Fund management and governance

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Chapter 17 – Fund management and governance

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Introduction

In recent decades, poor or weak governance has been associated with many of the major scandals in the financial sector. Whilst there are numerous notorious examples in consumer finance (e.g. insurance, mortgage and pensions mis-selling in the UK), global investment banking (e.g. LIBOR rate fixing, biased stock advice during the dot.com bubble, money laundering) accounting and auditing practices (e.g. Arthur Anderson), corporate malpractices (e.g., Enron and WorldCom in the US, Olympus in Japan), such high profile cases have perhaps provided rather extreme examples of governance failures as well as involving criminal and fraudulent behaviour. Part of the explanation of the now infamous collapses of multiple major banks and other financial institutions in the global financial crisis (e.g. Royal Bank of Scotland in the UK, Anglo-Irish Bank in the Republic of Ireland, Lehmans and Bear Stearns in the US) has also been attributed to problems of corporate governance.

Whilst disentangling the causes of such major corporate failures can be complex, unethical and/or self-interested behaviour tend to be pervasive problems for and in organisations who are managing resources or funds on behalf others. Principal-agent and moral hazard problems have long been a noted feature of situations where individuals who act either as employees, advisors or managers are paid to use their efforts, to provide advice to or to act on behalf of another. Conflicts of interest can commonly arise since company directors, fund managers or external advisors are paid professionals with their own interests which may not necessarily be aligned with the interests of "principals". However, in a fund management context such conflicts of interest can be numerous and varied and can be hard to delimit. In a speech in 2012, the US Securities Exchange Commission's Director for the Office of Compliance Inspections and Examinations highlighted that:

> "Conflicts of interest exist throughout the commercial world. They are a particularly important challenge for large and complex financial institutions, which can have affiliations that lead to a host of potential conflicts of interest. If these are not carefully managed, this then leads to failure to protect the client's interests, with attendant regulatory and reputational risks that could be disastrous."

In the fund management sector, key issues tend to concern how funds and their boards (the clients of the fund manager) are informed of procedures for dealing with conflicts of interest, how such conflicts are handled and reported. In the funds themselves, board members, trustees and/or directors many also have conflicts of interest which may need to be recognised, recorded and supervised. Where asset management is outsourced, side-by-side arrangements involving the management of a number of accounts can create conflicts of interest where an investment manager may favour one account over another. Potential problems can occur where different fee structures may incentivise managers to prioritise certain clients. If the manager has co-invested in only some funds, there are clear incentives to favour the funds where they have more 'skin in the game'. Whilst less likely in illiquid real estate markets, investment strategies for one client may affect the performance of other clients. Cross-trading between clients also needs to be managed. Many approaches can be used to resolve such conflicts. With a range of costs and benefits, they can include firm or team specific trading strategies, creating ‘silos’ that limit information sharing about clients, mandatory consultation with compliance teams or oversight groups. As we shall see below, a primary concern of governance is with ensuring that the costs and risks potentially created by such conflicts of interest are minimised.

Although poor, negligent and sometime fraudulent real estate lending practices have been significant in headline making corporate banking scandals, a number of high profile governance failures have also occurred in the commercial real estate investment sector. Early in the 2000s, the so-called ‘Frankfurt real estate scandal’ involved a whole range of problems including systematic bribery of fund managers by real estate developers, architects and construction companies in order to obtain contracts and/or buy buildings on corrupt terms. For instance, buyers and sellers of real estate assets were found to have engaged the services of real estate agents *after* a sale was completed and to have then split the agent's fee among themselves. It was also suggested that bribes were paid among fund management organisations to corruptly influence the outcome and level of bids in sales transactions. In 2007-8 in the Netherlands, the Philips pension fund was investigated by the Dutch regulator. Sixteen real estate professionals were arrested and accused of being involved in an illegal scheme believed to have cost the Philips pension fund millions of Euros. The investigation focused on fraudulent real estate transactions involving internal asset managers agreeing relatively low values for assets with external valuers, before properties were sold to business connections. The properties were then later ‘flipped’ for the market value, with the price difference being divided between the participants. Of course, these examples are fairly extreme. In reality, individual and organisational self-interested actions will tend to be more subtle and nuanced. However, whilst the individuals themselves remain primarily culpable, the organisational decision-making and risk management processes that ‘permitted’ such behaviours are the essence of governance in the commercial real estate investment sector.

While the scope of these terms has been mutating and is contested, governance related issues are often central to the bundle of interrelated factors that are increasingly used to measure the ethical performance of businesses. In the last two decades, a plethora of acronyms such as ESG (Environmental, Social and Governance), CSR (Corporate Social Responsibility), RPI (Responsible Property Investment) and SRI (Socially Responsible Investment) have become increasingly mainstream within the real estate investment community. In this chapter, we explore how governance issues affect real estate investment markets and processes. In terms of outcomes, the empirical evidence on the relationship between governance performance and financial performance is reviewed. In the first section, the concept of governance is discussed and its key dimensions are identified. This is followed by a brief examination of the real estate investment sector identifying some of the key areas that need to be ‘governed’. Specific areas where governance issues emerge in real estate management, brokerage, appraisal and unlisted real estate fund management are discussed. There is, then, a discussion of the evidence and expectations regarding governance and investment performance in the listed real estate sector. Finally, conclusions are drawn.

