LSE Works: Financial Markets Group public lecture

Corporate Boards: facts and myths

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Suggested hashtag for Twitter users: **#LSEworks**

Corporate Boards: Myths and Facts

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- Interdisciplinary group
- Housed at the Financial Markets Group (FMG)
- Dedicated to the rigorous analysis of Corporate Governance issues
- Runs a series of regular events
- Check out CG Research Debates schedule
  - Brings practitioners and academics together
  - Free!

Corporate Boards: Myths and Facts

- Myth: What I think is false.
- Fact: What I think is true.
- Myths are mostly backed by no evidence, or by highly-selective, academically-suspicious evidence.
- Facts are backed by evidence that most would consider credible.

Five Corporate Governance myths

1. Unconstrained managers, helpless owners.
2. Boards don't matter.
3. The lapdog board.
4. The watchdog board.
5. One size fits all.

Myth #1:

Unconstrained managers, helpless owners

Facts

- Most companies around the world are closely owned and run by the same individuals, families, and governments.
- No meaningful distinction between managers and owners in such cases

In countries where large firms are owned by dispersed shareholders (UK and US, mostly), there exists a number of governance mechanisms:

- Boards
- Shareholder activism
- Proxy contests
- Takeovers
- Laws and regulations
- Media
- Reputation
- Stakeholder governance (creditors, customers, employees)
- Competition

Myth #2:

Boards don’t matter

Facts

- Sudden deaths of some directors affect stock prices.

- Directors of firms that experience proxy contests find it difficult to obtain additional board appointments.

- In China, the hiring of directors with foreign experience improves their firms' performance.

Myth #3:

The lapdog board

Explaining the myth

- Directors rarely vote against management.
- Disagreement inside the board is hard to document.

Facts

- About half of directors that publicly announce their resignations leave while criticising the firm.
- Even in China (where votes have to be disclosed) independent directors disagree with management!
- CEO turnover is more sensitive to performance if the board is more independent.

Myth #4:

The watchdog board

Explaining the myth

- Boards only have one role: To monitor the CEO and other top executives

- Some boards may be lapdogs, but they should be watchdogs instead.

Problems with the watchdog view

- It doesn’t recognize that boards perform multiple functions:
  - They monitor management.
  - They advise management.
  - They provide connections with the external environment.

- It doesn’t recognize that tough monitoring is not always good.

Costs and benefits of *Friendly Boards*

Adams and Ferreira (2007) argue that friendly boards are sometimes optimal, especially when the advisory role of boards is very valuable.

Facts

- Survey evidence that CEO-director friendship ties improve communication.
- Evidence that director independence worsens performance in some firms.
- CEOs are fired too often for reasons outside their control.

Myth #5:

One size fits all

What makes an effective board?

The typical answer:

- A list of attributes:
  - Independence
  - Experience
  - Industry/financial/legal expertise
  - Education
  - Diversity
  - Political connections
  - Etc.

The typical approach:
Performance follows structure

Examples:

- Does board independence improve firm performance?
- Do small boards improve firm performance?
- Does board gender diversity improve firm performance?

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What has the literature found?

- Characteristics of effective boards:
  - Independent
  - Industry Expertise
  - Small
  - Connected
  - Reputable
  - Comprised only of CEOs
  - With at least three women
  - With no "busy" directors
  - No foreigners allowed!

What makes an effective board?

An alternative answer

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What makes an effective board?

- A list of forces or conditions:
  - Financial incentives
  - Reputational incentives
  - Ethical motives
  - Laws and regulations
  - Media
  - Behavioural biases
  - Markets and Competition
  - Etc.

