

How Do Directors Evaluate their Board's Effectiveness and Internal Operations?

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Board of Directors: Research Questions

- Does the **structure of the board** determine the quality of the board?
- Does "**one size fits all**"?
- Who "**monitors the monitor**"? Do boards collude with (or are they dominated by) the CEO? Are board members overcompensated?
- Can **regulation** improve board quality? Should we impose "good governance practices" on all firms?
- Effect of certain **practices**:
 - **Staggered Boards**: Is it good that the board can be replaced easily?
 - **Board Independence**: Is it bad to have many insiders on the board?
 - **CEO Duality**: Is it bad if the CEO is also the chairman of the board?

Board Structural Characteristics: Effect on Performance

Structural Attribute of the Board

Findings from Research

Independent chairman

No evidence

Independent directors

No evidence

Lead independent director

Modest evidence

Board size

Mixed evidence

Diversity / female directors

Mixed evidence

“Busy” boards

Negative impact

Boards “appointed by” the CEO

Negative impact

Is the current Corporate Governance System in the best interest of shareholders?

Element of the CG System	YES	NO
Congress	La Porta et al. (2006)	Leuz and Wysocki (2016) ; Zhang (2007); Larcker, Ormazabal, and Taylor (2011)
SEC		Larcker, Ormazabal, Taylor (2011)
Proxy advisors	Alexander, Chen, Seppi, and Spatt (2010)	Malenko and Shen (2016) Larcker, Ormazabal, McCall (2013; 2015)
Rating agencies	Anderson, Mansi, and Reeb (2004)	Griffin, Nickerson, and Tang, 2013; Barth, Ormazabal, and Taylor, 2012

Mixed evidence...

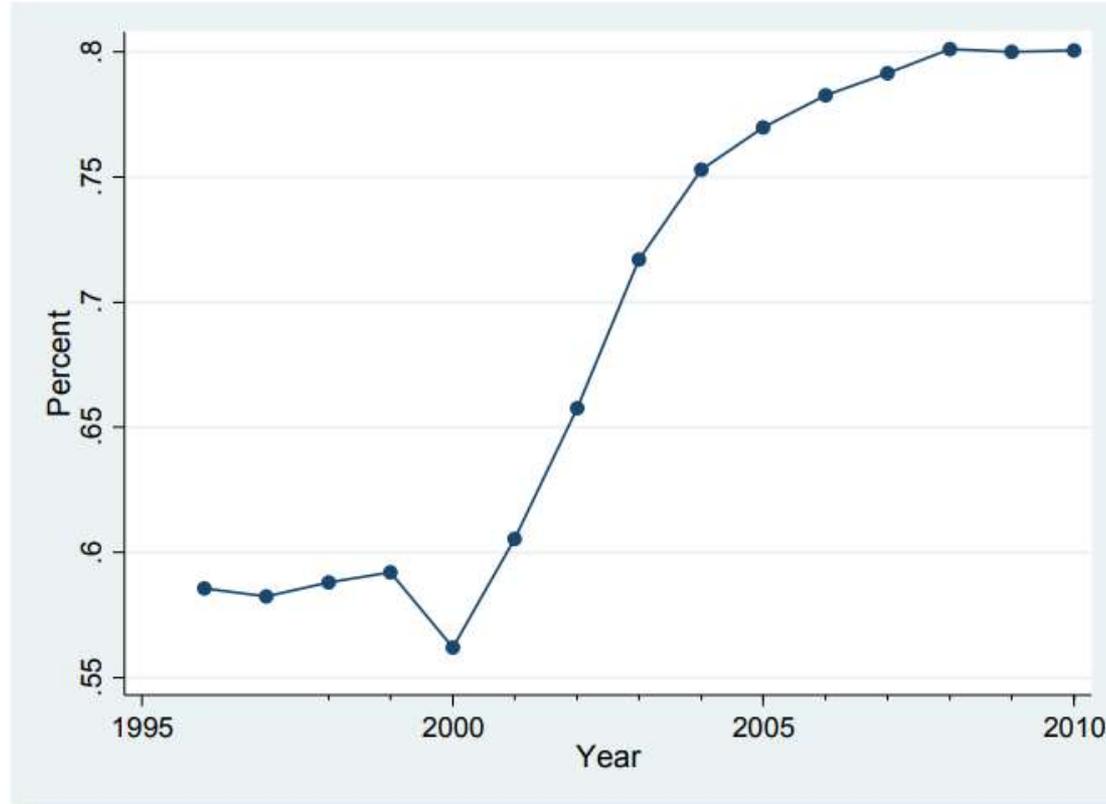
Is the current Corporate Governance System in the best interest of shareholders?

