



Outside Directors

Distinguished Scholar of 2002

Keynote Address to the Annual Meeting of the Eastern Finance Association

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I thank the Eastern Finance Association for honoring me as the EFA Distinguished Scholar of 2002 and for inviting me to present the Keynote Address of its 2002 annual meeting.

The topic of my talk today is “Outside Directors.” I have chosen this topic for three reasons. The first, so it seems at least to me, is that the global economy appears to have recently become caught up in (or perhaps have come down with) what might be characterized as a virulent attack of “outside director mania.” As my colleague and co-author, Jay Dahya, and I document, between 1993 and the end of 2001 at least 18 countries worldwide have witnessed the publication of officially-sanctioned reports that establish minimum standards for representation of outside directors on the boards of publicly-traded companies (Dahya and McConnell, 2002). These are typically labeled “Codes of Best Practice.” Most of these specify that a board comprise a minimum fraction of outside directors, most typically 50%; others specify a minimum number of outside directors, and a few specify both a minimum fraction and a minimum number. These countries include Australia, Brazil, France, Italy, India,

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Hong Kong, Malaysia, Singapore, South Africa, and Thailand, among others. In most countries, the newly-pronounced standards represent a dramatic upward shift in the representation of outside directors. For example, in Brazil as of 1990, the combined stock exchanges had 312 listed companies. Of these, only 53—representing 17% of the total—had outside directors comprising 50% or more of the board. In 2000, the IBGC issued its *Code of Best Practice of Corporate Governance*, specifying that publicly-traded companies have at least 50% outside board members.

Of course, critics of U.S. boards will argue that these proposals are at best eyewash because even in the United States, where boards with a majority of outside directors are commonplace, outside directors are little better than skills selected by a company's CEO to do his or her bidding regardless of the effect on other shareholders.

That brings me to my second reason for talking about outside directors, and that is because I have been recently doing research on this topic. I am convinced, at least momentarily, that the topic of outside directors is, or at least should be, a topic of utmost concern to other finance scholars such as those assembled here for the 2002 edition of the EFA annual meeting as well as editors of finance and economics journals worldwide.

My third reason for choosing to talk about outside directors is that I am one. I am currently an outside director for a midsize bank in California. Thus, my hope is that in talking about this topic, I will bring to it at least the appearance of having inside information. And, as scholars of the financial marketplace, most of us firmly believe that the only type of information worth having is inside information. Thus, in order to forestall everyone from tuning out immediately, I feel compelled to hold out the prospect of revealing inside information.

With these three reasons for selecting the topic of my talk, the theme for my talk will be threefold as well. First, I will try to convince you that the recent worldwide epidemic of coercive guidelines for inclusion of outside directors establishes laboratories for conducting research on boards of directors that is largely, if not entirely, free of the type of endogeneity that has historically plagued research on the effects of outside directors. The endogeneity embedded in many studies of outside directors has been described and lamented elsewhere (perhaps most prominently, but not exclusively, by Hermalin and Weisbach (2002)) so I will only comment briefly on those shortcomings here.

Second, I will try to convince you that the view held by board critics, that outside directors are easily-manipulated handmaidens chosen from a small pool of the incumbent CEO's cronies, is too simplistic.

Third, I will use this forum as an opportunity to urge caution in compelling companies to conform to a single model of board composition. While most, if not all, of the recent initiatives worldwide to increase representation of outside directors on the boards of publicly-traded corporations have been endorsed by governments, to date, to my knowledge, none have been enacted into law. They have, however, not been without clout either. Indeed, many have been advanced by the

relevant country's major stock exchange, some have been adopted as a requirement for listing on that exchange, and all have been implicitly endorsed by the country's government.

Why do I believe that the recent spate of officially-sanctioned calls for more outside directors provides a unique laboratory for circumventing the endogeneity embedded in studies of corporate boards? The endogeneity arises, in part, because most of the studies, or at least those studies published in English, are based on U.S. companies. In large part, the concentration on U.S. companies occurs because, as I noted above, outside of the United States, corporate boards with more token representation of outside directors have historically been a rarity. A number of studies of U.S. companies have documented a correlation between specific actions taken by the board and the fraction of the board comprising outside directors. U.S. corporate boards typically are in place and have been in place for some period of time prior to the action. Thus, interpretation of the results is ambiguous. It is unclear whether the action taken by the board occurs because the board is dominated by outside directors, or whether the board is composed of outside directors because economic forces have propelled the board in that direction, recognizing that a particular action will be appropriate at some time in the future.

