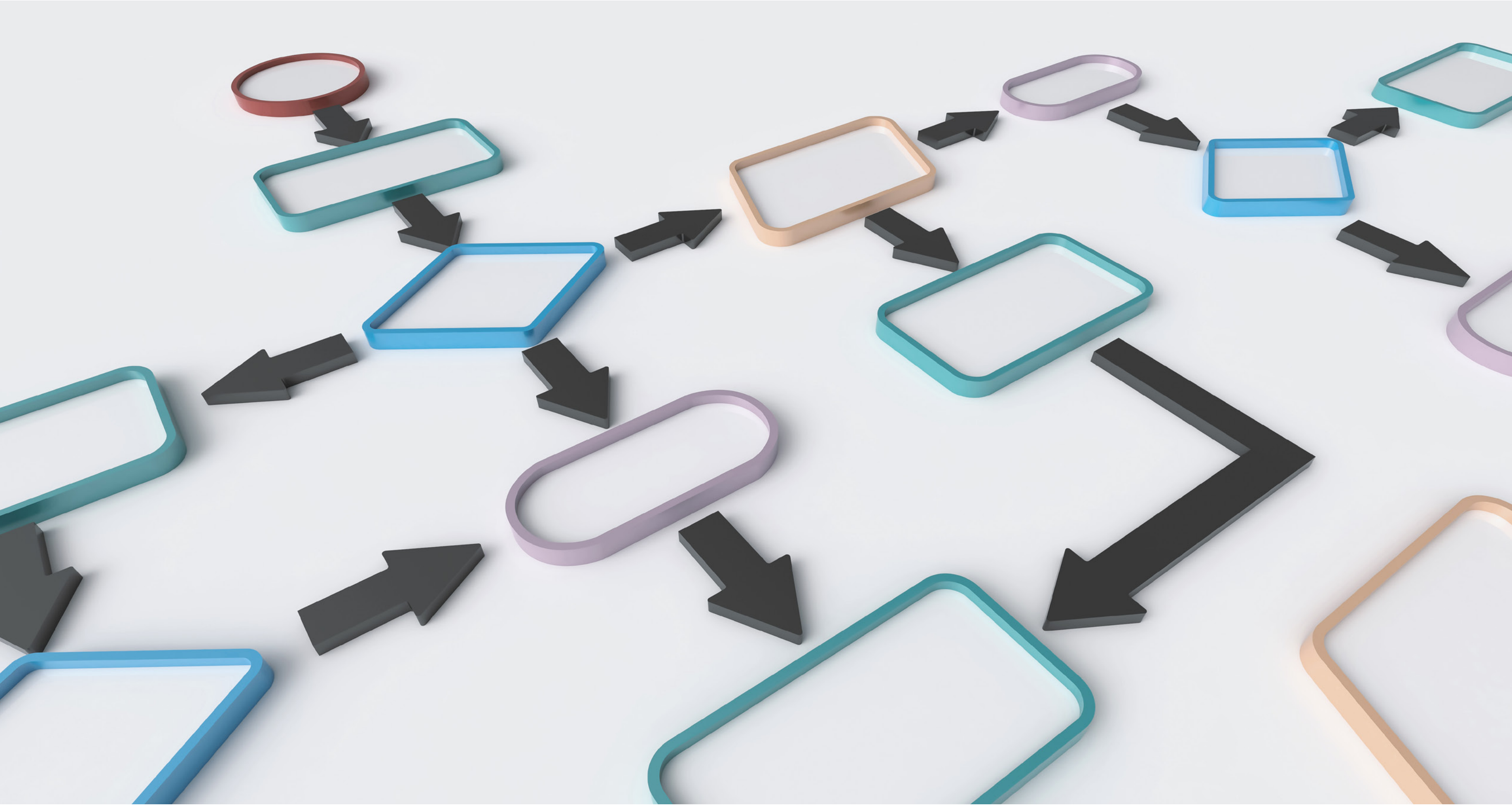
Strategy & Corporate Finance Practice

# Boards and decision making

What the pandemic has taught board directors about high-consequence, low-probability decisions.