Element of the CG System	YES	NO
Stock exchanges	Miller, 1999 ; De Carvalho and Pennacchi (2012)	DeMarzo, Fishman, and Hagerty (2005); Aggarwal, 2002
Stock indexes	Chattopadhyay, Shaffer, and Wang (2020)	Harris and Guriel, 1986; Chen et al., 2004;
Media	Dyck and Zingales, 2002; Miller, 2006; Dyck. Morse, Zingales, 2010; Dai, Parwada, and Zhang, 2015	Core, Guay, and Larcker, 2008; Miller, 2006; Dyck, Volchkova, and Zingales, 2008
Politics	Faccio, 2006; Goldman, Rocholl, and So, 2009; Cooper, Gulen, and Ovtchinnikov, 2010	Yu and Yu, 2011; Correia, 2014; Bourveau, Coulomb and Sangnier (2016); Jagolinzer et al., (2020)

Mixed evidence...

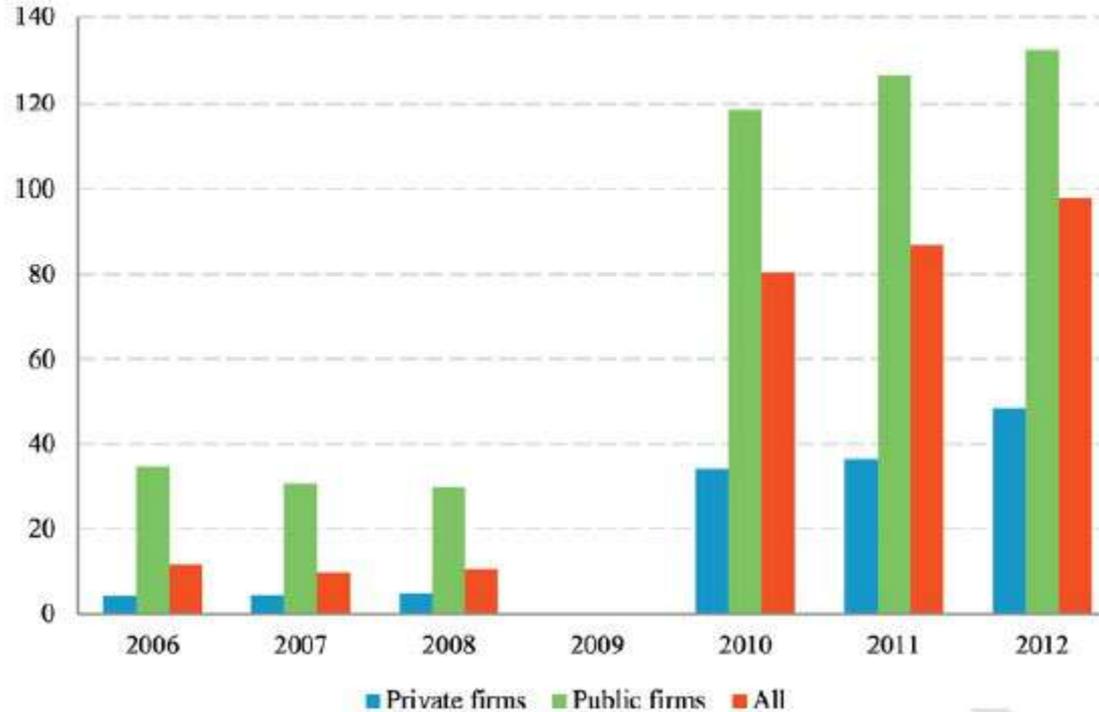
How are things evolving?

More independent directors



How are things evolving?

Directors assume more risk



Annual average total limits of D&O insurance (in US\$ millions).
Source: Towers Watson's Directors and Officers Liability annual surveys.

(Ormazabal, 2018)

How are things evolving?

Fewer listed firms (in the US)



(Doidge, Karoly, Stulz, 2017)

How are things evolving?

