Monitoring Managers: Does it Matter?
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Summary -1

- Monitoring (by the Board of Directors or by a large shareholder) plays an important role in our theories on corporate governance
- Monitoring allows the Board to replace bad quality managers
- Moreover, monitoring allows the Board to distinguish between the case when poor performance is due to bad luck and the case when it is due to low effort by the CEO
- Unfortunately, we have little empirical evidence on how effective monitoring is
- This paper fills this gap
- More precisely, it asks two questions
  1: do boards fire managers for incompetence, poor performance, or bad luck?
  2: does the firing of top managers affect firm performance?
Data on EBRD investment funds in transition economies:
- Board interventions, firm performance, reported management performance

Great data set!

Obvious endogeneity problem: Board intervention may be triggered by bad performance

**Instrument**: corporate law changes that strengthen Board power (ability to fire management)

Potential problem: in transition economies corporate law changes may be associated with other major changes occurring at the same time (e.g., macroeconomics shocks)

Luckily, corporate law changed are **staggered** in the countries represented in the sample
Main results
- Top managers fired for incompetence/bad performance (not bad luck)
- Replacing top managers increases firm performance
- Threat of firing has no effect on performance
The Theoretical Predictions

- What are the theoretical predictions on the effect of monitoring on performance?
- In case of a simple model of hidden characteristics (adverse selection), monitoring allows the Board to replace bad managers → improved performance
- In case of a simple model of hidden actions (moral hazard) monitoring allows the Board to disentangle bad luck from lack of effort → improved performance (but: in equilibrium manager will not shirk)
- In case both agency problems are present at the same time, Board may be reluctant to fire a high quality manager even if he/she has exerted low effort when quality of a potential replacement uncertain
- It may be optimal not to monitor (i.e., not gather information about manager’s ability): Crémer 1993
Crucial point: corporate law changes in transition economies increase the Board ability to fire managers in case of bad performance.

Not clear what happened before the law change.

Board could not fire manager, but maybe Board had other instruments to induce CEO to quit (say, reduce compensation).

It would be interesting to compute the sensitivity of the firing decision to bad reports for the same firm before and after the law change.
Instrumental variable -1

- Instrument for Board intervention: the change in Board power due to legal reform
- This assumes that Board power affects profitability through the firing decision
- But a change in Board power may affect profitability in different ways
- In particular, it may affect CEO effort
For instance, CEO optimal compensation package will be different before and after reform in Board power.

In the absence of a firing threat, only bonuses can be used to induce high effort.

After the reform, the optimal compensation package will be a mix between monetary bonus and firing threat.

Higher effort (or same effort at lower cost) $\rightarrow$ improved performance.

By ignoring the effect on effort, the IV estimate on the effect of Board intervention may be biased.
Ownership

- The effectiveness of Board monitoring depends on the ownership structure.
- For instance, if the company is family held and it is run by a family member or if the CEO is the majority shareholder, Board **real** power may not be affected at all by the reform even though **formal** power has changed.
- Inefficient managers may remain in power even when inefficient.
- Conversely, the controlling shareholder may decide to fire a good manager because it does not allow the extraction of private benefits.
- Caveat: not easy to use ownership information as ownership is endogenous.
Performance

- Performance is measured as the ability of the EBRD fund to sell its stake.
- If stake is sold within two periods after CEO firing, this is considered as successful intervention.
- But we cannot rule out that the stake is sold for different reason.
- For instance, stakes may become more liquid after reform change.
- Or, fund manager may simply give up and liquidate the stake.
- On the other hand, results unchanged when measuring performance with IRR.
Quality of reporting affected by law changes

- The paper finds that monitoring not effective on the "intensive margin": the threat of being fired does not affect manager’s behavior
- Performance score flat around the date of law reform (see Figure 4 in the paper)
- However, both manager behavior and the quality of monitoring will change after the reform
- Managers may work harder because they are afraid they can be fired
- On the other hand, higher incentives to monitor because monitoring becomes more effective
- Overall effect unclear
Summing up

- The paper tackles one of the crucial issues in the field of corporate governance: the role of monitoring.
- Great data set and well crafted empirical investigation.
- Its main conclusion is reassuring: **monitoring managers matters!**
- It would be nice to know more about the impact of managerial compensation and the role of the ownership structure.
- Interesting topics for future research, but this is already a very good paper.