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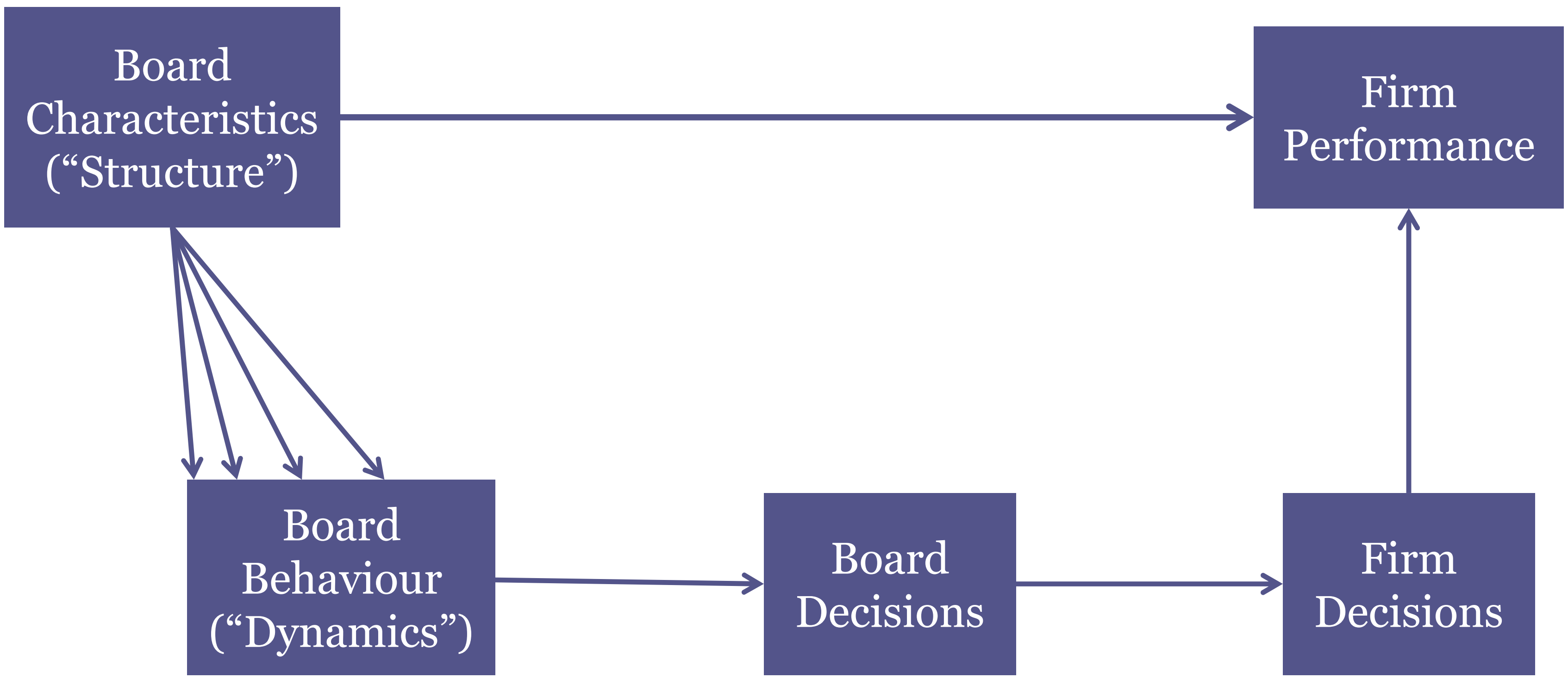
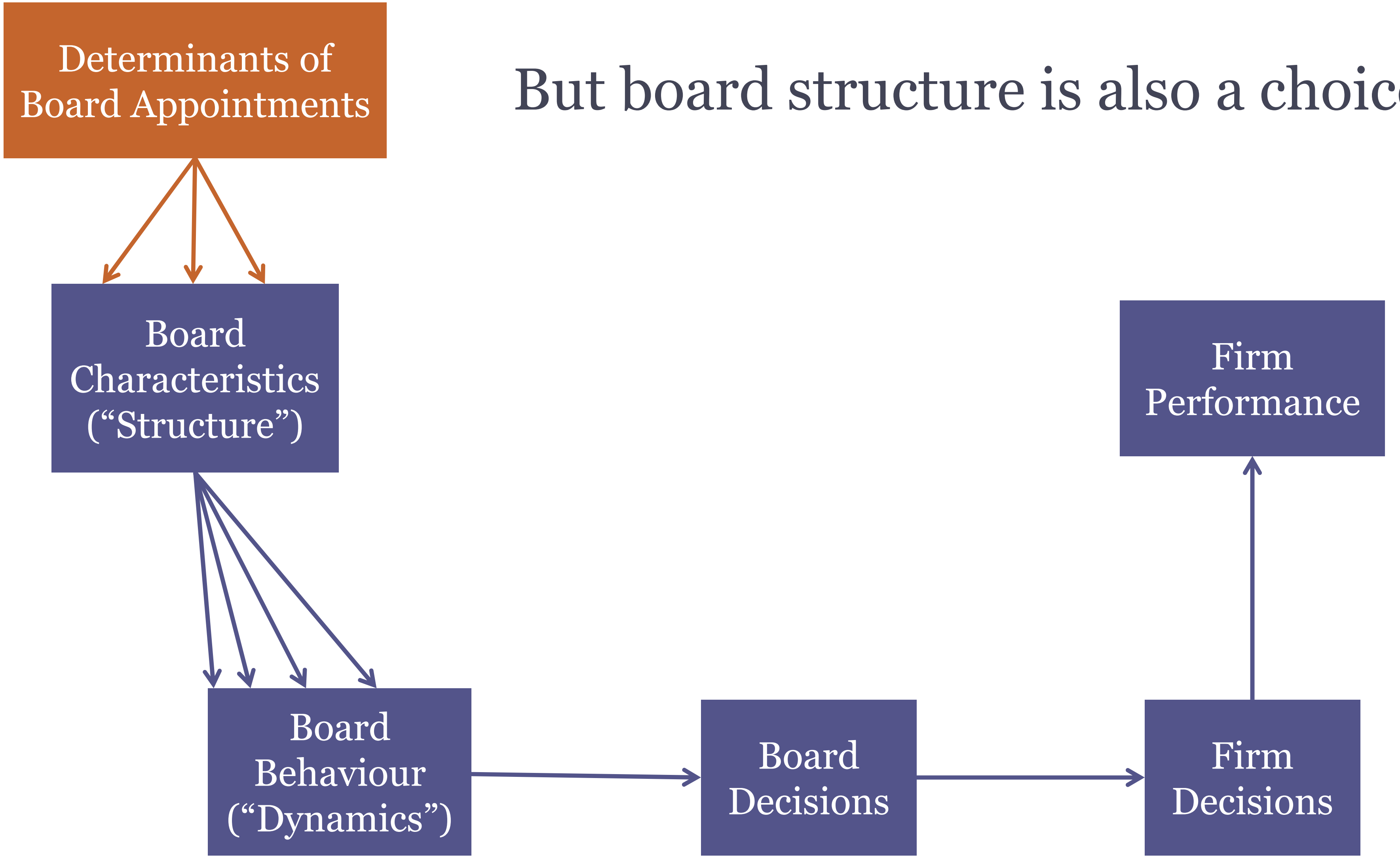