Concepts of governance

The concept of governance is used in a wide range of contexts and has been described as a broad term that “can convey a slightly different meaning depending on who uses it” (Aubut, 2004, p.8). From a broad socio-political perspective, governance broadly concerns the rules and structures that societies use to organise themselves. Terms such as power, accountability, stakeholders, control, decision-making, authority, interests, risk management, equity and transparency tend to be central to theorisations of governance. On their website (https://iog.ca/), The Institute on Governance succinctly state that "Governance determines who has power, who makes decisions, how other players make their voice heard and how account is rendered". More specifically, *corporate governance* is concerned with:

> "the system of rules, practices and processes by which a company is directed and controlled. Corporate governance essentially involves balancing the interests of the many stakeholders in a company – these include its shareholders, management, customers, suppliers, financiers, government and the community. Since corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure."

The emphasis is then on the framework of procedures, regulations and guidelines by which senior management ensure accountability, equity and transparency in relationships with stakeholders such as employees, investors, suppliers and customers. This framework will often need to involve practices for managing the sometimes diverging interests of stakeholders. Its scope is influenced by different types of informal and formal contractual arrangements between companies and their stakeholders to configure the distribution of obligations and rewards. The basics of corporate governance structures consist of a board of directors who appoint managers and external auditors who are responsible for a range of decisions on disclosure of information to shareholders, board members and the public, remuneration of senior managers, and supervisory structures.

'Demand' for governance in the commercial real estate investment sector, like any other investment sector, is related to the largely inevitable incompleteness of contracts between the various stakeholders. Since it is usually not possible to fully allocate financial surpluses in every possible contingency, particularly in outsourced structures, contract incompleteness can create scope for opportunistic behaviour. Such problems tend to be exacerbated by the larger degree of asymmetric information. It is an inability to contractualise all possible contingencies that creates the need for some type of governance process. Rajan and Zingales (1998) identified two necessary conditions for a governance system to be needed. First, the relationship must generate some potential for abnormal gains from the transaction. Second, the abnormal gains are not perfectly allocated in advance. Without specific contractual terms, outcomes respecting the distribution of potential gains has to be determined during the period of the contract. This is essentially the role of the governance process.

In order to inhibit "agents" from taking decisions that favour their own interests, organisations tend to introduce checks and balances. Often attempts to achieve some element of separation of powers are at the core of governance. The emphasis of '*internal* (my italics) governance' tends to focus on setting organisations' objectives, risk control, organisational structure, the allocation of authority and responsibility, reporting lines, compliance and internal auditing. For instance, covering the financial services sector Article 22 of Directive 2006/48/EC, requires that:

> "every credit institution has robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, adequate internal control mechanisms, including sound

administrative and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management”

Clearly, the potential scope of governance is wide-ranging and contextual. The relative importance of the various dimensions of governance will vary with the nature of the relationships or processes that are being governed.

Governance and the real estate sector

Like most business sectors, the real estate sector can be analysed as a network of relationships, contracts, knowledge, capital and assets. Although in most real estate markets and with marked variations, a large proportion of real estate is owner-occupied, in many countries a substantial proportion of commercial real estate is owned directly by investors or indirectly by investors in various “pass-through” vehicles as a quasi-financial asset. These pass-through vehicles such as REITs and unlisted real estate funds are essentially asset management organisations. An important market shift in the last two decades has been the transformation in the range and scope of real estate investment organisations and their support service providers. In addition to the longstanding occupational pension funds, insurance companies and listed real estate companies, many of whom have themselves evolved significantly, relatively new categories of real estate investment organisations have become increasingly prominent. Sovereign wealth funds, specialist open and closed end real estate funds, investment banks, specialist real estate investment managers, private equity groups and endowments funds have emerged as significant market participants. Whilst sometimes engaging in real estate development, their core activities tend to focus on the assembly and management of portfolio of tenanted real estate assets.

Each type of real estate organisation will be exposed to different types of operational risk – the risk of losses stemming from inadequate or failed internal processes, people and systems or from external events – and will, therefore, focus on different aspects of governance. Whilst the boundaries between the different sub-sectors can be blurred as they sometimes attempt to enter their competitors’ markets, it is clear that the real estate investment sector comprises a variety of market operators with a range of different time horizons, investment objectives, client types, and business models. This diversity of asset managers and asset holders reflects the proliferation of intermediation in the investment chain. An array of intermediaries – nominees, ‘fund of fund’ managers, investment consultants, distributors, asset and property managers, appraisers – are part of the network of real estate investment principals and advisors that require internal and external governance. Both occupiers and investors need to procure a range of real estate support services from third parties in order to hold real estate assets. Whilst many organisations will deliver some support services ‘in-house’, acting for both investors and occupiers there is a sector of third party real estate services providers to whom many real estate support functions are outsourced. The main types include a wide range of real estate management, legal, brokerage and appraisal services. These organisations are important in that they are often the ‘instruments’ through which real estate investment policies are executed.

