Independent Directors: Key Benefits and Advantages for Corporations

Gian Piero Cigna, *Senior Counsel, EBRD*

5 July 2017

The opinions expressed are the speaker's only and do not necessarily represent the position of the EBRD

European Bank
for Reconstruction and Development

Presentation Plan

European Bank
for Reconstruction and Development

- **What is "Corporate Governance"** and **why do we care?**
- **An effective board:** *key strategic functions of the board*
- **Why do we need independent directors?**
- **Is "independence" enough?**

What is

“CORPORATE GOVERNANCE”?

What is corporate governance?

European Bank
for Reconstruction and Development

"It is the system by which companies are directed and controls are implemented"

(Cadbury Report, 1992)

Why do we care?

Why do we care?

European Bank
for Reconstruction and Development

- Promotion of good corporate governance is part of the **EBRD Mandate** *(Art. 1 of the Agreement Establishing the Bank).*
- **Good** corporate governance **creates value**.
- **Bad** corporate governance creates **risks**
- **Good** corporate governance **improves accountability,** makes companies **more efficient, competitive and attractive for investors**, and **helps reduce losses.**

How?

Some examples…

European Bank
for Reconstruction and Development

- Companies with **a clear strategy** can better define **KPIs**, understand **challenges** and **risks** and mitigate them.
- If the firm's strategy and key objectives are not clear, measures tend to focus only on financial outcomes (imbalanced and incomplete view on the health of a business)
- An **effective**, **diverse** and **independent board** can determine credible objectives and drive management to achieve sustainable growth.
- Clearly defined **accountability lines** (*i.e., when it is clear who does what*) ensure effective decision-making and robust control environment
- Good corporate governance is not about having policies and codes in place, but having them **translated in good practices**

Which translates in **value creation**

European Bank
for Reconstruction and Development

WOOD

Energy, Romania — November 11, 2013

Romgaz

Buy

Initiation of coverage

Price: RON 30.0 (IPO price)
Price target: RON 42.6

Exploring the wealth of Dracula

We initiate coverage of Romgaz with a BUY rating and a RON 42.6/share 12M price target (PT) – an average of our NAV-based SOTP and DCF valuations – implying 42% upside from the IPO price. We believe the IPO price offers considerable appreciation potential in the next 12M if: 1) the royal and politi critic utilis

Expected Events

10% non-operated stake in two blocks in the Black Sea (Trident and Rapsodia) and has an option to acquire a 10% stake in Media XV block from Exxon and Petrom. Despite the expensive deep offshore exploration, we see no major investments from Romgaz into these licences until at least 2016-17E.

Corporate governance

Currently, Romgaz is continuing to resemble a state-owned enterprise, without any basic corporate governance principles or policies in place. Prior to the IPO, Romgaz and the government agreed on a Corporate Governance Action Plan, which should be implemented by the end of 2015. The action plan, among other things, is aimed at ensuring: 1) the appointment of two additional independent non-executive directors to the board, who have not been government officials in the past five years; 2) that independent directors should be a majority in the audit and remuneration committees; 3) the creation of an internal audit function; and 4) the strengthening of the internal code of conduct. Romgaz also wishes to comply with the Bucharest Stock Exchange's Corporate Governance Code, which calls for an adequate (at least one-third, including the chairman) number of independent non-executive board members. The presence of EBRD as a shareholder may help to improve the corporate governance standards.

Key board and management members

European Bank
for Reconstruction and Development

"Thanks to the EBRD we understood the value of good governance, which helped us to successfully list on the London Stock Exchange.

Investors particularly prized the presence of independent directors on the board"

CEO of an Egyptian Energy Company

So, the role of the board is….

European Bank
for Reconstruction and Development

….to provide leadership within a framework of prudent and effective controls which enables risk to be assessed and managed.