Probability of Hostile Takeover

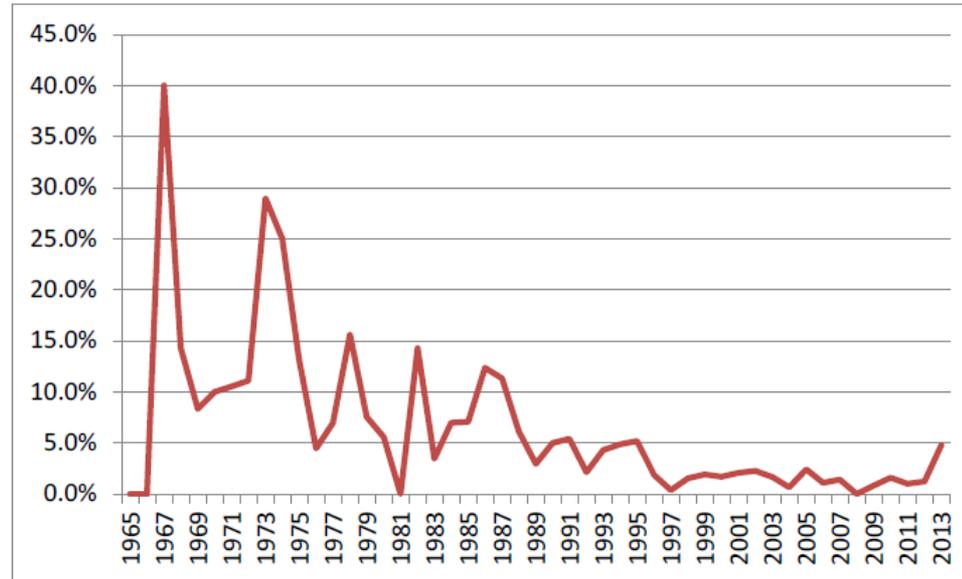


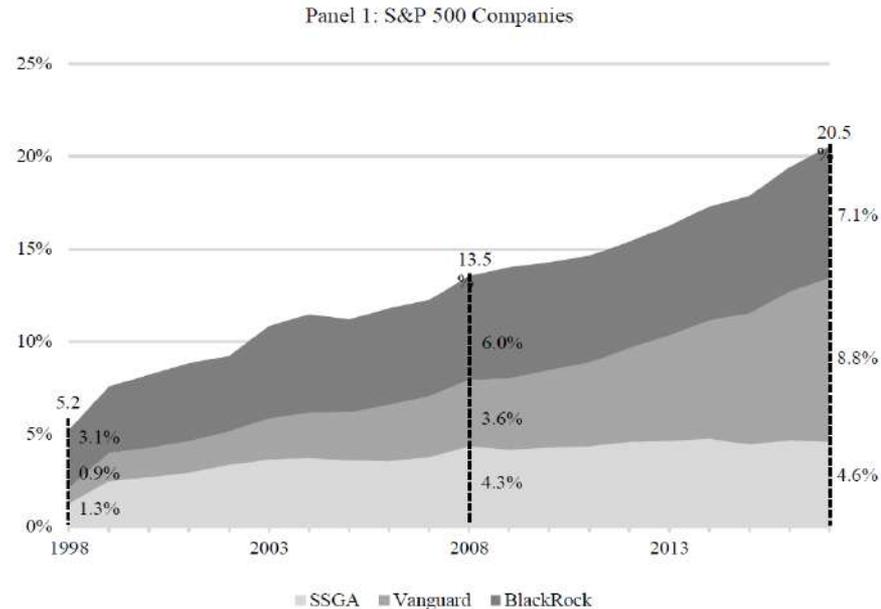
Figure 2. Conditional on being acquired in a given year, probability of hostility (equal-weighted). Firm-years are coded 0 for friendly takeover and 1 for hostile takeover. Firm-years with no takeovers are excluded.

(Source: Cain, McKeon, Solomon, 2014)

How are things evolving?

Rise of index investing and large asset management firms

Figure 1. Percentage of Corporate Equity Held by Big Three Index Funds

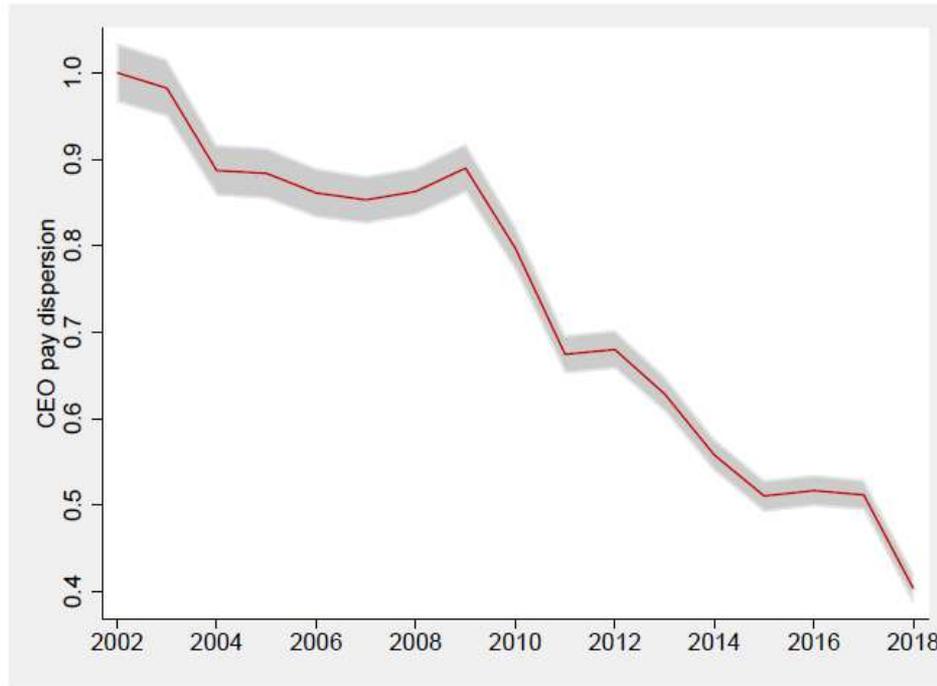


(Bebchuck and Hirst, 2019)

How are things evolving?

