AI Governance as Capital Efficiency: Implica for Private Equity Stakeholders

The 2025 Autumn Governance Series

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SEP 29, 2025

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Reframing Risk: From Defensive Compliance to Investment Alpha

Private equity has traditionally treated governance as a defensive shiel been about avoiding penalties, limiting reputational exposure, and sati regulators with minimal disclosure. That mindset no longer suffices. T of artificial intelligence (AI) has introduced what might be called *algori materiality* — the idea that algorithms now shape material financial ou

The thesis is simple: AI governance is no longer a matter of reputation management. It is a lever of **capital efficiency.** AI is embedded in the mechanics of private equity — deal sourcing, receivables forecasting, l and tax planning. Each of these use cases can produce efficiencies tha improve fund performance. But these gains are fragile unless they are governed.

Governance is the mechanism that transforms potential volatility into efficiency. It is what converts a promising model into a reliable tool. AI governance is not abstract. It is operational. It involves standards, proc and controls that ensure AI is accountable, auditable, and strategically with financial goals. For private equity, that means focusing on three d

- **Data governance:** ensuring inputs are accurate, compliant, and trustworthy.
- **Model governance:** validating algorithms, explaining them to stakeholders, and monitoring for drift.
- **System governance:** documenting deployment decisions, maintain oversight, and preserving reversibility.

Boards must recognize that short-term AI wins without governance g hidden liabilities. Over time, these liabilities crystallize into technical c regulatory risk, and suppressed exit valuations. Conversely, well-gover implementations create efficiencies that are durable, defensible, and transferable at exit. Governance is therefore not only about *protecting* but about *compounding it.*

The Performance Gap: How Governance Maturity Differentiates Fund Returns

A widening performance gap is emerging between managers who trea governance as fiduciary and those who see it as compliance theatre.

Limited Partners (LPs) are already recalibrating their expectations. His returns matter, but increasingly, LPs are prioritizing operational trans and governance maturity. Many LPs are willing to walk away from man who cannot demonstrate credible oversight of their operational platfo their eyes, governance maturity has become a proxy for whether effici claims are durable or cosmetic.

When governance is weak, the consequences are not theoretical. Late model failures — such as hidden bias in HR screening or algorithmic d logistics forecasting — do not remain buried. They surface in the form discrimination claims, regulatory inquiries, or sudden liquidity shocks. a portfolio, these failures compound, leading to higher insurance costs increased audit scrutiny, and valuation discounts.

For boards, this means AI oversight is not a “nice-to-have.” It is a fiduc concern. Failing to oversee algorithms is equivalent to failing to overse capital structure or liquidity management. Directors must demand reproducible processes, audit trails, and documented decision paths. Standards such as the NIST AI Risk Management Framework provide a roadmap for translating broad principles into verifiable oversight.

The Fiduciary Duty of AI Oversight

As algorithms increasingly determine logistics, tax filings, and even pe decisions, they become material financial assets. The integrity of these systems cannot be delegated solely to management. Boards have a fidu duty to demand clear governance artifacts: model documentation, mo reports, fairness assessments, and decision logs.

Regulatory trends reinforce this duty. The U.S. Securities and Exchang Commission (SEC), for example, has designated a Chief Artificial Intelli Officer. While private equity is not yet subject to prescriptive AI rules, regulators’ internal prioritization signals what is coming: heightened expectations that all financial actors demonstrate structured AI oversi

For directors, the message is clear: AI oversight is now part of fiduciar responsibility. The failure to demand governance artifacts is the failure protect fund assets.

Quantifying Governance — Risks and Returi Across the Investment Cycle

Deal Sourcing and Due Diligence

AI governance begins before acquisition. In due diligence, the questior longer just whether a target's technology is modern, but whether it is **governable.**

Generative AI is already changing deal sourcing by enabling rapid anal vast datasets. In diligence, AI allows teams to stress-test a target's clai building prototypes that replicate or challenge the company's models. increases decision-making speed and precision. But the value of this capability hinges on governance: if a target's models are undocumente auditable, or dependent on opaque vendors, what looks like an asset m actually be a liability.

Poorly governed AI in a target company can become a hidden liability, creating exposure to regulatory penalties or reputational harm. Conve clean, auditable AI governance record reduces risk and increases buye confidence. Governance maturity thus becomes an unpriced asset at acquisition.

Value Creation in the Holding Period

During the holding period, governance converts technical promise int financial outcomes.

The critical shift is linking technical metrics to business results. Accur percentages mean little unless they translate into measurable busines improvements. Governance ensures that business results are **reprodu and credible.** For example, improvements in working capital managem must be shown not as one-off gains but as durable efficiencies backed model monitoring and data provenance.