The nature of the governance issues pertinent to real estate investment will also be affected by the method of real estate investment. REITs and listed real estate companies share most of the regulatory and governance regimes with the broader listed sector. In the literature on REIT governance, the emphasis has consequently been on ‘standard’ governance variables such as board independence, disclosure, and insider ownership. Unlisted real estate funds represent one of the fastest growing real estate investment routes over the last two decades. They are often called ‘private’ funds since they are not quoted on any public exchanges. There are a large number of different fund structures which are based in a wide range of regulatory jurisdictions. As a result, it can be difficult to categorise and classify many of the funds in the unlisted sector. Across global real estate markets, there is a large array of unlisted, private vehicles (e.g. limited partnerships, trusts, private companies) with different legal structures in a range of regulatory domiciles that are used to pool real estate assets. After discussing some of the governance-related issues that can emerge in acquiring and holding real estate assets, we then look at governance issues in the unlisted and listed sectors in more depth.

Governance issues in the real estate management process

Like many other business sectors professional and industry body regulations are common elements of governance in the real estate sector. Professional bodies typically set standards of professional qualifications and practice and maintain databases of qualified persons. They confer the appropriate designations; provide guidance on conduct and practice, investigate grievances and misconduct penalties. Internationally, there are a variety of models for governing professional organisations who, in turn, are themselves part of the range of governance regimes that monitor and supervise real estate professionals. In the UK, and in a growing number of other international real estate markets, the Royal Institution of Chartered Surveyors (RICS) has been the most prominent professional body. There is an ongoing debate within the European Union about the balances between local and international regulation, state and voluntary self-regulation. In the UK, there has been a long tradition of professional self-regulation. The RICS is a good example of a self-regulating profession in the real estate sector. Whilst it is independent, significant changes to its constitution have to be ratified by the UK Government. The membership of The European Association of Real Estate Professionals provides a good database of the main professional associations in Europe.

In 2014, the RICS released the Real Estate Management Code. Many of the key principles of the code echo the governance concerns that are found in other areas. A number of the key principles are outlined. Real estate managers should:

> “ensure that clients are provided with terms of engagement which are fair and clear, incorporate details of complaints handling procedures [...] do the utmost to avoid conflicts of interest and, where they do arise, to deal with them openly, fairly and promptly […] ensure that all communications are fair, clear, timely and transparent in all dealings with clients […] ensure that any client money is held separately from other monies, and is covered by adequate insurance.”

Many of the themes in governance can be seen in apparently prosaic issues such as services charges (Common Area Maintenance fees in the US). Problems can arise from a basic conflict of interest between the owner’s concern with maintaining the property in the long term and the occupier’s shorter term perspective. The tenant typically does not want to pay for works from which they may derive little benefit. Not least because they may intend to vacate. In addition, compounding the misaligned incentives problem, the owner is typically spending the occupiers’ money and may have little incentive to ensure ‘best value’. A number of problems have occurred:

- Use of service charge income on capital expenditure to improve rather than maintain the asset.
- Poor procurement practices and failure to procure ‘best value’ providers of services.

- Failure to pass on commissions obtained on insurance policies to the occupiers.
- Where the service charge is 'bundled' with rent in a single payment, owners provide poor quality services in order to maximise their income.
- Inadequate justification of expenditure by the owner and/or poor transparency in costings.

The key issue requiring robust governance was summed up in a legal case in the UK. The judge stated that:

> "Tenants who agree to service charge clauses […] rely upon the professional people involved performing their roles with professional scrupulousness, diligence, integrity and independence and not in a partisan spirit, supposing their only task to be to recover as much money as they can for the landlord." (Princes House Ltd v Distinctive Clubs Ltd 2006)

The RICS Code of Practice for service charges in commercial property has become a key mechanism through which the service charge process is governed. It provides lengthy and specific guidance on a wide range of service charge issues. However, it is well summed up in the introductory section which states that:

> "In incurring costs in the provision of services, the manager is spending the occupiers' money. Managers are therefore expected to demonstrate a high degree of competence, professionalism, integrity, diligence, objectivity and transparency in dealing with the service charge accounts." (RICS 2014, p.6)

A key decision for investors in real estate investment portfolios is how to structure their procurement and delivery of property management – specifically whether to deliver in-house or to outsource to property management service providers. Anecdotal evidence suggests that, over the last two decades, it has become increasingly common for real estate investment organisations to outsource property management which many have come to regard as a non-core activity. Like many outsourcing arrangements, operational risks generated by principal agent issues have meant that the governance of this type of interfirm relationships has tended to involve a wide range of highly contractualised, control mechanisms. Outsourced property management agreements are used to set out in detail the specification of the service, pricing and financial performance penalties (or incentives), service levels and performance metrics, delegated decision rights and responsibilities, conflict resolution procedures and provisions for contract termination. For UK funds, key performance indicators – such as percentage of rent collected within three days of due date or percentage of service charge collected within three days of due date – tend to be the main mechanism of monitoring performance. In a market characterised by a limited number of large scale services providers, information leakage is an issue and investors/fund managers – themselves prone to conflict of interest problems – have had to ensure that they are comfortable with internal confidentiality procedures put in place by their providers who are often delivering similar services to other real estate investment organisations.