More similar compensation contracts

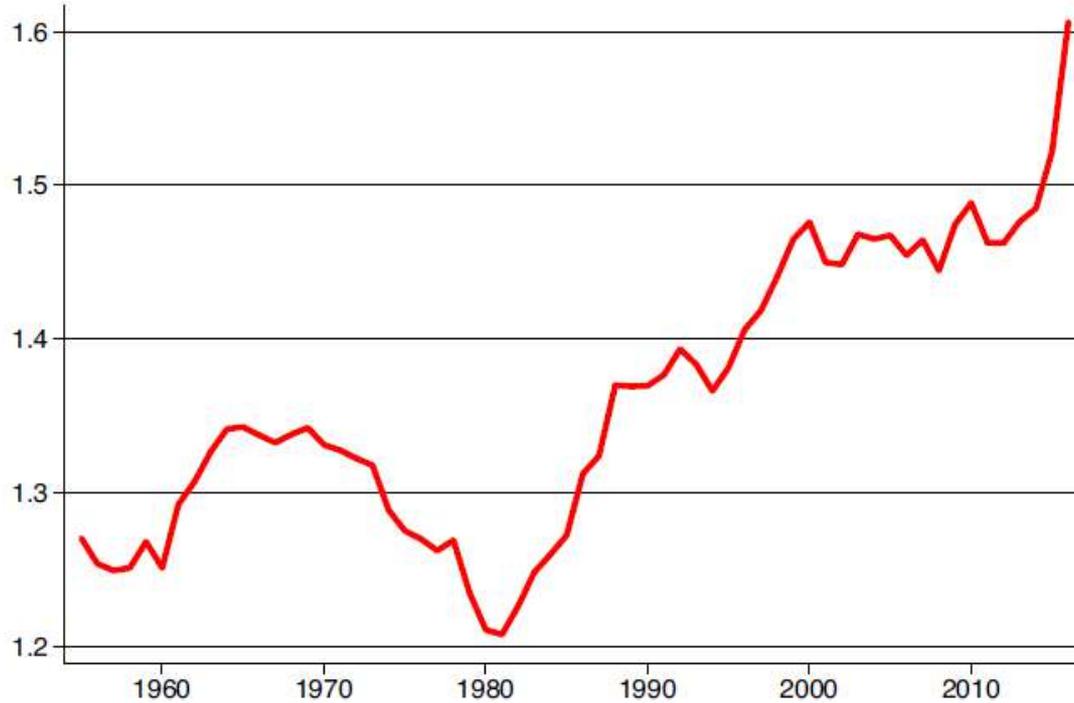
$$\text{Dispersion} = \frac{\text{stdev}(\text{CEO pay})}{\text{median}(\text{CEO pay})}$$



(Jochem, Ormazabal, Rajamani, 2021)

How are things evolving?

Increasing market power

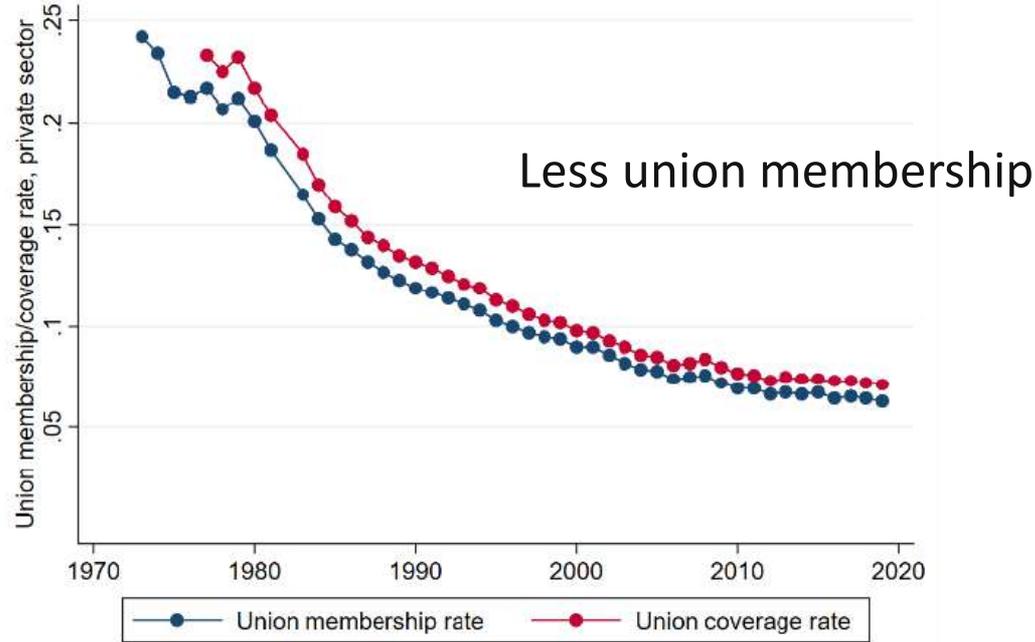


Average markups

(De Loecker, Eeckhout, Unger, QJE 2020)

How are things evolving?