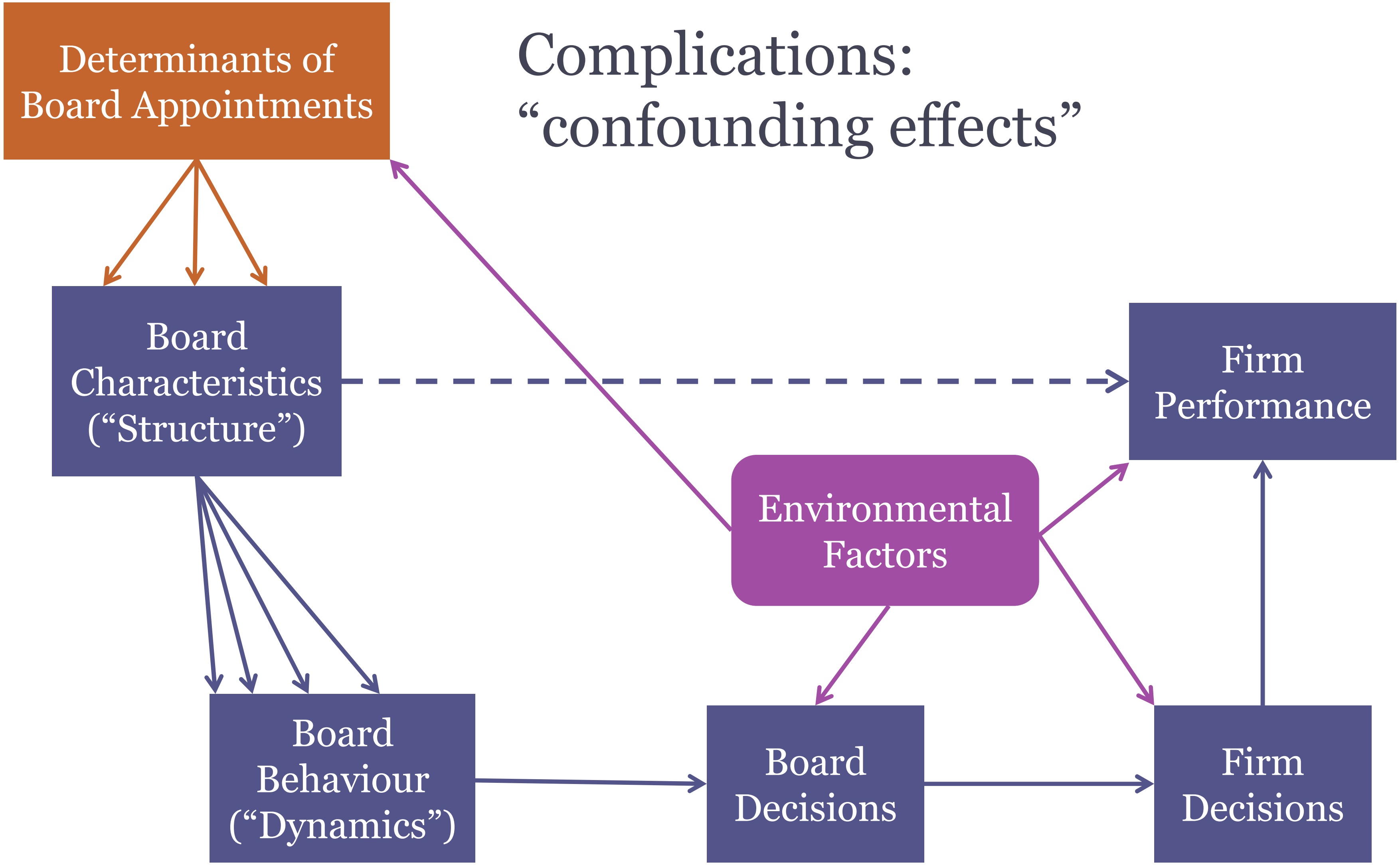
The longer road: “Channels of influence”