Governance issues in the real estate acquisition process

Buying and selling commercial real estate assets involves a process of exchange that occurs over an extended period and incurs risks and costs of a character and order that differ from those involved when trading mainstream equity and debt securities. This stems from the private and dispersed nature of commercial real estate markets and the fact that real estate assets are heterogeneous, with varying physical, spatial and legal characteristics. Buyers normally have to spend significantly more time searching for suitable assets and sellers normally must spend time attracting buyers. Often there are a range of professionals working in different organisations involved in the real estate stock selection and acquisition process – fund managers, researchers, asset managers, brokers and acquisition specialists. Individuals influencing stock selection and pricing decisions will be prone to different pressures and have a range of motivations which may, in turn, bias their actions and advice both consciously and unconsciously. For instance, Graff and Webb (1997) explain return persistence in real estate assets as a consequence of agency costs arising from incentives (bonuses, fee structures) for managers to acquire assets and to overbid for rarely available assets. In the UK, Gallimore, et al. (2008) identified a number of potential problems that investing organisations need to consider in governing real estate asset acquisition processes.

- Employed by third party firms, brokers acting for investors may be primarily motivated to generate fees from transactions rather than to ensure appropriate asset selection and pricing by their clients.
- Internally employed individuals who are responsible for the buying process for their investment organisation may be incentivised to acquire high quantities of stock rather than the high quality stock at appropriate prices.
- Fund managers who are remunerated on the basis of portfolio size may be incentivised to acquire assets in order to increase the size of the portfolio under management and, consequently, increase the size of their fee income.
- Fund managers often have to decide how to allocate high quality assets offered to them among different clients and may allocate assets to maximise benefits to themselves or their organisation rather than to their clients.

This is essentially a concern with different operational risks within the real estate asset acquisition process. Gallimore et al. (2006) concluded that, for large UK investing institutions, the real estate investment processes were relatively well governed. The potential for poor decision-making at the individual asset level was limited by a number of 'checks and balances'. Institutional buyers tended to be expert and were aware of brokers' misaligned incentive structures. They had, therefore, sufficient knowledge to critically evaluate brokers' advice. Brokers had counterincentives in terms of repeat business and potential reputational damage. Within the investing organisations, it was acknowledged that individual buyers should not be rewarded by volume of transactions. Their remuneration was normally linked to corporate and team performance rather than just individual performance. In addition, the decision-making process was invariably joint – initial recommendations and evaluations were closely scrutinised by fund managers and/or committees of senior, experienced experts. The central role of joint-decision-making in controlling operational risks is illustrated in Figure 17.1, which provides a schematic representation of the various participants in the real estate acquisition process for institutional investors.

[FIGURE 17.1 ABOUT HERE]

In institutional investment organisations, systems of consultation and approval are a vital part of operational risk management in the stock acquisition process. The fund manager is often the key pinch-point in the process. In consultation with the professional responsible for buying new stock, the fund manager typically contributes to the evaluation process. This tends to involve oversight of the testing of assumptions and modifications to cash flow models. Commonly, once a fund manager decides to pursue an acquisition, there are further formal layers of approval in place. Most institutional investment organisations have some form of investment committee comprising senior fund managers and, usually, the head of research who need to approve proposed acquisitions. Key issues concern how much delegated authority should be given to fund managers. These processes and delegated levels of approval are part of the investment management mandate agreed with the client.

The amount of client involvement in individual buying decisions will often depend upon the investment management agreement and the degree of discretion that this gives.

The demand from investors for high quality stock can produce moral hazard for sellers' brokers. Whilst it is difficult to demonstrate that there are systematic problems, anecdotes exist of various poor practices including acting for buyers as well as sellers, accepting inducements from buyer's to provide "inside information" on competitors' bid levels and/or providing biased advice to seller in return for tangible benefits from the buyer. The Investment Property Forum's (IPF) *Protocol on Open Market Investment Agency* provides a case study of a professional self-regulation model to handling conflicts of interest in the brokerage sector. The IPF identifies that:

> "The potential for conflict of interest has become a fact of modern investment agency. Such situations should always be managed proactively and transparently to ensure trust and confidentiality is maintained at all times." (Investment Property Forum 2014)

Common governance themes are outlined in the protocol focusing on clarity and fairness in terms of engagement, maintenance of conflicts of interest databases and reference to complaints-handling procedures and redress schemes. Most of the protocol is concerned with multiple introductions (where multiple individual agents in a firm 'introduce' an asset to multiple potential buyers) and dual agency (where other individual agents from the firm of the seller's agent acts also for the buyer). The protocol emphasises the role of a maintaining a *barriers policy* that seeks to ensure that *deal teams* from within the same firm acting for different clients on the same transaction have strict separation of information flows. Effective from 2018, the RICS released their own Professional Statement on *Conflicts of Interest – UK Commercial Property Market Investment Agency* (RICS, 2017) that addresses similar issues in the brokerage sector.

Governance issues in real estate appraisals

With broad implications for interrelated issues such as data quality, approaches to portfolio construction strategies and market performance measurement among others, a key feature of commercial real estate markets is the requirement for appraisals to act as substitutes for observed prices. For listed securities, the price of assets is observable and performance and values can be monitored in real-time. In marked contrast, given the absence of continuously traded and deep markets, real estate appraisals perform a vital function in real estate markets by acting as a surrogate for prices. Appraisers provide key information estimating the trading prices of real estate assets.