Declining workers' power



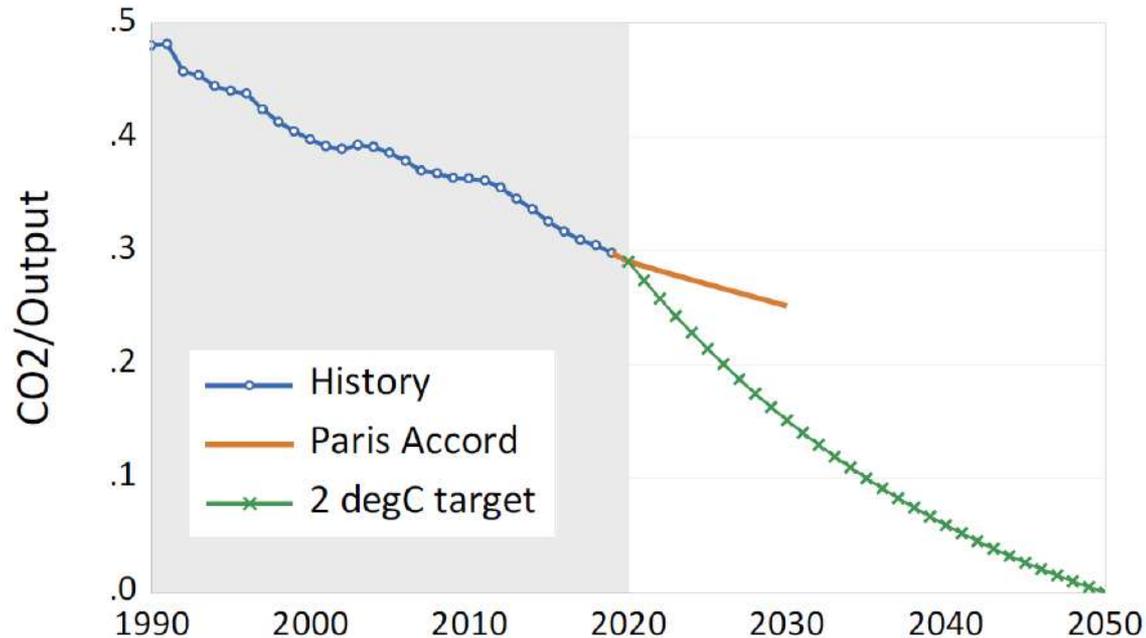
Note: Union membership and coverage rate are from UnionStats.com, calculated from the CPS by Hirsch and Macpherson.

(Stansbury and Summers, 2021)

How are things evolving?

Environmental efforts are not enough

Decarbonization: History and Future



(Nordhaus, 2021)

How are things evolving?