But board structure is also a choice



Complications: “confounding effects”



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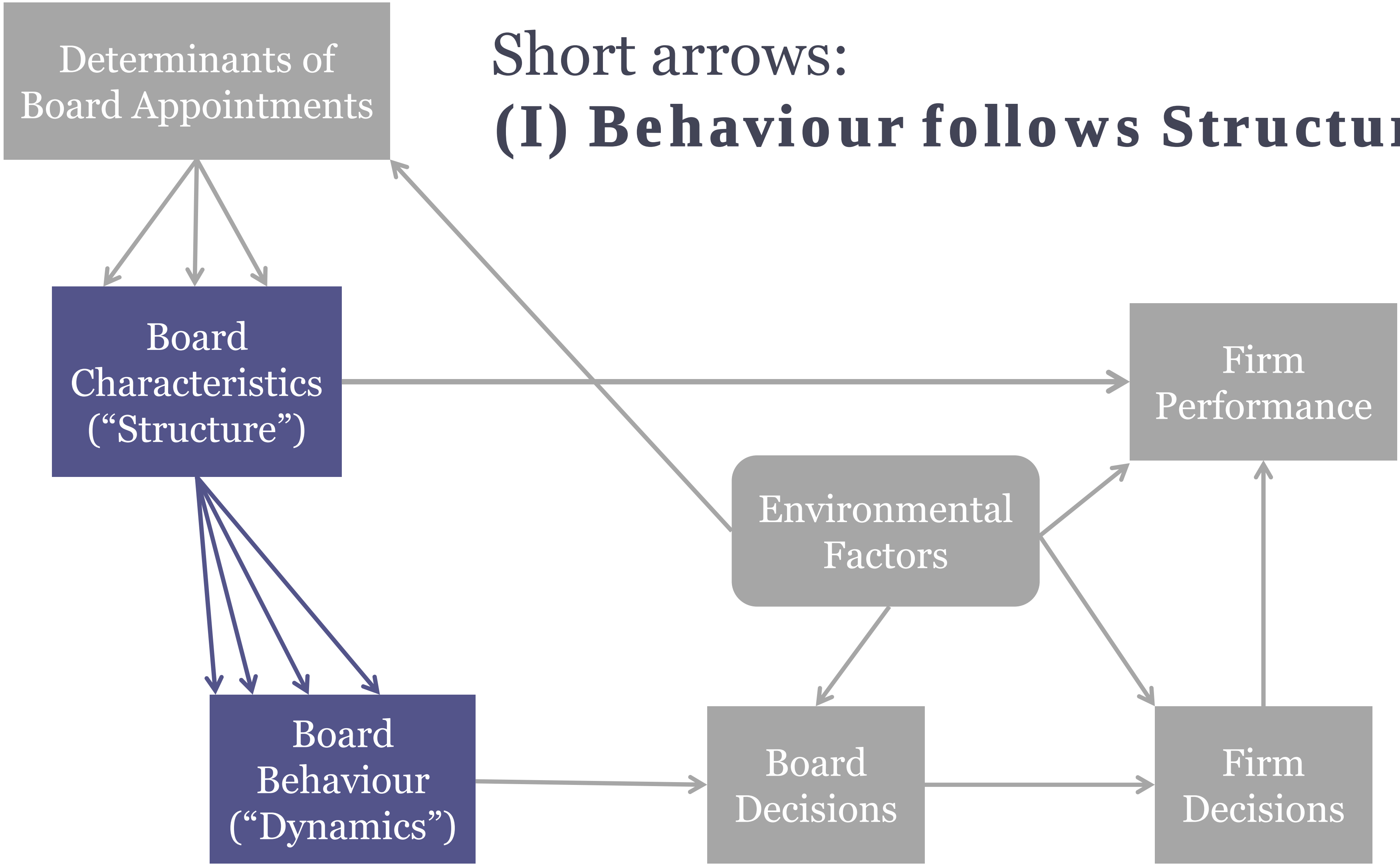
Short arrows:
(I) Behaviour follows Structure



Example: Attendance Behaviour

"It's a tough call. We have enough people to vote on the proposal, but not enough to do the Wave."

Fact

Average board meeting fee in S&P 1500 firms from 1996 to 2003 (in 2003 US dollars):

$1,014

But…

Meeting fees ↑ by $1000 →
Attendance problems ↓ by ~10%
(most conservative estimate)

From Adams and Ferreira,
“Do Directors Perform for Pay?” (2008)