Appraisals may need to be commissioned for a number of purposes. A proportion consists of single, transaction-related appraisals in which the appraisal can be critical to the completion of the transaction. Periodic, repeated appraisals of the same asset tend to take place for investment performance measurement and for financial reporting. Typically, they are used as a metric to measure financial ratios and fund managers' bonuses. Clearly, when remuneration is linked to investment performance which, in turn, is based on appraisals; there are obvious incentives for fund managers to attempt to bias appraisals. Appraisals are also used to set unit pricing for unlisted real estate funds where bid and ask prices are set on a net asset value basis. Accurate appraisals are particularly crucial to this type of fund manager when demand to redeem units is high. In addition, appraisals can be used to assess whether investment funds or real estate companies that are geared are compliant with minimum loan-to-value ratios.

Similar to auditors, accountants, equity and rating analysts, real estate appraisers act as information intermediaries. In particular, they can add value by providing credible information related to financial performance. There is a large body of academic research on information intermediaries to suggest that their advice may not always be independent. For example for equity analysts, Lin and McNichols (1998) and Michaely and Womack (1999) found that analysts' recommendations were affected by their firm's business relationship with a company. In the real estate literature, there is a body of work that has identified different types of influence (coercive, covert, reward, information) of different categories of appraisal (transactional, periodic) at different stages of the process (instruction, information collection, calculation, reporting and so on). The vast majority of existing research has been either quasi-experimental (Hansz 2004; Amidu and Aluko 2007; Amidu et al. 2008), interview-based (McAllister et al. 2004; Crosby et al. 2004; Levy and Schuck 2005) or postal survey-based (Smolen and Hambleton 1997; Worzala et al. 1998; Gallimore and Wolverton 2000; Yu 2002). A stylized fact that emerges from this body of work is that appraisals are often not independent.

Most appraisers have anecdotes of attempts by clients to influence the outcome of an appraisal and, as noted above, the academic literature is replete with evidence of this influence. The appraisal process facilitates high levels of interference by clients. This ranges from the selection of the appraisers to the discussion of the outcome at draft appraisal meetings. The bonus structures of clients are sometimes based on short term outcomes tied to performance targets. Additionally, the fee structure of clients is also often tied to appraisal outcomes. In the bank lending sector, there are more stakeholders in addition to the lender such as brokers, other professionals and, possibly, providers of insurance, guarantees and indemnities. According to Crosby et al. (2010), even though the appraiser should have the aim to produce an objective independent valuation, they can be subjected to pressure by other stakeholders in the transaction (including the individual banker). They may all have a vested interest in the deal going ahead and a lesser interest in the performance of the loan and/or the asset.

This discussion raises issues of internal supervisory relationships within organisations including fee structures, appointing and reporting mechanisms between the appraiser and client, and professional supervisory processes and their effectiveness. In mature real estate markets, the requirements and conduct of appraisals are typically governed by a blend of governmental legislation and professional institutions. In the UK, the most important professional regulatory body is the RICS, which produces guidance on professional standards. The RICS (2012) states that appraiser must act independently and objectively at all times and their professional standards provide some examples of threats to their independence or objectivity. The valuation standards also identify the particular threat to objectivity of communication with a client before a report is produced:

> "A threat to the valuer's objectivity can arise where the outcome of a valuation is discussed before its completion with either the client or another party with an interest in the valuation. While such discussions are not improper, and indeed may be beneficial to both the valuer and the client, the valuer must be alert to the potential influence that such discussions may have on his or her fundamental duty to provide an objective opinion". (RICS 2012, VS 1.7, para 7))

Following problems of client influence in appraisals identified in the UK through academic research, professional regulatory requirements to record meetings on 'draft' appraisals were introduced, see Baum et al. (2000). After the Carsberg report in 2002, the RICS developed a compliance team to monitor client influence. However, to date we know little about how it is operating and whether it is effectively countering any influence issues which remain.

Governance issues in unlisted real estate funds

As noted above, a notable feature of the unlisted real estate sector is the diversity of the vehicles. In the UK, investment in unlisted real estate funds is generally undertaken through employing one of three legal formats: partnerships, unit trusts or companies. Broadly speaking, the range of funds can be seen as lying on a continuum in terms of size, trading volume, number of investors, sector focus, gearing and rigour of regulatory framework. The vehicles can range from joint ventures – vehicles with two or three investors pooling capital and expertise for a fixed period to acquire a clearly defined asset base – towards open-ended property funds with a high proportion of retail investors and a large portfolio of assets (in value and number). While joint ventures are normally customised towards specific investor needs, retail property funds can be highly regulated to decrease investor risk and, as a result, have relatively homogenised formats. Such diversity makes it difficult to generalise about the governance issues in unlisted real estate funds.

