days, finishing down 14 percent in October. The world markets lost 19 percent and emerging markets lost 29 percent.

Then in October the credit squeeze started and consumer credit was tightened. Retirement savings were wiped out along with record amounts of wealth, reported Dave Carpenter and Tim Paradis in the Huffington Post on October 31st.

On Thursday, October 23, 2008—in the middle of *the meltdown—Alan Greenspan testified to Congress. He stated that he was shocked at the breakdown of the U.S. credit markets —specifically that he was partially wrong to resist regulation of some securities. Despite concerns in 2005 that investors were underestimating risks, he testified that, "this crisis, however, has turned out to be much broader than anything I could have imagined."*

On the same day Nancy Marshall Genzer of Marketplace spoke with Morris Davis (former Fed Economist and then University of Wisconsin Professor) and Douglas Diamond (University of Chicago Finance Professor and visiting scholar to the Federal Reserve Board of Richmond) for analysis of Greenspan's testimony.

Genzer points to a quote from Greenspan made three years ago stating, "The impressive performance of the U.S. economy over the past couple of decades offers clear evidence of the benefits of increased market flexibility."

According to Davis, "It looks like he had perfect foresight at the time, but the truth of the matter is I think he was ignoring a lot of people that suggested there might be a big problem." In addition Davis states, "Greenspan did get conflicting advice, but some economists warned him that the housing market could collapse.

So, was Greenspan genuinely surprised? "Yes," says Diamond who stated, "Well, I think he had a very simple view of the world that free markets always provided very good incentives."

Summarizing Genzer's report, it states that, "Today Greenspan avoided taking personal responsibility for the crisis. But, he did say it was a mistake to assume that banks would stay out of trouble to protect their shareholders."

In a Reuter's article on October 23, 2008, by Mark Felsenthal states that, "With a general election looming November 4, U.S. lawmakers were sharply divided along political lines in either blaming regulators or bickering for failure to prevent the crisis that has gripped financial markets around the world. Republicans, for their part, singled out government sponsored mortgage finance agencies Fannie Mae and Freddie Mac for their role in unsettling financial markets and faulted Congress, which has been led by the Democrats since 2006, for failing to pass measures to rein them in sooner."

Institutional Memory Loss

As venerable 100-year-old banking institutions crumbled around us three years ago, it was challenging not to conclude that corporate governance was anything other than an absentee proprietor. In fact there seems to be a gap between the experience felt in 2008 and the tenor of the present debate on policy reforms and corporate best practices in risk management. For many politicians, shareholders and leaders in banking and industry, the meltdown appears a distant memory with corporate governance reform an anathema.

The very issues debated during the negotiations on reform legislation still flood the political agenda, centering on the relative roles of shareholders, boards and CEOs.

Can government regulate against excessive risk taking—specifically does The Dodd-Frank Act provide the policy framework for this? In addition, what should be considered best practice between owners—mostly institutional investor shareholders—CEOs and boards on alignment of accountabilities in risk management?

Turning to the Experts

In a forthcoming book, *Governance Reimagined: Organization Design, Risk and Value Creation*, David R. Koenig presents the analytical framework to help us look over our shoulder for a better understanding of present day debate on the intersection of corporate governance, risk management and fulfilling our values. This report culls concepts from his book.

Koenig's career focus has been on the pricing of risk and the governance of risk-taking ventures. Formerly an officer of the First National Bank of Chicago, Principal Financial Group, GMAC/RFC and U.S. Bancorp Piper Jaffray, he is presently CEO of The Governance Fund Advisors and CIO of RAM Investment Advisors. He has managed complex multi-billion dollar portfolios, developed multiple corporate risk management programs.

Representing the board and CEO perspective is former Freddie Mac executive vice president, general counsel and corporate secretary, Robert Bostrom.

His experience includes executive

management/legal oversight with National Westminster Bancorp, managing partner of Winston & Strawn along with his role as a lawyer with the Federal Reserve Bank of New York. Now a partner and co-head of SNR Denton's client practice overseeing the global financial institutions and funds sector, Bostrom shares his experience in advising corporate clients in the areas of risk management and corporate governance.