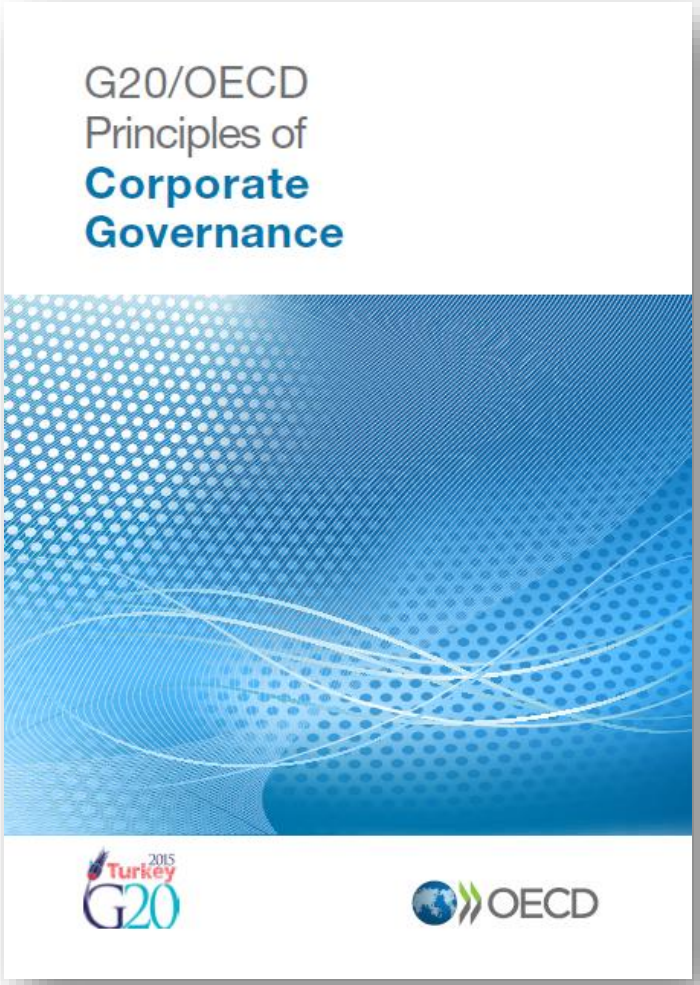
An independent, diverse and effective board is a pre-condition for a sustainable development focused on the attraction of long-term returns.

Does the board need to be independent?

European Bank
for Reconstruction and Development

The G20/OECD Principles of Corporate Governance recommends that:

"The board should be able to exercise objective independent judgement on corporate affairs"



Is there a value for the company?

European Bank
for Reconstruction and Development

Potential benefits:

(+) Represent the interests of the company and all shareholders.

(+) Provide “third-party” advice and oversight.

(+) Provide healthy challenge to management

Potential drawbacks:

(-) Might be less informed about company than insiders (especially if they only sit in committees).

(-) Might not behave with true independence

(-) Might not always be adequately qualified or engaged.

Shareholders like independent directors

European Bank
for Reconstruction and Development

Rosenstein and Wyatt (1990) examined the **stock market reaction to the appointment of independent directors.**

Sample: 1,251 independent director announcements (1981-1985).

Findings: Statistically significant positive stock price reaction in the 2-day trading window around the announcement. Results are strongest for small firms.

Conclusion: shareholders react favourably to the appointment of independent directors.

Shareholders like independent directors

European Bank
for Reconstruction and Development

Nguyen and Nielsen (2010) studied the **stock market reaction to the sudden death** of an independent director.

Sample: 229 deaths, 1994-2007.

Findings: Shareholders react negatively to sudden death of an independent director (-0.85% abnormal returns). Reaction is more negative when director serves key role: board chairman, audit committee member, or when overall representation by outsiders is low. Reaction is less negative when director has been on board long time.

Conclusion: shareholders react negatively to the loss of independent directors.

Journal of Financial Economics 95 (2010) 550–567

Contents lists available at ScienceDirect

Journal of Financial Economics

journal homepage: www.elsevier.com/locate/jfec

The value of independent directors: Evidence from sudden deaths

Bang Dang Nguyen, Kasper Meisner Nielsen

ARTICLE INFO

ABSTRACT

We investigate contributions of independent directors to shareholder value by examining stock price reactions to sudden deaths in the US from 1994 to 2007. We find, first, that following director death stock prices drop by 0.85% on average. Second, the degree of independence and board structure determine the marginal value of independent directors. Third, independence is more valuable in crucial board functions. Finally, controlling for director-invariant heterogeneity using a fixed effect approach, we identify the value of independence over and above the value of individual skills and competences. Overall, our results suggest that independent directors provide a valuable service to shareholders.

1. Introduction

Do independent directors provide a valuable service to shareholders? The dominant view on this question seems to be that independent directors are beneficial to shareholder value. This view is emphasized by an abundance of international guidelines for corporate governance and in regulatory initiatives following the corporate scandals of recent years.[1] Surprisingly, in spite of a rich body of academic literature on the topic of boards of directors, direct empirical evidence on the value of independent directors is scant. This paper attempts to fill this void by examining the stock price reaction to sudden deaths of corporate directors. Overall, we find that the sudden death of an independent director significantly reduces firm value by 0.85% and that the contribution to firm

[1] Examples include the Cadbury report in the UK, the Viénot reports in France, and the Sarbanes-Oxley Act in the US, which have all called for greater independence of the board of directors.

