Monitoring Managers: Does it Matter? by Cornelli, Kominek and Ljungqvist

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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?

Summary -2

- 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

Summary -3

- 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 $\longrightarrow$ 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 $\longrightarrow$ 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

Identification

- 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**

Instrumental variable -2

- 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) $\Longrightarrow$ 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

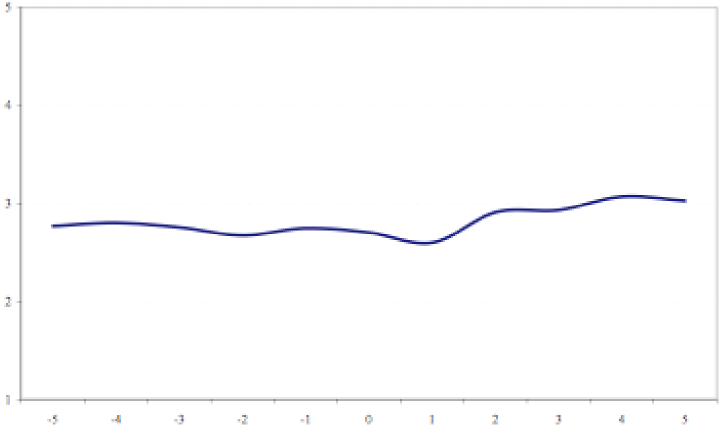
Performance

- 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

Interim performance score



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