As the former head of legal strategy during Freddie Mac's financial crisis and recovery—2006 to 2011—his views are unique through his experience in navigating a gauntlet of investigations, enforcement actions and litigation during the financial crisis.

Representing the shareholder (owner) perspective is former founding CEO of Norges Bank InvestmentManagement and the $480 billion Norwegian Government Pension Fund, Knut Kjaer. A pension fund veteran, Knut stepped down from the Norwegian pension fund in 2007 to serve as president of RiskMetrics Group—a leading provider of risk management and corporate governance products (through Institutional Shareholder Services). In 2010, Kjaer left RiskMetrics and now serves as Chairman of the Nordic private equity company FSN Capital Partners.

Kjaer shares his knowledge of financial markets and risk management, noting that perceptions of risk management have changed dramatically in light of the crisis. Kjaer brings his experience from managing one of the world's largest sovereign wealth funds. An innovator in stewardship and active ownership, he supports shareholders in exercising their ownership rights as long-term investors.

Risk and Value

Risk taking is a core function for companies. "Risk is a necessary element in the creation of value; hence, companies exist to take risk," states Kjaer.

According to Koenig, "Risk is a sometimes misunderstood and misused term. For most people, it connotes negative outcomes. However, risk has both positive and negative sides. Limiting oneself to just the negative outcomes can lead to sub-optimal decision making." In short, focusing on the negatives can drive a company to take bad risks or to miss out on the opportunity of good risks.

Risk is what attracts capital to the market. “Without risk there is no attraction to capital and without capital there is no banking system so managing risk comes down to the implementation of a proactive, preventative strategy at the board and management level,” states Bostrom.

However, understanding the complexity of risks taken by boards is a risk in and of itself. Kjaer states, “Every company needs to take risks to deliver value—it’s a part of the production process. However, sometimes risk taking is disguised by complexity so boards do not fully understand the implications of their decisions,” argues Kjaer.

He adds, “Investors played a key role in the recent financial crisis because we failed as owners of financial institutions and as investors by fueling leveraged investments into alternative asset classes and complex debt instruments without understanding the underlying risks.” Bostrom agrees stating that, “Yes, owners, specifically labor or public pension funds could be considered as ‘potential risks’ for boards and management in that demands for portfolio performance returns have driven boards to take excessive risks. As a result, it is important to consider the objectives of owners when creating an enterprise risk management plan.”

Bostrom adds that, “Boards must independently determine that management has implemented and maintained effective enterprise integration of risk management policies and procedures.”

To make this determination, however, boards must receive input from all levels of the enterprise.

Unfortunately, there is a gap between boards, management and those closest to the risk actions—unit heads or line management. Bottom-up or top-down, communication systems tend to distort messaging. In fact, “Studies suggest that by the time a message has been told four times it is more wrong than right,” says Koenig.

Companies may, consequently, operate through a broken system of unaligned priorities and incentives.

Alignment of Stakeholder Incentives

Defining an organization's capacity for risk is vital to long-term value and requires a better understanding by owners, boards and CEOs because it is often determined by the perceptions of parties outside of their control. Internal management must include input from other stakeholders. Koenig argues that, "when designed properly, risk taking can be managed very effectively and efficiently as a "common" – an asset to be jointly shared by smaller groups within an organization, but it takes looking at governance in an entirely new way."

He addresses the negative side of centralized, top-down risk management in that, "It conveys a sense of control when the complex nature of a business' network may make centralized control risk-additive. At a certain point in its development, an organization's size crosses a line to where centralized control makes it less able to adapt to changes in the marketplace and the perception of control is falsely comforting."

Decentralized risk—delegating it to smaller groups—provides greater ownership of outcomes by those closest to implementation of the risk strategy, thereby allowing for greater diversification, better return on risk capital and a perception by outsiders of exposure to lesser risk.