0304-405X/$ - see front matter © 2010 Published by Elsevier B.V.
doi:10.1016/j.jfineco.2010.07.004

Investors like independent directors

European Bank
for Reconstruction and Development

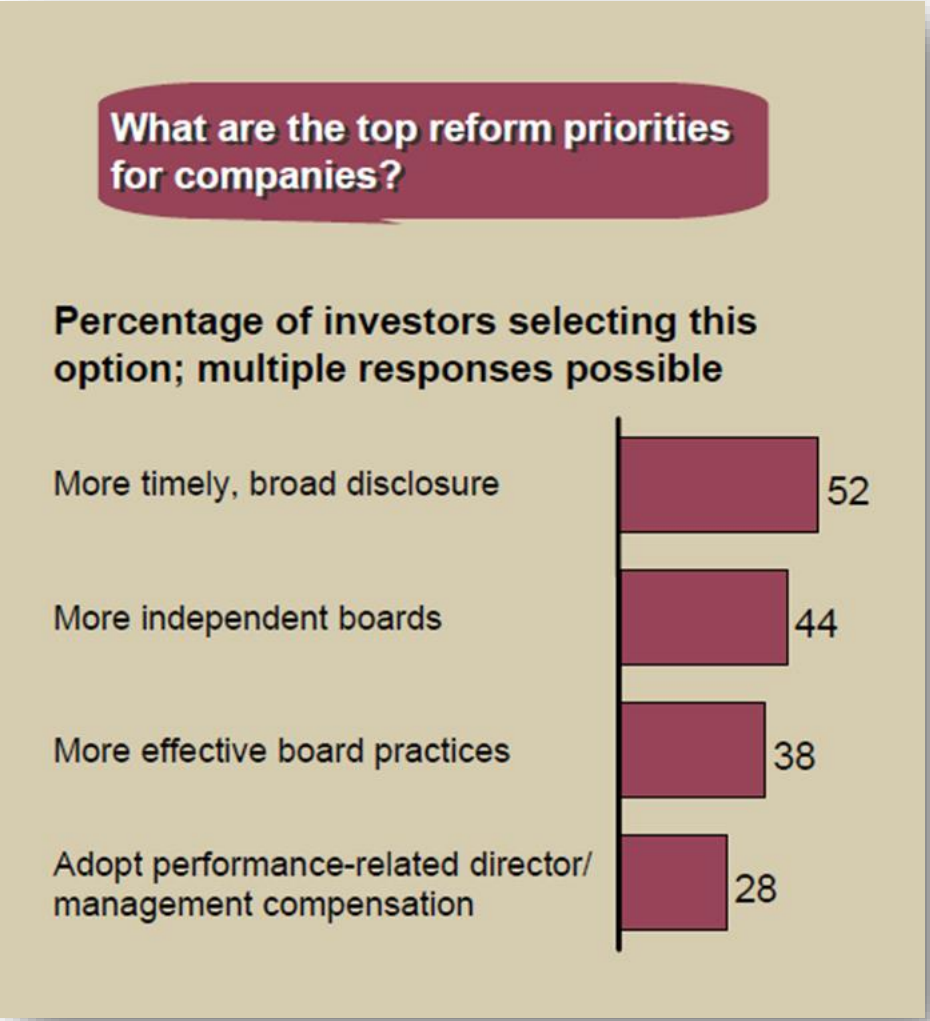
*The **McKinsey Global Investor Opinion Survey on Corporate Governance** (2002)* found that corporate governance is an established investment criterion.

Findings:

63% of investors would avoid certain bad governed companies

44% of investors would like to have more independent directors in boards

A significant majority of investors are willing to pay a 22% premium for a well-governed company