ESG Investing is on the Rise

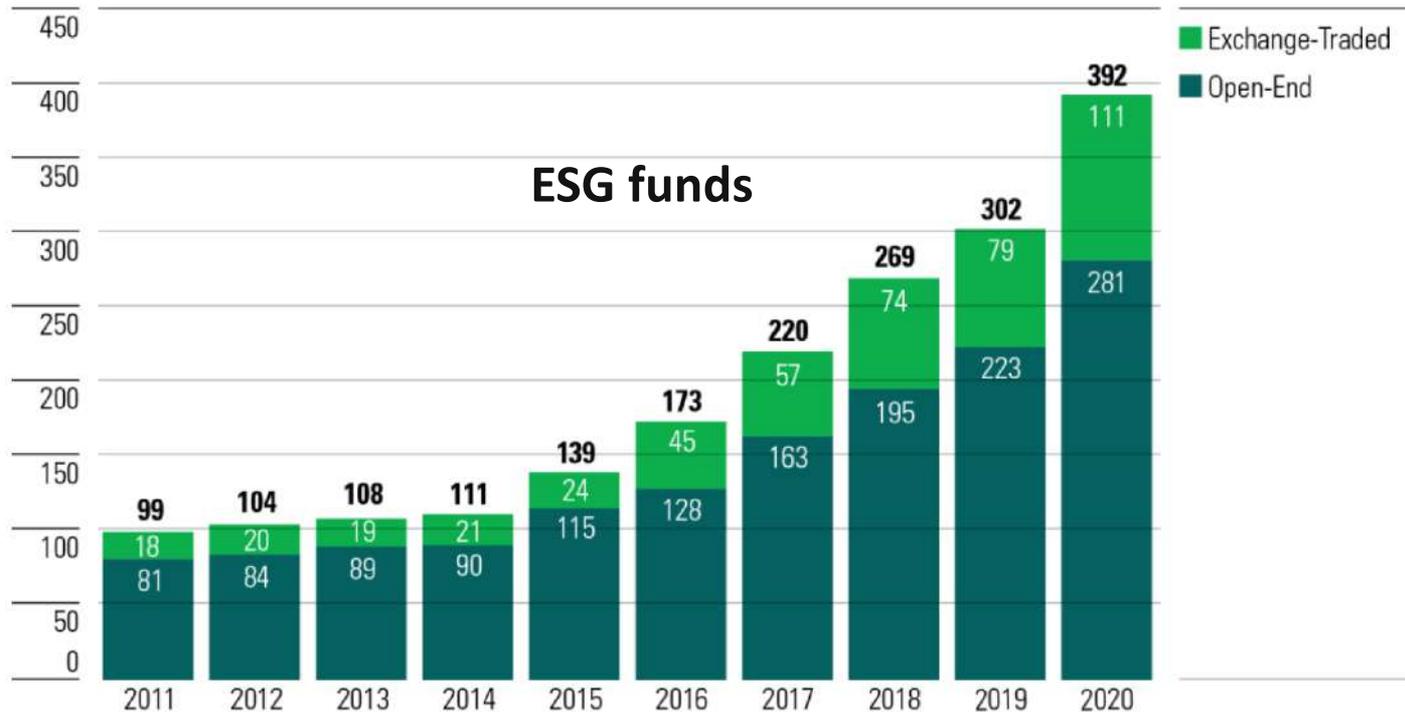
Assets under management (US\$ trillion)

N° Signatories



How are things evolving?

ESG Investing is on the Rise



Source: Morningstar Direct. Data as of 12/31/2020. Note: Includes funds that have been liquidated during this period.

How are things evolving?

ESG Shareholder Activism is on the Rise

Increasing success of ESG activism,
despite negative effects on stock prices!

<https://www.wsj.com/articles/activist-wins-exxon-board-seats-after-questioning-oil-giants-climate-strategy-11622050087>

BUSINESS

Activist Wins Exxon Board Seats After Questioning Oil Giant's Climate Strategy

Engine No. 1's victory in one of the most expensive proxy fights ever is unprecedented setback for Exxon and CEO Darren Woods

WSJ, May 26, 2021

XOM -0.47% ▼

How are things evolving?

ESG Shareholder Activism is on the Rise

But...are ESG efforts just “window-dressing”?



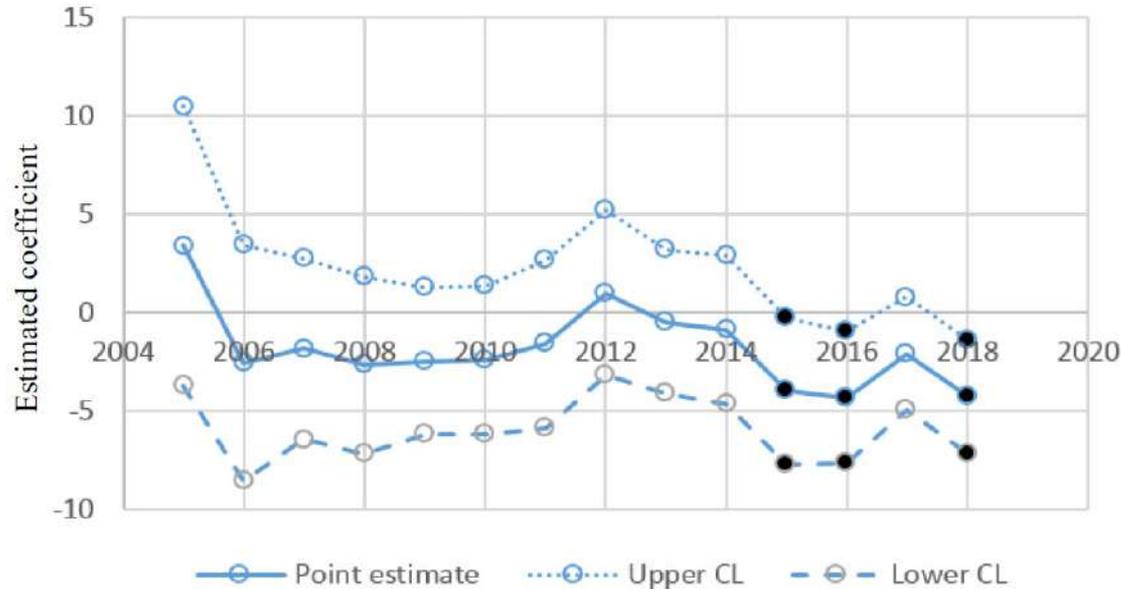
“Fink promises cultural change at BlackRock after discrimination allegations”

How are things evolving?