Additionally, such diversification protects against single points of failure, where one major negative risk being realized causes a collapse of the whole system around it.

Koenig further adds, "A board should not manage. Instead, it should serve as a governing body, providing leadership through construct. It should define objectives for the organization's leaders to pursue and also clearly articulate the limits on behavior within which those objectives can be pursued using the best abilities of the people to whom that risk-taking capacity has been delegated."

In fact, he argues that, "Boards need to be independent entities providing the expertise to envisage strategic goals and then hold those who receive their authority to pursue them to account."

Bostrom argues that alignment should occur through the creation of an ERMC (Enterprise Risk Management Committee) to be, "Chaired by the CEO or president of the company, managed by an executive level professional, specifically a chief risk officer, with the expertise and credentials required to properly advise the executive on all facets of risk management." Koenig adds, "Risk management professionals are particularly good at defining and scoping out possible outcomes. When used to support the decision-making process, rather than avoid loss, they can play a meaningful role in the allocation of an organization's risk-taking capacity." The chief risk officer and the ERMC, "should report to the audit committee or other special risk committee of the board and should be comprised of line and support management in all areas of value creation," states Bostrom.

According to Koenig, "Boards exist to govern—to form the accountability link between the providers of risk-taking capacity—for example, owners, lenders, business partners—and operators of an organization." Kjaer agrees in that, "The company is owned by somebody—the shareholders. They take on the risk of the company. Management runs the company on behalf of the owners." He adds, "Following a period in recent history, management power has been institutionalized at the expense of owners. Owners are now regaining ground—a primary benefit of recent reform policies. More power has been returned to those who own the risk."

In addition, there are stakeholders beyond owners, the board and CEOs such as employees, service communities, customers, vendors and contractors. Should they be considered in the risk management strategy?

One example of this involves labor union-based pension funds. Recent studies have indicated that labor unions use their board positions to leverage labor benefits.

In response to this Kjaer argues, "I don't see in general that employee board members are there just to protect their interests or to push for higher wages and benefits. Employees have a long-term interest in success of their companies. Service on the board makes them responsible. It provides a role as change agent and helps management in securing agreements on positions."

Real Checks and Balances

Koenig re-imagines governance through a venture-capital portfolio type system of freedom along with checks and balances that address the complexities of risk management. This system is designed to be adaptive in nature and brings into the process those inside and outside of the organization who are relevant to stewarding company risk.

Before the board and CEO can allocate risk down to line management, he shares that, "companies need to develop the capacity to take risk, attract people and technologies to do the act of risk taking, and to engage the whole network in the risk-taking process." Considered *Networked and Distributive Governance*, this model of managing risk takes into the account the many relationships in the process that effect successful risk management and value creation.

According to Bostrom, the ERMC, "should be established, composed of all support areas such as IT, finance, audit, legal, compliance, human resources and public relations as well as primary business line management." His approach is preventative in nature and designed to identify gaps in existing risk capability so that they can be eliminated or mitigated, thereby adding integrity and accountability to the risk management system. He agues that, "This allows all needs to be considered so the board fully understands the risks they are taking, to modify them in compliance with strategy objectives and to evaluate their effectiveness."

The delineation of roles and responsibilities is an important component in developing a real checks and balances system and drives healthy corporate governance and risk management. Boards and CEOs see owners as a potential risk because moving toward the alignment of incentives may threaten existing management dominance. Kjaer believes that, "Real checks and balances should be part of the risk management system and provide an on-going reporting mechanism to the board."

The challenge in making this system work is the degree that self interest dominates the process and prevents the reshaping of boundary lines between owners, boards, CEOs and others such as line managers, vendors or communities—those whose roles may influence the risk management process.

In analyzing the failings of the financial system, Kjaer states that, "Before the crisis I met with CEOs of some U.S. financial institutions to discuss governance of their companies. The role of the CEO and his leadership style, CEO dominance in the dual role of board chair, the lack of an independent board, the difficulty in receiving information from line management required for assessing risk and the centralized management of companies all accounted for recent failings of our capital markets system."