For example, in the U.S., boards with a higher fraction of outside directors are significantly more likely to appoint an outside CEO than boards with relatively fewer outside directors. But does that occur because the board has a lot of outside directors, or is it that the company is best served by having both an outside CEO and by having a majority of outside directors? If it is the latter explanation, then what we are observing in our statistical studies is a spurious correlation between the fraction of outside directors and the tendency of these same companies to appoint outside CEOs, rather than a cause and effect relationship between outside directors and the appointment of outside CEOs.

To put it differently, as with many topics in economics and finance, controlled experiments regarding boards of directors are difficult to find. A desirable controlled experiment would exogenously disrupt a board's composition (for example, by adding or subtracting outside directors) and then study the board's decisions over time to make a determination as to whether those decisions differ in comparison with another company or set of companies that was not subject to this external shock. Alternatively, the board's actions could be compared with the actions of the board prior to the exogenously induced change in composition. If the board's decisions do differ, there is a second, and equally important, question: Are the decisions better? The second question is important because it seems to assume that the motivation for compelling companies to add outside directors is that doing so will lead to better board decisions and eventually better corporate performance. Whether that presumption is justified is an open question.

It seems to me that the recent rush of coercive mandates to increase outside directors represent the type of external shock that is analogous to the conditions required

of a desirable controlled experiment. It is not a perfect analogy because the countries involved have voluntarily put forth the proposed guidelines even if specific companies have not. Furthermore, although the committees that have developed the guidelines have been influenced by political considerations, the individuals comprising the committees have come from the private sector. Often they have been corporate executives, accountants, academics, and representatives of the major stock exchanges. Thus, it is possible that publicly-traded companies, or more accurately their managers, in each country implicitly have demanded more outside directors and, thus, have demanded that a committee be appointed to establish guidelines for more outside directors. If so, it could be argued that the reports are the endogenous product of a country-wide system of corporate governance. To me, that seems somewhat implausible, given that these same corporate managers could just as easily have included outside directors on their boards at any time in the past and have chosen not to do so.

Alternatively, it could be that a separate shock altered economic conditions worldwide such that boards with a majority of outside directors suddenly became (almost) universally optimal. I cannot dismiss that possibility out of hand, but I also cannot envision what that shock might have been. Additionally, if that were the case, again, companies could have added outside directors voluntarily without official guidelines. The guidelines appear to be superfluous.

Thus, with those two mild caveats in mind, the publication of a mandate to increase outside directors comes very close to meeting the requirements of a desirable controlled experiment that circumvents the endogeneity that has made interpretation of studies of the effect of outside directors on board decisions difficult to interpret.

As regards my second point, that outside directors are not merely shills for management, I will comment on some research that I have been conducting recently with my colleague Jay Dahya, but I will first comment on my own experience. As I mentioned, I am and have been an outside director for Los Padres Bank in Solvang, California for about six years. But this is not the first time I had been a director of a financial institution. The first instance occurred many years ago, when I was appointed to the board of directors of the Federal Home Loan Bank of the 6th District of the Federal Home Loan Bank system. This experience allows me an excellent benchmark for thinking about the independence and the role of outside directors.

The board of each FHL District Bank is composed of about 12 “industry” directors and five “public interest” directors. At the time, the industry directors were also CEOs or presidents of Savings and Loan institutions (S&Ls). The S&Ls, in turn, owned the stock of the FHL Bank. Thus, the S&L presidents ostensibly represented shareholders. But the S&Ls and their presidents were subject to oversight, regulation, and discipline by the president of the Home Loan Bank of their respective districts. You can well imagine that the industry directors at the time were an especially acquiescent group. After all, what kind of reckless industry director would challenge the president of the FHL Bank on Monday when that very same person might just find on Tuesday that the offending director’s S&L happened to be in violation of one or more highly subjective standards for the operation of a “safe and sound” financial

institution. I can assure you that the industry directors were unlikely to challenge the actions of the management of the District Bank on whose board they served.

The public interest directors, or P.I.D.'s as we were known, were a somewhat different kettle of fish in that none of us were beholden in any way to the president of the bank for our tenures or appointments; we were ostensibly appointed by the president of the United States, or more accurately, by the then-serving chairman of the Federal Home Loan Bank, who was in turn appointed by the Oval Office. Of course, in most cases, the chief attribute of a P.I.D. was that he or she had played a key role in the political party of the person then serving in the Oval office. I and several other finance professors were appointed as directors of various regional banks in the early 1980s, despite not having had the prerequisite training of working with or contributing generously to the party then in power. We were appointed because the chairman of the Federal Home Loan Bank was a professional economist and had determined that the sorry state of the S&L industry at the time (some of you may remember the so-called S&L crisis of the 1980s) could be improved by having a few economists as directors of the various District banks. (Sadly, in my view, that experiment was short-lived and was reversed as soon as a new chairman was appointed.)