Governance also reduces audit exposure. When tax credits or complia filings are supported by clear documentation, disputes are minimized confidence is strengthened. Insurers, auditors, and regulators increasi for governance evidence, and firms that can provide it face fewer chall and lower overhead.

The balance for management is between control and velocity. Too mu oversight can slow deployment. Too little invites risk. Governance fran embedded in MLOps pipelines — continuous testing, versioning, reproducibility — strike the balance by automating oversight. The key proportionality: directing governance rigour toward high-risk systems streamlining oversight for lower-risk applications.

Exit and Valuation Defence

At exit, governance maturity becomes central to the equity story. Buye longer accept efficiency claims at face value. They ask: *Can these claim audited? Can they survive regulatory scrutiny*?

Without verifiable governance, buyers apply discounts. They cannot af
inherit opaque systems that may carry regulatory risk. For mid-marke
PortCos, the cost of implementing explainability and audit trails may f
onerous. But the cost of failing to do so is far greater: suppressed mult
drawn-out negotiations, and reduced buyer confidence.

The mandate is clear: investing in governance is an essential compone
exit preparation. It protects valuation and strengthens buyer trust.

The Structural Costs of Negligence

Navigating the Global Regulatory Maze

The regulatory landscape is tightening. The EU's AI Act creates strict
obligations for high-risk AI systems, many of which map directly to co
PortCo use cases — HR, logistics, and financial services. Compliance fa
carry steep costs: heavy fines, restricted market access, and reputatio
damage.

The U.S. landscape is more fragmented, but momentum is growing. Th
approach for global managers is to design governance to meet the hig
standards — often European — and apply them consistently. This avoic
fragmented compliance regimes and positions the fund as a trustwort
operator across markets.

Vendor Risk

Third-party AI vendors are often the weak link. When a Portfolio Com
(PortCo) relies on a vendor's opaque system, it inherits risk without co

exit, the inability to audit or explain a vendor system becomes a liabilit

GPs must therefore treat vendor contracting as risk management. Con must mandate audit rights, transparency, and indemnification. Withou PortCos incur what is effectively operational debt. The cost of buying replacing a vendor midstream is far higher than negotiating transpare upfront.

Insurability and Risk Transfer

Insurers are recalibrating their models to account for AI. Strong gover frameworks improve insurability, reduce premiums, and expand cover Weak governance raises costs and restricts access.

Boards should see governance not only as regulatory compliance but a insurance strategy. A governance framework that satisfies regulators v usually satisfy insurers as well, reducing the cost of risk transfer.

Stakeholder Mandates and the Governance Maturity Curve

Boards of Directors

Boards would benefit from formalizing AI oversight as a core duty. Auc Risk Committees should require governance artifacts — model documentation, fairness checks, and monitoring reports. Without arti claims of efficiency are speculative. With them, they are credible.

Limited Partners and Funds of Funds

For LPs, governance maturity is a new alpha signal. Due diligence questionnaires (DDQs) must evolve to demand AI-specific evidence: m drift reports, explainability documentation, and vendor audit clauses. can add value by benchmarking governance maturity across managers identifying systemic risks, and curating higher-quality opportunities.

General Partners

GPs must cascade governance standards across PortCos. Articulating principles without enforcement is insufficient. A risk-tiered approach stringent governance for high-risk systems, lighter-touch automation low-risk. This ensures discipline without stifling efficiency.

Family Offices

Family offices, often concentrated in growth-stage companies, face el exposure. Their mandate is to require governance artifacts — audit rig model documentation, and alignment with recognized frameworks. Do protects downside and signals professionalism, making them more att co-investors.

The Governance Maturity Curve

Funds fall on a spectrum from reactive (oversight only after failure) to strategic (governance embedded across the lifecycle). Strategic funds credibly present governance maturity as evidence of disciplined mana reassuring LPs, securing favourable insurance, and defending exit valu

Tactical Implementation — A 12-Month

Roadmap

- **Months 1–3:** Formalize governance mandate at board level; invento use cases; define required artifacts.
- **Months 4–9:** Harden systems and vendors; negotiate audit rights; external assessments; align insurance and regulatory strategies.
- **Months 10–12:** Integrate governance metrics into reporting; demo improvements to boards and LPs; institutionalize MLOps pipelines

A Narrowing Window

AI governance is not an administrative burden. It is a material determi performance and credibility. Boards that ignore it will see assets penal LPs withdraw, and insurers increase costs. Boards that formalize overs enforce standards, and demand verifiable evidence will capture compo advantages.

The competitive window is closing. Early adopters are embedding gov maturity as capital efficiency. Others must follow, or risk being left bel

This article explores ideas from “Shaping the Decade: Governance, Sustainability, and AI 2026–2036,” a comprehensive guide for boards navigating the intersection of governance, technology, and stakeholde capitalism. For those ready to learn more about AI, this book offers pra strategies and insights.
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