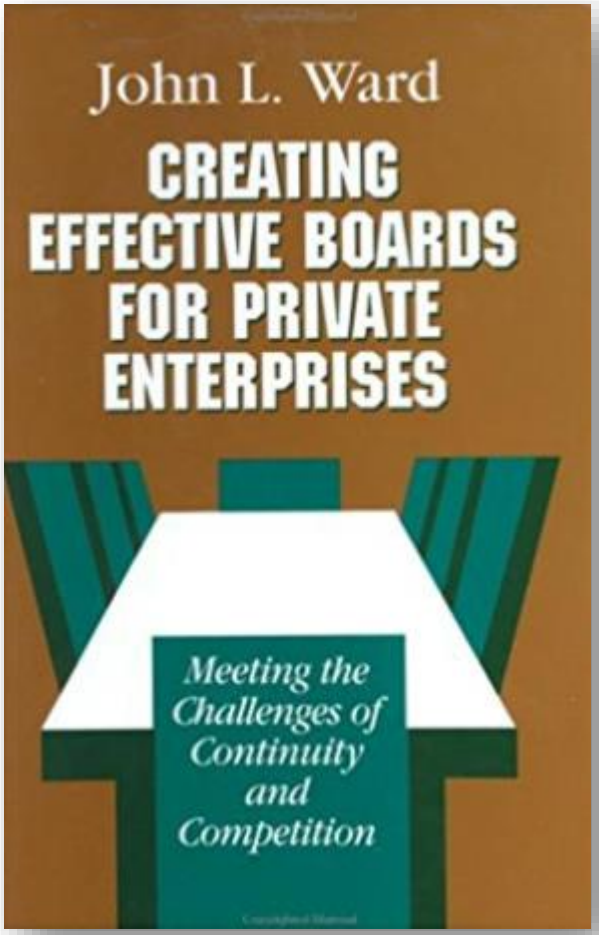


This is not only for listed companies and banks

European Bank
for Reconstruction and Development

Over 95 percent of family businesses do not survive the third generation of ownership.

A study conducted in the United States showed that the existence of an **active and non-family-controlled board was the most critical element in the survival and success of these companies**.



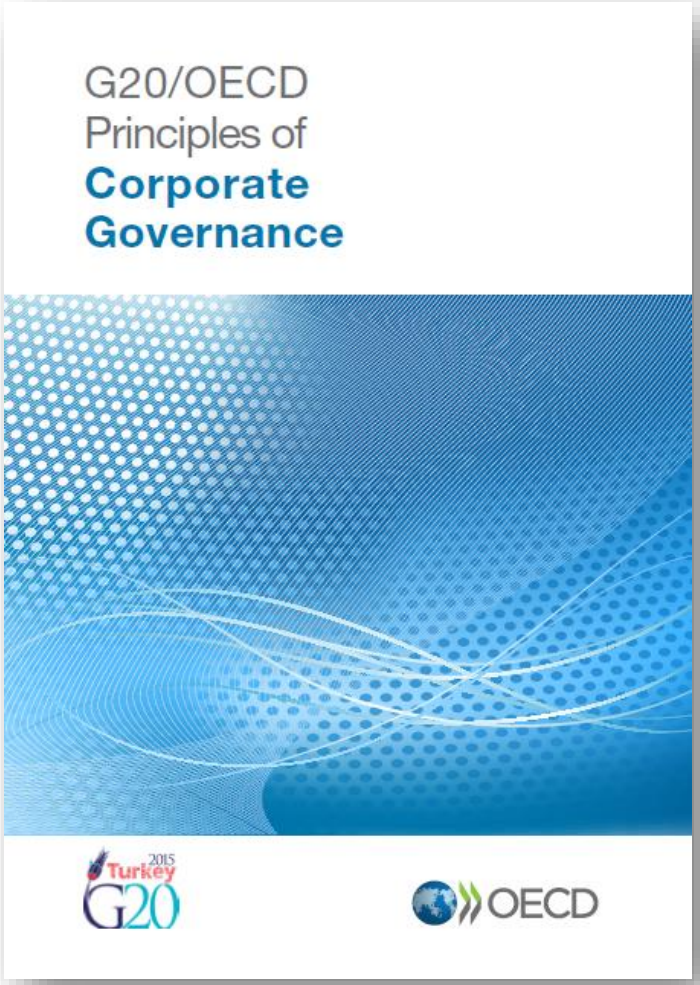
What is independence?

European Bank
for Reconstruction and Development

Most legislation and codes define independence in negative (non-affiliation) criteria only.

THIS IS NOT RIGHT!

Negative criteria *defining when an individual is not regarded as independent should be complemented by* ***"positive" examples*** *of qualities that will increase the probability of effective independence. (OECD)*



Independence “of mind”

European Bank
for Reconstruction and Development

The key is the challenging attitude

What can independent directors bring to the company?

European Bank
for Reconstruction and Development

- Contribute significantly to the decision-making of the board and bring an outside perspective on (definition and review of) strategy and robustness of control
- Adding new skills, experience and knowledge that might not be available within the firm
- Bring an objective view to the evaluation of the performance of the board and management
- Making hiring and promotion decisions based on values and independent from the controlling shareholders.
- Play a key role in areas where the interests of management, the company and its shareholders may diverge (e.g., executive remuneration, succession planning, M&As and the audit function)

“Independence” alone is not enough

European Bank
for Reconstruction and Development

Independence needs to be coupled with the necessary functional qualification and expertise…

“Independence” alone is not enough

European Bank
for Reconstruction and Development

…along with engagement and full understanding of the company’s business…

“Independence” alone is not enough

European Bank
for Reconstruction and Development

…with the stature and courage to ask those questions that otherwise would not be asked…

European Bank
for Reconstruction and Development

Questions?

cignag@ebrd.com
www.ebrd.com/law