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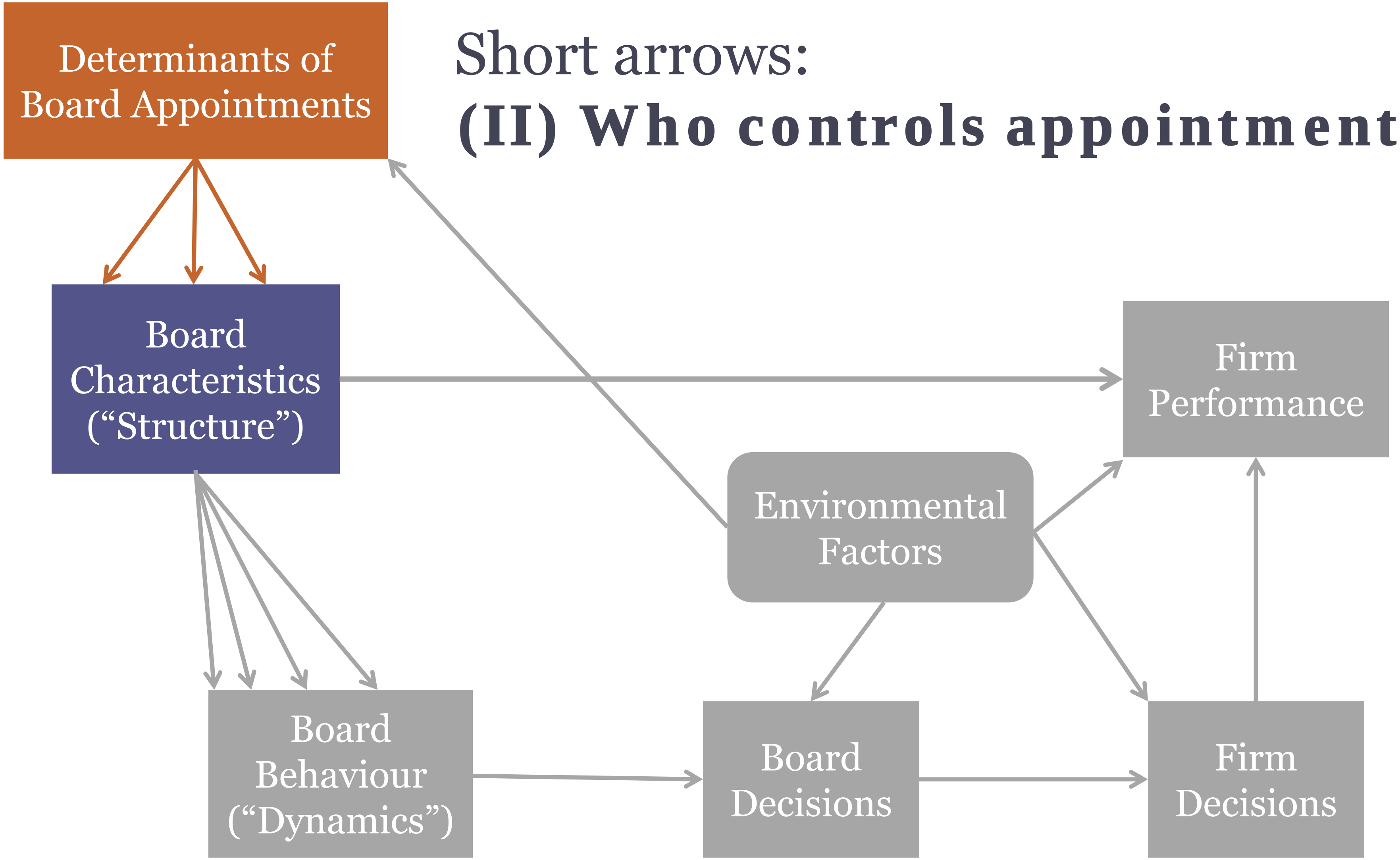
What else affects attendance?

- Adding one more female director reduces **male director** attendance problems by 10%
  - From Adams and Ferreira (2009), Women in the boardroom and their impact on governance and performance.
- Conclusion: board directors' attendance behaviour is affected by both <u>financial and social incentives</u> ("peer pressure")

Short arrows:
(II) Who controls appointments?



The role of creditors in governance

Example: (From Reuters, 2011)

Struggling Irish telecoms firm Eircom has appointed several **independent directors** as part of a deal with lenders **to waive conditions of its debt** pile of 3.75 billion euros.