It is also clear that an investment in unlisted real estate funds will have different characteristics relative to a direct acquisition of the underlying real estate assets. These characteristics may be perceived as both negative and positive. Relative to direct ownership, there are significant differences in liquidity, trading and price formation, search costs, financial structuring, holding costs, management control, lot size, taxation and transaction costs *inter alia*. However, just as importantly, there will be significant inter-vehicle differences in all of the qualities listed above. Most of the unlisted real estate structures have in common the delegation of fund and asset management functions to third party managers. Whilst the length and size of the investment chain can vary, the result can be a range of potential misalignments of interests that need to be 'governed'.

Many of the potential moral hazards are implicit in the European Association for Investors in Non-Listed Real Estate Vehicles (INREV) corporate governance guidelines. INREV's corporate governance guidelines provide a useful and comprehensive description of the scope of the issues that can fall within the remit of corporate governance in the unlisted funds sector. Fuller details can be found in the INREV Guidelines. With apologies for such a lengthy list, the broad headings relate to provisions for:

- amendments to the constitutional terms of the fund agreement,
- handling of defaulting investors,
- composition of the investment committee,
- investor approval rights over third party service providers,

- vehicle documentation on control mechanisms and risk control procedures,
- codes of ethics,
- provision for manager removal,
- the extent, disclosure and pattern of co-investment,
- voting rights,
- the existence, composition and powers of a non-executive board,
- transparency and rights of investors to obtain information,
- quality and frequency of investment reports,
- rights to inspect accounts and records,
- investors' engagement with appraisals;
- use and appointment of external valuers,
- the use and disclosure of side letters or agreements,
- investors' rights in the event of changes to key personnel,
- fee and carry structures,
- protocols for conflicts of interest,
- exclusivity on investment opportunities and
- the terms of confidentiality clauses.

Even within some of these broad headings, there can be a numerous ways in which potential conflicts of interests between managers and investors need to be governed.

Governance and investment performance in the listed real estate sector

From the conceptual discussion of governance above, it is clear that an expected outcome of good governance is expected to be improved financial performance mainly through reduced risk and better risk-adjusted performance. Improvements in financial performance can be directly linked to rationales for allocating resources to high quality governance. Governance has been analysed through a number of theoretical lenses which generate contrasting expected relationships between governance performance and business performance. For instance, instrumental stakeholder theory stresses the contribution of relationships with key stakeholders (other than shareholders) such as employees, suppliers, unions, customers and the local community to business performance. Closely related stakeholder–agency theory emphasizes how high quality governance can reduce the agency costs within corporate structures by improving interest alignment and monitoring of the actions of employers, managers and employees. Similarly, firm-as-contract theory also highlights the significance of, often implied, contracts with stakeholders as drivers of firms' financial performance. Hence, the expected causal relationship is that the quality of governance should be a determinant of business performance.

In contrast, slack resources theory implies the opposite relationship – that business performance is a determinant of the quality of governance. It proposes that surpluses generated by strong prior business performance release resources for governance activities. While theories are often presented as mutually exclusive, it is possible that, similar to issue of motivation, the relative importance of resource availability and the salience of relationships with stakeholders may vary between sectors or firms and/or over time. Russo and Perrini (2010) reports that firm size is a decisive factor and argues that a social capital approach is more relevant for understanding governance commitments of SMEs whereas stakeholder theory is more apt for explaining the actions of large firms.

The mechanism by which a strong commitment to good governance is value adding in terms of improved corporate financial performance can be difficult to disentangle. The direct costs of allocating capital to governance activities are relatively straightforward to measure. The direct costs are associated with the implementation, monitoring and reporting of governance processes. Indirect costs are also produced by the rejection of potential profitable business opportunities that may conflict with good governance-related objectives. It is not axiomatic that benefits are dominated by costs. Analyses of how corporate governance performance affects corporate financial performance in terms of returns, risks and company value tend to focus on more nebulous (but possibly no less important) factors. Linking back to stakeholder and firm-as-contract theories, the arguments for a positive effect on financial performance tend to emphasize increases in relational wealth, see Luo and Bhattacharya (2009). Factors broadly related to trust, such as increased transparency and reduced information asymmetry, may create reputational and branding benefits that improve key relationships with employees, shareholders, customers, suppliers and the community. A strong governance commitment implies more information about the expected cash flow distribution, reduced principal-agent costs and lower investors' risk premium. More directly, the cost of capital may be reduced as well-governed firms may be prepared to place a lower risk premium on well-governed businesses.

Clientele effects are another possible mechanism by which governance performance may lead to a range of different effects on prices, returns and risk. The key transmission mechanism is that a decrease in the size of the investor base produces a neglect effect associated with exclusionary screening, lower demand for interests in poorly governed investments, a consequent negative effect on prices and a positive effect on returns. The body of work on the performance of securitized SRI funds is broadly consistent with underperformance in terms of returns (Bauer et al. 2005; Geczy et al. 2005; Renneboog et al. 2008). The outcomes are a higher cost of capital and lower security prices for 'sin' stocks, albeit their returns can be higher. Another strand in this argument focuses on the role of differences in investor beliefs about the expected performance of well and poorly governed investments. One argument is that that good corporate social performance sends a signal of high quality management.