In looking toward better risk and governance systems in the future, Bostrom believes that, "A decentralized *baton-up approach* allows for the risk management process to reflect, recognize and assess risks at operating levels and places accountability at these levels."

Single Points of Failure

Avoiding single points of failure is an essential first step towards the creation of a company's resilience to risk. "If a system is brittle, it can break even if one thing goes wrong and if is not attended to quickly or effectively," says Koenig.

"Financial markets are adaptive, complex and fragile systems. Regulation cannot keep tabs on excesses. The market system works because of the power of self-interest. Although regulation creates transparency and imposes some restrictions, integrity is a dimension that needs to be added to how companies are managed," Kjaer further adds.

However, not all single points of failure are due to criminal activities or mismanagement. "Companies with single product lines, a company's over-reliance on one customer or dependence on short-term funding are subject to quick and dramatic ends to their existence if these keystone parties fail or walk away," says Koenig. We should expect all systems to fail at some point. To better govern a company, the focus must be on creating systems that break well.

Kjaer adds, "It is possible for a system to have all of the structures in place for good governance and risk management yet still fail. If the system is by design corrupted, it will take excessive risk and have a greater chance of failing. In the case of Freddie Mac and Fannie Mae, they are considered privately owned entities pursuing an important public prioritized function underwritten by the taxpayers. It was bound to fail—the downside underwritten by the government."

Too Big to Fail

A colloquial term that emerged in discussions on reform policy and regulation, "too big to fail" refers to certain financial institutions so large and so interconnected that their failure would be disastrous to an economy.

In a December 2009 Bloomberg article Alan Greenspan is quoted as saying that the U.S. should consider breaking up large banks because, "If they are too big to fail (TBTF), they're too big." Others consider this approach counterproductive, arguing that banks and financial institutions should be left to fail if their risk management is not effective. Koenig believes that the risks associated with TBTF can be more effectively managed through many of the operating principles of *Networked and Distributive Governance.*

He argues that companies, "Create more freedom to innovate and instill greater accountability by distributing the responsibility to manage risk capital as 'commons' throughout small networked groups. These groups can address key communication and risk-appetite issues in managing complex organizations, can innovate better and can make more effective use of the scarce commodity known as risk capital."

At first glance, building flexible hierarchies where controls are decentralized and employee autonomy is expanded in a post-meltdown world elicits a negative reflex—appearing to be an additional layer of risk. The natural response is to attempt to regulate away the undesirable behaviors and associated outcomes.

However, "Regulation will not effectively manage self-interest," states Kjaer. In fact, adds Bostrom, "The pendulum has swung from perhaps too much risk-taking to reform legislation attempting to remove all risk from the system." Although he is not a proponent of democratizing risk management, his form of centralization allows for input and operational accountabilities from both bottom-up and top-down.

Centralization—although a relative term—has the potential to truncate the flow of important communications unless there is a cultural imperative or shared vision along with a set of operating rules for employment of risk capital. Bostrom argues that, "It is essential that the board and CEO understand the nature of all risk. Having input from up, down and in support of line management is critical to understanding the full nature of risk appetite and mitigation."

Moving to the Long Term

Kjaer points out a timely and relevant sentence in a Financial Times article that reads, "Why set maximizing shareholder value as the company goal when shareholders actually are absent from stewarding the companies?"

The purpose of reimagining corporate governance and risk management is to begin to restore the balance between corporations, society and institutional investor owners through a system that allows for maximum flexibility and innovation in taking risks needed to create value.

"If we define maximizing shareholder value over the long-term, we should be able to bring stakeholders (in addition to owners, boards and CEOs) into the equation, manage the complexity of the business model and more effectively mitigate the downside risks of our equity culture—a powerful driver of wealth and prosperity," states Kjaer.

On the subject of mitigating downside risks, Bostom proposes that, "To identify and to understand the vulnerabilities of a company allows you to mitigate overall downside risk and to be prepared to avoid or lessen the downside effects when a crisis occurs."