ESG Shareholder Activism is on the Rise

The Big Three are effectively pushing firms to decrease emissions

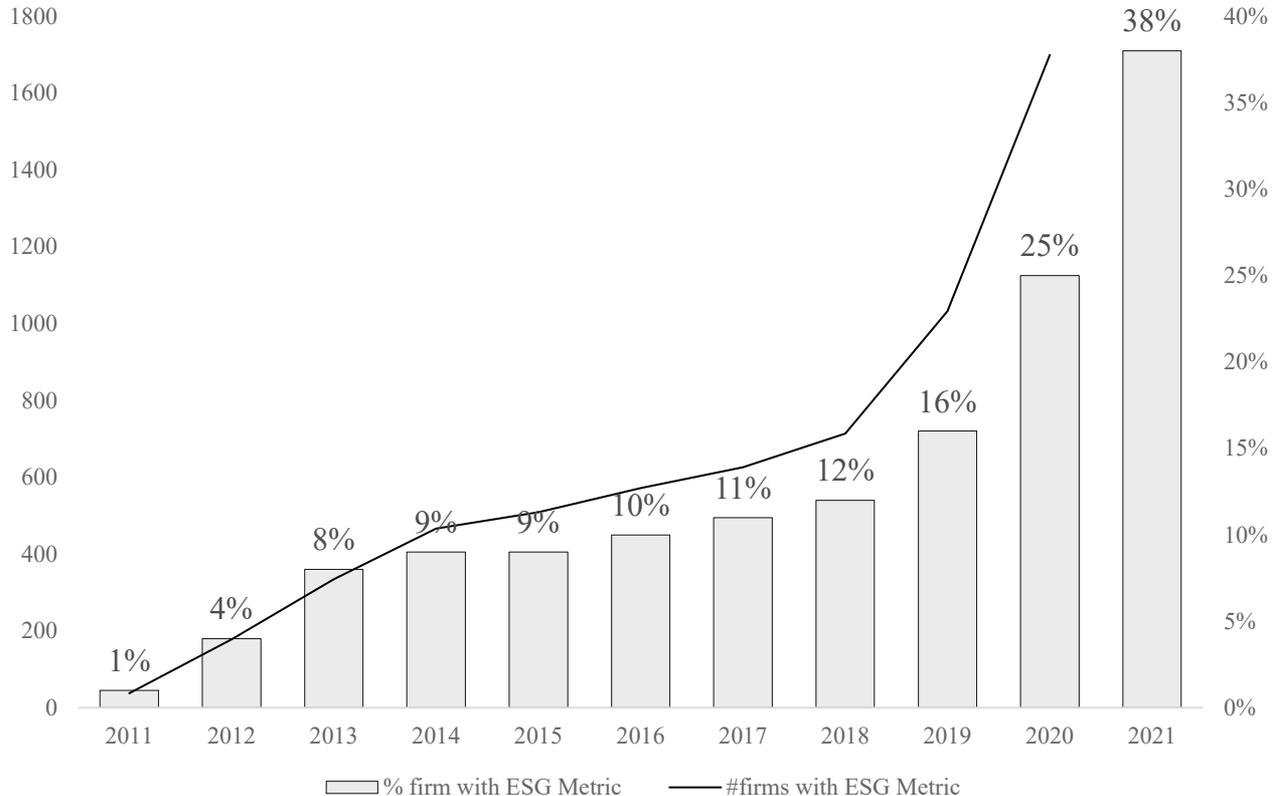
$$\text{Log}(CO_2)_{it} = \alpha + \beta * \text{Big3_Hldg}_{it-1} + \gamma * \text{NonBig3_Hldg}_{it-1} + \Phi * \text{Controls}_{it-1} + \tau_t + \delta_i + \varepsilon_{it}$$



(Azar, Duro, Kadach, Ormazabal, JFE 2021)

How are things evolving?

Firms including ESG metrics in Executive Compensation



(Cohen, Kadach, Ormazabal, 2022)

Take-Away

- While important, the (external) corporate governance system has limitations (in particular, the structural attributes of the board)
- The internal functioning of the board is crucial, and the job of directors is becoming increasingly challenging
 - ✓ Crucial role of the **organizational culture**
- But how can we learn about it?
 - ✓ Data limitations (there is no public information about it)
 - ✓ We need field research (experiments, surveys)

