Governance and controls in the perfect storm

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Over 12 months ago the Economist Intelligence Unit (EIU) and PricewaterhouseCoopers conducted an online survey of senior executives from institutional investors and alternative investment providers. Over 220 executives from the Americas, Asia and Europe participated in the survey, which was conducted between December 2007 and January 2008.

The EIU also held 30 one-to-one interviews with some participants. The conclusions of the survey were clear as to the need for a growing focus on governance. Participants commented that investors have tolerated weak governance and risk management in the past few years as returns have been good and the sector has been evolving.

At that time, given that sector returns were moderating and it was felt the sector had matured, investors were expecting to be more exacting in future. When asked about the criteria behind a decision to deselect a provider, the key driver was not performance, as is the case when making a selection; rather it is transparency and the quality of risk management. Returns have deteriorated further over the year since the survey was conducted, and investors are becoming increasingly focused on governance and risk management. Performance in this area is becoming a differentiator in the marketplace. We do not expect this to change in the foreseeable future either and those engaged in delivering governance and controls should prepare themselves to deliver against tougher benchmarks over the medium term.

As you might expect, much of the recent PricewaterhouseCoopers UK Real Estate Client Conference was focused on the current state of the market and the impact this is having on organisations in the sector. In periods of such uncertainty, the importance of managing to ensure risks are mitigated wherever possible, becomes even more relevant. One of the conference sessions looked at the options for corporate governance, controls and reporting to stakeholders in the light of recent events and pronouncements.

Listed entities

- Corporate governance for companies listed on stock exchanges around the world is generally well established, but these are being tested by current challenges.

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- Audit committees are generally finding that understanding the mitigation of key risks and challenges is more difficult when times are hard than when everything is on the up. Time commitments are increasing for committee members as their need to assess the current status requires an enhanced level of detail. The ability to access such information easily may not be possible when one is not involved in the daily running of the business.
- Communication between executive and non-executive members needs to be transparent and to flow easily to avoid response to governance requests eating up time available to run the business. This point echoes the survey findings referred to above.

Unlisted entities

- Currently there is no formal governance model that applies to unlisted entities. Many organisations have one or more key committees for oversight, often in the form of an investment committee, to which significant decisions are referred. The more formalised structures in place will often have a mix of executive and non-executive members. However, this remains voluntary and in most cases is driven by the experience of key individuals from their past organisations, or is derived in response to investor requests.
- As discussed elsewhere in this edition of UK Real Estate Insights, changes in European legislation are being proposed in relation to Alternative Investment Fund Managers which could actually apply to hedge funds, private equity funds, real estate and infrastructure funds, Real Estate Investment Trusts, listed investment trusts as well as other forms of collective investment vehicles. While there is a draft directive at present, should this be adopted it will push much of the current listed company governance and controls onto areas of the industry that have previously been free of such encumbrances.
- For the non-listed entities such governance guidance as the Directive offers is helpful. However, there is a concern that it is very prescriptive and far-reaching, such that it is unlikely to suit all. It will result in difficulties in application.

In the event that an organisation is listed, the governance challenges right now are around ensuring that the systems and controls in place are able to respond to the storm. These tend to be tested to their limits only when the storm is upon you and so making sure you keep your eyes on this as well as everything else cannot be avoided.

Equally, checking back with those engaged in oversight of your organisation is important; responding to ad hoc requests often takes longer than if they were known about in advance. Communication, along with anticipation, of additional information can be helpful. So for example some audit committees are now seeking direct contact with external property valuers, with the valuers attendance at audit committee meetings giving non-executives the opportunity to gain a wider understanding of the process involved and to ask direct questions (see the April edition of UK Real Estate Insights, 'Reporting property valuations: do you know the risk?' for more information on this particular issue).

For those involved in a currently unlisted environment, adherence to any industry guidance, for example if you are FSA regulated, clearly remains a key driver for retaining the confidence of your stakeholders. If you are currently unregulated then you have choices as to your approach to governance, but such choices may be removed in future. This may be driven by the EU Directive, but also in times of uncertainty, whatever financing or investment is available will focus on the organised, well-managed, proven and well-controlled business models. A robust controlled environment, which mitigates the risks, enables those engaged in managing the day to day to be confident that the business will continue, even with the focus having shifted to new areas of concern. Those in such a position are fortunate and will already have had time to amend their view of risk and flex controls to adapt. Those that were not so prepared will be finding life very difficult.

Therefore, revisiting your governance approach is a recommendation right now. Is it still fit for purpose in the current environment? Are you transparent enough in sharing your areas of concern with those involved in governing your organisation? Are your investors clear as to the risk profile you are adopting? All of these are pertinent questions that anyone running a real estate business should be able to answer without too much thought.

Whether you are currently thinking about starting a new venture or engaged in running an existing business, you ignore risk mitigation through controls and good governance at your peril; at some point it will come back and bite you very hard!

Erica Conway presented this session at the conference and is an Assurance Director in our real estate practice in London.

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