As I noted, the P.I.D.'s were independent of the bank president and so were well positioned to question management's decisions. But most of the P.I.D.'s had very little training in either finance or accounting and had relatively little direct connection to the banking industry. Furthermore, the P.I.D.'s were appointed to serve the "public interest" rather than the owners' interests; and that term carried with it the usual ambiguity of what, exactly, is the public's interest. So, for the most part, the P.I.D.'s were well intentioned, but poorly armed for their ill-defined mission. This experience gave me valuable insight into how *not* to construct an effective board of directors.

Now let me compare my FHLB experience with my experience at Los Padres Bank. Los Padres has nine branches, most of which are located on the mid-California coast. The bank has about \$750 million in assets and about 300 stockholders. The board is composed of three management directors and six outside directors. Each of the six outside directors was, indeed, an acquaintance, but certainly not a crony, of management prior to his election to the board. The outside directors comprise a heterogeneous group. One is a lawyer, one is a portfolio manager, one is the now-retired founding president of the bank, one manages his own insurance agency, one is a retired educator with 30 years of administrative experience in the public school system, and there is me. Each member of the board owns at least some stock in the company and the outside directors collectively own about 6% of the outstanding shares. The outside directors are unquestionably independent of management. And the board clearly sees its job as representing shareholders: The board asks questions of management, and the board probes management's recommendations and decisions. Thus, in comparison with the board of the FHL Bank, there is no comparison. Independent/outside directors do ask more and tougher questions. I have learned that outside directors *can* have an impact.

But what I have learned most emphatically is that the board of directors does not manage a company. That is the job of management. The board's job is to hire, motivate, and monitor management. If the board does that job well, most of the time, the board will agree with management's proposals. What will then be observed, even among the best boards or perhaps especially among the best boards, is what appears to be a mostly passive board. If the board does a good job of selecting the CEO, which is a key board task, the board will rarely intervene. If the board does not agree with management, the board may wish to rethink its choice of management. That is, rather than managing the company, the board will identify a new CEO. Thus, a good board will appear to do very little most of the time.

All of this now brings me to the research on outside directors that I have been conducting with Jay Dahya (Dayha, McConnell, and Travlos, 2002). Given my prologue, I suspect that you can easily guess what the research involves. Yes, it involves an analysis of corporate board decisions in a country that has put forth a *Code of Best Practice* for corporate boards that specifies a minimum representation of outside directors. In our case, the country is England. The guidelines are set forth in the *Report of the Committee on the Financial Aspects of Corporate Governance*, more familiarly known as the *Cadbury Report*, after the committee's chairman, Sir Adrian Cadbury. The *Report* was published in December 1992 and was supported by the London Stock Exchange, which requires that all listed companies comply with the recommendations of the *Report*—or explain to shareholders why they do not.

Publication of the *Report* has had a dramatic impact on the composition of U.K. corporate boards. In 1990, for only 21 of the *Financial Times* 500 companies did outside directors comprise a majority of the board. As of 2001, that number had increased more than ten times.

And, yes, the question we explore in our research is whether boards that have recently altered their compositions to include more outside directors make different decisions. That is, we use the United Kingdom as a laboratory to analyze a “natural” experiment. In particular, we ask whether the newly-altered boards make different decisions with respect to the turnover and appointment of CEOs. According to our analysis of U.K. companies, the answer is decidedly “yes.” We find that boards that have added outside directors are more likely to dismiss a CEO when corporate performance is poor and they are more likely to hire an outside CEO regardless of whether performance is good or bad than they would have been prior to adding outside directors, and in comparison with a control group that does not alter their boards. The conclusion to which I come is that outside directors *do* make a difference.

Why then do I urge caution in coercing publicly traded companies to add outside directors? I do so for two reasons. First, as a strong believer in the virtues of a market economy, I am inherently inclined to believe that companies will supply the types of boards that investors demand. If investors demand outside directors, companies will supply them. The second reason I urge caution has to do with the shortcomings of the extant research on corporate boards. In particular, the research supports the conclusion that boards with outside directors make different decisions, but the research has not

yet demonstrated whether those decisions are better. That then happily brings me to the conclusion of my talk—happy in that I am concluding and happy that I am able to conclude with a call for more research. We are still in business.

References

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