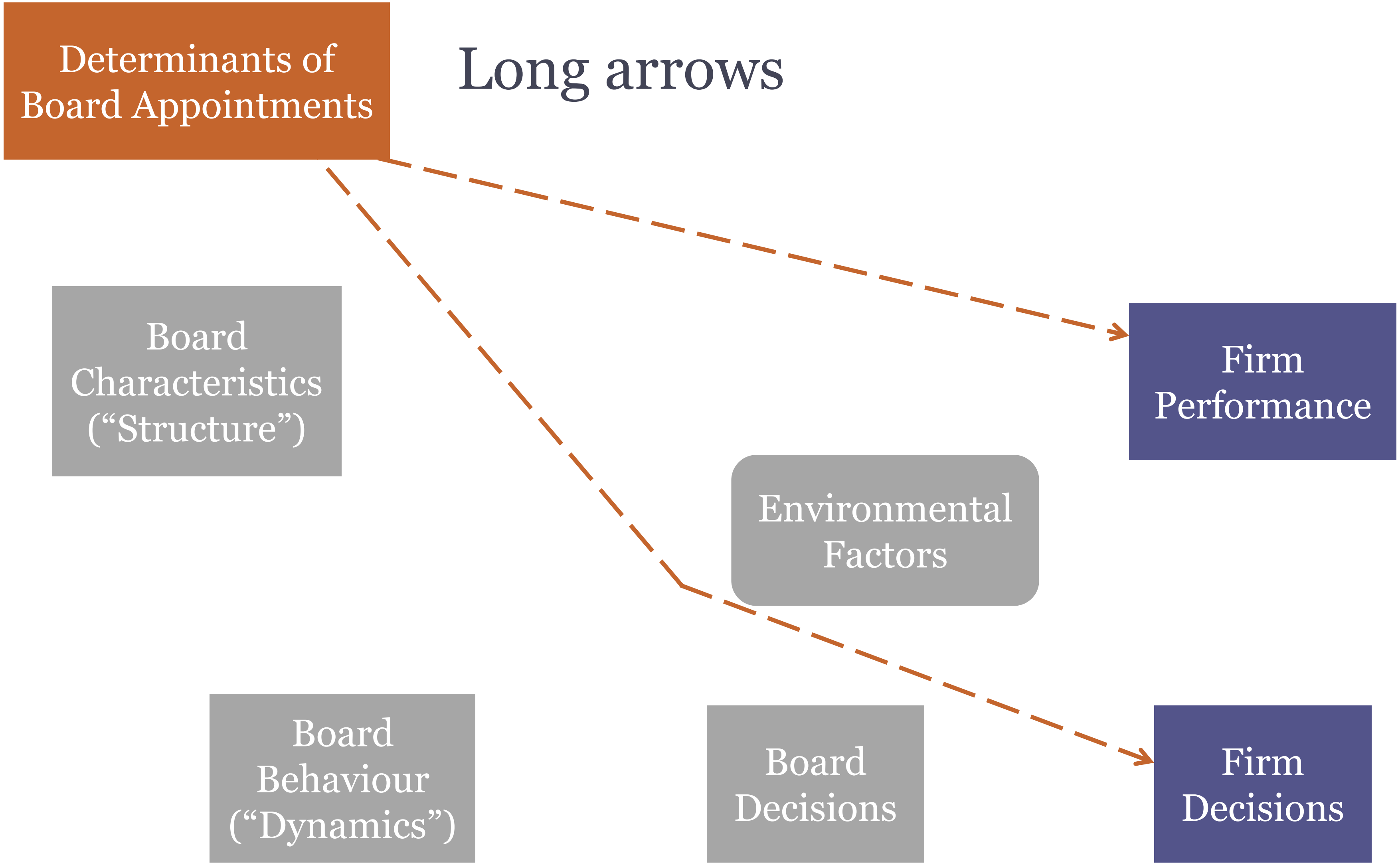
Creditors want board independence

- The number of independent directors increases by roughly 30% in the first two years following a loan renegotiation with banks.
  - From Ferreira, Ferreira and Mariano (2014), “Unfriendly Creditors: Debt Covenants and Board Independence.”

Implications (a bit speculative)

- Creditors “prefer” a more independent board.
- Independent directors are likely to favour safer and conservative projects.
- Growing, innovative firms should then have fewer independent directors.

Long arrows


Determinants of Board Appointments
Board Characteristics (“Structure”)
Firm Performance
Environmental Factors
Board Behaviour (“Dynamics”)
Board Decisions
Firm Decisions

What if boards are insulated from shareholder pressure?

- Firms' charter and by-law provisions (together with state corporate law) may restrict the ability of shareholders to replace board members.

- "Insulation provisions" are difficult to remove and can thus last for a long time.

Banks with more insulated boards in 2003 were:

- Less likely to take risks.

- 18 percentage points less likely to be bailed out in 2008/09.

  - From Ferreira, Kershaw, Kirchmaier, Schuster (2013), “Shareholder Empowerment and Bank Bailouts.”

Takeaways

- Academic research reveals that boards matter.
- But they matter in subtle and often surprising ways.

Takeaways

- Directors perform multiple roles.
- Friendly boards are not always bad.
- Regulation that pushes for more independence and shareholder empowerment can have unintended consequences, as the financial crisis revealed.

Thank you

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