In the listed real estate sector, transparency and disclosure in financial reporting have been highlighted as key governance issues. Creating potential adverse selection problems, a lack of transparent financial information can result in greater information risks for investors who, in turn, experience increased uncertainty about the true economic value of the firm. Without sufficient controls and monitoring, investors will tend pay the same prices for 'lemons' and 'good' companies. In this context, the European Public Real Estate Association's (EPRA) Best Practice Recommendations (BPR) on financial reporting can be interpreted as an association-based mechanism that is intended to improve corporate governance in the listed real estate sector and reduce the information risk borne by investors. The BPR guidance from EPRA attempts to standardise many financial performance metrics and to overcome discrepancies in reporting within the European real estate sector with the intention of improving the consistency and transparency in financial reporting. In the US, in a study of the effect of similar industry initiative by NAREIT on reporting of *Funds From Operation*, Baik et al. (2008) found that industry guidance curtailed manager opportunistic reporting and investors perceived less manipulation and greater reliability.

Such agency problems may have two effects on a firm's stock price: they can influence expected cash flows accruing to investors and the cost of capital (Drobetz et al 2004). It is expected that the extent of these effects will depend on the quality of governance. There is a substantial body of theoretical work to suggest that high quality financial information can reduce the cost of equity capital by increasing market liquidity or increasing the demand for a firm's securities and by reducing investors' information risk reducing shareholders' monitoring and auditing costs. Whilst it is possible to hypothesise various linkages between governance and investment performance, empirical evidence or any effort towards ascertaining that is fraught with formidable challenges. Part of the difficulty relates to the fact that there are so many complex links in the causality chain. Does quality of governance affect investment performance or does quality of investment performance affect quality of governance? Is there a self-reinforcing pattern – does an improvement in business performance cause an improvement in governance which causes further improvements in business performance and so on? Alternatively, is there an omitted variable that is causing both improvements in both investment performance and governance performance? Such issues create difficult problems for researchers attempting to address the research question – All else equal, what is the effect of governance performance on investment performance? The other part is the severe lack of good-quality information and data on aspects of the whole process. Whilst quality of governance is at least measured for listed firms, there are few such measures for many other real estate investment organisations.

A particular problem of research on corporate governance is the measurement of governance performance. Researchers have focussed on individual variables such as remuneration, board independence and insider ownership. There are also a number of composite indexes that attempt to measure corporate governance performance. Although governance can be quite broad in scope by itself, it is often bundled with a number of other activities (social and environmental) as a corporate attribute. It is then blended with other measures of corporate environmental and social performance to create Environmental, Social and Governance (ESG) performance metrics. Whilst incorporating a large number of variables, in the listed sector the key category headings in corporate governance performance tend to focus on disclosure and auditing, remuneration, board structure and shareholder rights with numerous sub-categories. It is notable that a number of 'rating the ratings' studies have found that different indices are corporate governance can be weakly (and sometimes negatively) correlated with each other, see Daines et al. (2010) and Brown and Caylor (2006). Variation between the various governance indices has been explained by a lack of consistency and theoretical justification for the inclusion and weighting of different variables in the different indices. Clearly, the quality of governance can then be difficult to measure.

Inconsistency in empirical findings regarding the relationship between governance and corporate financial performance has been attributed to the range of metrics of corporate financial performance used. This does not include operational performance issues such as staff turnover or numbers of patents. A key problem is that there are large variations in the timescales in the transmission of the governance activities to different outcomes. Share prices can be affected by new information on governance almost instantaneously. However, the lags and processes between improvements in governance and improvements in profitability or turnover are likely to be much more lengthy and intricate.

Governance and investment performance: some evidence

Outside of the real estate sector, there is a voluminous empirical literature examining whether corporate ESG performance predicts corporate financial performance. Not surprisingly, it has produced an assortment of findings (for reviews see Orlitzky et al. 2003; Margolis et al. 2007;

van Beurden and Goessling 2008; Cai et al. 2011). While a detailed review of this literature is outside the scope of this chapter, it is clear that the topic is fraught with problems due to potential publication bias, differences in sampling periods and potential endogeneity of corporate ESG performance. Ruf et al. (2001) propose that causes of the identified lack of consistency in empirical studies include weak theoretical foundations, inadequate and inconsistent measurement of corporate ESG performance and corporate financial performance, weak methodology and sampling problems. In direct real estate, poor data is also a key issue.

Supporting the theoretical predictions regarding information disclosure, there is also substantial empirical evidence that disclosure quality or earnings transparency lowers firms' cost of capital. A number of studies have found a negative relation between various proxies for disclosure quality or earnings transparency and cost of equity capital (Botosan 1997; Botosan and Plumlee 2002; Bhattacharya et al. 2003; Barth and Landsman, 2003; Francis et al. 2004). There is also a fairly established body of research suggesting that discretionary disclosure lowers the cost of debt (Sengupta 1998), increases stock liquidity, stock performance and institutional ownership (Healy et al. 1999), increases analyst following (Lang and Lundholm 1996) and decreases bid-ask spreads (Welker 1995). Essentially, transparency and disclosure in financial reporting and corporate governance may enable companies to signal quality in management and control. These signals may have a potential to lower agency costs by reducing conflicts of interest and investors' costs of monitoring management and searching for information.