Survey research on the internal functioning of the board

- Survey questions & interviews to reliably capture **internal board dynamics** (e.g., behavioral integration; Hambrick, 2007; Boivie et al., 2021)
- Focus on **board relationships to variety of stakeholders** to understand outcomes (Raes et al., 2011; Simsek et al., 2018)
- More **‘teamness’** in top teams correlates with a more positive climate, less teamness with a more corrosive climate (Ou et al., 2014; Raes et al., 2013; Raes et al., 2022)
- Director **personality characteristics and cognitive biases** may shape strategic decisions and organizational outcomes (Chatterjee & Hambrick, 2007; Hambrick & Mason, 1984; Boivie et al., 2021)

Board Effectiveness

	N	Mean	% Rated 4 or 5
<i>Risk management oversight:</i>	577	3.90	0.69
Compliance	569	4.07	0.78
Risk management	572	3.68	0.59
Cybersecurity	574	3.18	0.31
Financial planning	572	3.86	0.69
This board serves as a good steward of the company's assets for shareholders	573	4.41	0.94
This CEO-board relationship sets the right tone for the rest of the company	575	4.22	0.87
<i>Strategy guidance and appraisal:</i>	577	3.73	0.63
M&A	563	3.60	0.52
Global expansion	528	3.31	0.40
Innovation	570	3.38	0.44
Technology	561	3.46	0.47
Monitoring strategic decisions	576	3.79	0.67
Strategic planning (including plan B or worst-case-scenario planning)	574	3.69	0.62
This board plays a significant role in the setting of company's strategy	577	4.02	0.82
This CEO and board are aligned on vision and strategy	575	4.15	0.86
This board's nonexecutive directors are aligned on vision and strategy	572	4.09	0.85
<i>Management evaluation and selection:</i>	577	3.60	0.55
HR/talent management	576	3.34	0.43
Compensation	576	3.72	0.62
CEO evaluation	576	3.84	0.67
CEO succession planning	577	3.49	0.47

Internal Board Operations

	N	Mean	% Rated 4 or 5
<i>Director engagement:</i>	577	4.07	0.78
Staying current on industry	573	3.84	0.67
Staying engaged between meetings	569	3.68	0.58
Overall, all directors are well prepared for meetings on this board	573	4.30	0.92
I feel connected to the mission of this company	576	4.47	0.95
<i>Interpersonal relationships:</i>	577	4.17	0.82
Collegiality	572	4.32	0.85
Relationship between shareholder and nonshareholder directors	500	3.74	0.55
It is clear what is—and what is not—acceptable member behavior on this board	572	4.02	0.81
The CEO communicates and consults with this board in an appropriate and effective manner	576	4.20	0.87
I feel my voice is heard on this board	576	4.48	0.95
<i>Board meeting management:</i>	577	4.15	0.85
Time management (e.g., digesting all materials; allowing adequate time for thoughtful discussion and debate)	561	3.70	0.60
Independent thinking (independent from management as well as from fellow directors)	574	4.06	0.78
We are able to have open and candid discussions on this board	576	4.39	0.93
This board has a “devil’s advocate” in most debates	575	3.85	0.75
Agenda topics and materials accurately reflect priorities of board	577	4.37	0.96
Sufficient time is allocated during board meetings to discuss strategy	573	3.98	0.82
This board’s overall effectiveness would be lessened without executive sessions	571	4.28	0.86
Overall, the committees on this board work well	573	4.39	0.96
Overall, the general meetings of this board are productive	573	4.32	0.94
<i>Internal governance:</i>	577	3.79	0.65
Board composition (e.g., appointing directors with skills and experience board needs)	576	3.97	0.73
Evaluation of individual directors	576	3.33	0.44
Alignment on role of independent directors	572	4.15	0.80
Creating effective board structure (leadership roles, committees)	575	3.90	0.69
Integrating new members	569	3.96	0.71
Addressing problematic directors (e.g., domineering, disruptive, asserting personal agenda, silent)	567	3.68	0.59
This board provides effective training for new directors	573	3.51	0.58
<i>Aggregated internal rating</i>	577	4.04	0.77

Findings

- 1. Internal board operations** are associated with **board effectiveness**
- 2. Board effectiveness** is associated with **firm outcomes**:
 - ✓ Financial performance (?)
 - ✓ Reporting quality and transparency
 - ✓ Compensation practices
 - ✓ Investment (M&A activity)

Framework

Functions of the board (Canals, 2022)

1. Define or review the firm's **purpose** and make sure shareholders and major stakeholders are in alignment
2. Debate and approve the firm's **strategy**, in cooperation with the CEO
3. **CEO and senior leadership development**, including their succession plans
4. Make the board an **effective team** of individuals
5. **Engage** pro-actively with **shareholders and other key stakeholders**
6. Regularly **monitor performance** and **risk** and in a holistic way (financial and non-financial)

In Summary

- The economic context and the corporate governance system are **evolving fast and in a complex way**
- Analyzing board structures is not enough; we need more research on the **internal functioning** of the board
- It is particularly important to **integrate the findings from different research fields**
- **Recommendations for practice** should be made based on consistent/validated findings