Two easy actions to improve your corporate governance

Since the beginning of the financial crisis that started in 2008, the role of corporate governance has been hotly debated.

July 12, 2013

The global financial crisis revealed severe shortcomings in corporate governance, fueling debate on the responsibility of governance mechanisms and structures in promoting or preventing future collapses.
IESE's Pascual Berrone and Dionisio García-Píriz analyze current systems and make recommendations for new governance policies in their chapter, "Will You Keep an Eye on My Investment? An Empirical Analysis of the Link Between Institutional Investors and Boards of Directors," which was published in *Governance in Action Globally* (Oxford: RossiSmith, 2013).

One of the basic assumptions of corporate governance is that the board's main purpose is to defend the interests of shareholders.

Interviews and surveys were conducted with institutional investors and board chairs from Spanish publicly traded firms to test the validity of this assumption.

Institutional investors were chosen because they represent the major owners of equity in corporations, while board chairs were chosen because, being at the apex of the organization, they are the chief representatives of board actions.

The level of agreement between these two groups was tested with questions regarding the following: the importance of corporate governance; its effectiveness; the level of satisfaction and influence of institutional investors; corporate social responsibility; and future challenges for firms.

Differing standpoints

Results indicate that the views of institutional investors and boards of directors vary significantly.

Institutional investors tend to place higher importance on aligning executive pay with corporate goals, transparency and equal treatment of shareholders.

Board chairs, on the other hand, stress separating the functions of the CEO and the chair, the formal evaluation of board activities and the systematic rotation of directors.

Institutional investors were found to exert very limited influence on shaping boards. This may be because they are satisfied and do not see any need to interfere.

However, there would appear to be more to it than that, because when institutional investors are dissatisfied with management, many indicated they would prefer to sell their stakes in the firm.

This suggests that they consider the cost of selling large stakes to be lower than the cost of trying to effect change in governance, perhaps because incumbent board members are powerful enough to disregard their efforts.

Either way, institutional investors would seem to exert low levels of influence.

Regarding other corporate governance issues, institutional investors tend to favor those aspects that secure short-term profitability, while boards tend to favor long-term and strategic elements.

Both coincided on future governance challenges, such as guaranteeing the independence of directors, professionalizing board member status and protecting minority shareholders.

Two easy actions worth implementing

Although many have called for reforms, it is not clear what form they should take. Given the differences that exist regarding the relative importance of corporate governance issues, the authors suggest some common ground, with two straightforward and easy-to-implement actions.

- *Align executive pay with long-term goals*. The institutional investors surveyed felt that aligning bonus schemes with strategic objectives should be a priority.
- *Separate CEO and chair roles*. Although most of those surveyed said they separated the roles of CEO and chair into two separate people, more than a third of companies interviewed maintained CEO/chair duality, in which the same person wore both hats, and only a few systematically rotated board members. This separation needs to better promoted and formalized.

If there is to be greater involvement of institutional investors in corporate governance issues, such as remuneration, as proposed by the European Commission, then shareholders will need to be empowered in order to influence boards in desired directions.

One of the issues on which both institutional investors and board chairs agreed was that corporate governance played a role in the financial crisis. However, to reduce their vulnerability to another crisis happening, these actors will need to arrive at some consensus concerning what role exactly, and focus their reforms accordingly.

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