Given the greater availability of data, it is to be expected that the vast majority of the empirical work on the relationship governance and performance has been in the listed real estate sector – and mainly on the US real estate listed sector. There is a body of work, most of which looks at US REITS on the relationship between corporate governance and firm performance (Ghosh and Sirmans (2001 and 2003); Feng et al. 2005; Bauer et al. 2010; Bianco et al. 2007; Hartzell et al. 2008). In most of these studies, the researchers tended to focus on individual governance variables in order to identify which of the conventional corporate governance mechanisms, be it board size and independence, insider ownership, ownership concentration play a significant role in the governance structure of US REITS and the REITs performance and market value. Results have been mixed. Bauer et al. (2010) used an index of governance strength rating as proxy of corporate governance system and examine its relationship to the performance of US REITs. They failed to find that corporate governance had a significant influence on REITs' performance. They suggest that, since the result contrasts with previous findings from studies of wider corporate performance, due to requirement to distribute at least 90% of operational earnings there are reduced agency costs for REITs and governance is, consequently a less important factor.

In these studies, financial disclosure transparency by US REITs as one of the corporate governance variables was not explicitly examined, although it is an important governance issue. In the European listed sector, Muller et al. (2011) examined the effects of the adoption of IAS 40 on fair value reporting in the European listed real estate sector using bid-ask spreads as the dependent variable. They argued that this allowed them to assess perceived differences in information asymmetry across investors and thus directly measure the impact of fair value reporting on the information environment. Comparing mandatory provision of fair value information to voluntary provision, they found that mandatory adopters experienced a larger reduction in their information asymmetry as indicated by lower bid-ask spreads—following the adoption of International Financial Reporting Standards. This evidence is consistent with the improvement of the information environment for investors by mandatory provision of fair values. However, they also found that differences in bid-ask spreads persisted. In the post-IFRS adoption period, firms that did not provide investment property fair values prior to IFRS continue to have higher bid-ask spreads than firms that did. This was interpreted as being consistent with investors continuing to have concerns about the reliability of mandatory adopters' fair value disclosures due to the variation in those firms' institutional structures and implementation.

Kohl and Schaefers (2012) is probably the most relevant and robust previous empirical study of European listed property companies. They test whether the principal corporate governance mechanisms such as board size and independence, insider ownership, institutional ownership have significant effects on book-to-market ratio. They also include a disclosure variable, a self-constructed transparency index based on the EPRA Best Practice Policy Recommendations as one of the significant corporate governance variable. They find a significant positive effect of better disclosure and firm value as measured by book-to-market ratio. However, it is notable that they do not include controls for variables that may affect book-to-market ratios such as focus on real estate development as opposed to investment assets.

Conclusion

One of the main difficulties of analysing governance in the context of real estate markets is that it is such a broad, multi-dimensional, even nebulous, concept. Perhaps it is too obvious a point to make but it may be worth reiterating that problems of misaligned incentives, moral hazard and conflicts of interest are far from unique to commercial real estate markets and tend to raise difficult issues for all public and private sector organisations. Governance in this commercial context is mainly about identifying and mitigating the potential costs of such problems. In different contexts, different emphasis tends to be given to different aspects of governance. Even when the concept of governance is explicitly defined in order to evaluate its quality, there are major challenges in then measuring and quantifying it. In a commercial real estate investment market characterised by chains of intermediaries and typically outsourced support services such as brokerage, appraisers, asset managers, and fund administration, mitigating principal-agent costs can become a key business performance issue.

A number of features seem to be at the heart of the concept of good governance. Broadly the focus is on the protection of the interests of 'principals' such as investors, trustees, and clients from self-interested behaviour by 'agents' such as fund managers and service providers. Aspects of governance such as fairness and equity are essentially concerned with normative ethics. The typical stress on communication, transparency and disclosure can be interpreted in the context of mitigating problems of information asymmetry. The emphasis of codes, guidance, procedures and processes that are related to the identification and management of moral hazards. Robust governance should then produce reductions in operational risk, improvements in quality assurance and decreased potential for reputational damage. A whole range of approaches to oversight and formal and informal regulation are used. Oversight can typically involve joint decision-making with peers, audits and independent directors. Procedures and processes are often governed by professional or internal codes of practice and/or guidance. There are then strong grounds for expecting a positive relationship between good governance and business performance. The level of disclosure is expected to be negatively associated with information risks and monitoring costs for investors. Robust risk management procedures tend to be regarded positively by investors since they should make the organisation more resilient to external shocks. Fairness and equity with key stakeholders is expected to build trust with stakeholders with the literature highlighting the multitude of benefits that trust can create for firms.

Clearly there are good reasons to expect a positive relationship between governance and business performance. However, even where data are available, there have been major challenges in investigating the relationship between governance and business or investment performance. Given the multitude of factors that determine the performance of a listed company and the often intricate linkages between these factors, it can be difficult to isolate the effect of a single variable such as governance. It is also worth bearing in mind that governance metrics are usually based upon a composite measure of a range of attributes such as the quality of disclosure and board independence. It is notable that different governance metrics can produce quite different rankings. Perhaps more problematically, in private commercial real estate investment markets many of the governance issues have remained relatively unscrutinised in terms of research.

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