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**This episode** of the *Inside the Strategy Room* podcast tackles the topic of decision making in the boardroom. It's the third in our continuing series on board perspectives around the most important issues facing organizations. In this session, Frithjof Lund, the leader of our board services work, leads a discussion with three experts. Aaron De Smet, who helps organizations improve their performance and agility, and senior expert Leigh Weiss are co-authors of a recent article about decision making in uncertain times. Suzanne Nimocks is a director on the boards of ArcelorMittal, Owens Corning, Ovintiv (formerly Encana), and Valaris (formerly Ensco Rowan), as well as a former senior McKinsey partner. You can listen to the episode on Apple Podcasts, Spotify, or Google Podcasts. This is an edited transcript of the discussion. For more conversations on the strategy issues that matter, subscribe to the series on Apple Podcasts, Spotify, or Google Podcasts.

**Frithjof Lund:** The quality of the decisions that boards make is, in large part, a measure of those boards' effectiveness. Suzanne, can you tell us about the decision-making processes on the boards you are involved in?

**Suzanne Nimocks:** Sure. I think board decisions fall into four categories. There are HR-related decisions around CEO succession, board succession, and executive compensation. There are financial decisions related to capital allocation, balance sheet management, and dividend policy. Then there are strategy- and M&A-related decisions around the purchase and sale of assets or businesses. Finally, you have governance-oriented decisions around structure, processes, and decision rules. Because boards of directors don't usually do their own analyses but rely on management teams to present them, the decision-making processes focus on asking challenging questions, playing devil's advocate, and helping management come up with alternatives.

**Frithjof Lund:** What do you see as the key pitfalls that boards can experience when making decisions?

**Suzanne Nimocks:** Relying entirely on presentations that management pulls together without probing for additional information is definitely one. Another pitfall is groupthink, when everyone has a similar point of view. It is important to have diversity of thought in the boardroom so people with different perspectives can challenge the ideas. And the third one is making decisions too quickly, without enough information.

**Frithjof Lund:** Aaron, which of the elements Suzanne mentioned do you think are most critical for board-level decisions?

**Aaron De Smet:** A lot of the decision-making issues that crop up are just more acute for boards. If you have a groupthink problem, for example, the board has nobody above it to keep that in check or ask, are we all too much on the same page? Similarly, if the board gets into a habit of rubber-stamping decisions brought to it, there is no governing mechanism that comes into play to correct it—until something potentially catastrophic happens that shows a lack of checks and balances.

**Leigh Weiss:** What is clear from the research is that for high-consequence decisions that the board and the executive team make together, the number-one predictor of these decisions being made fast and leading to better performance is the quality of the debate that goes into them. And one of the hallmarks of a high-quality debate is the diversity of perspectives brought to bear. Boards and management teams that are best able to manage high degrees of uncertainty and risk are those that bring in experts one would not normally find within the organization. For example, you would not expect a bank to have an expert at dealing with natural disasters, but as financial institutions increasingly handle mortgages on properties exposed to floods, that may be an important consideration.

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**Aaron De Smet:** Some boards are very good at certain types of decisions and not so good at others. For example, many are good at fiduciary and financial responsibilities because it is standard practice to bring in both internal and external experts in those areas, but they may not do the same on strategic matters. And some management teams don't always welcome healthy dialogue and debate with their boards. If they look to the board to merely review and approve, they are missing an opportunity. For their part, boards can fall into the trap of asking a few tough questions but then effectively rubber-stamping the decision the management wants no matter what.

**Frithjof Lund:** Making big decisions is challenging under normal circumstances, but during the pandemic the frequency of such decisions has grown. Aaron, how are organizations and boards you advise reacting to this change?

**Aaron De Smet:** The first thing you notice is they are meeting with boards more often because more decisions are coming up with more uncertainties and higher stakes. We saw this happening incrementally even pre-COVID-19 because of the faster pace of change and more turbulent business environments, but the pandemic has turbocharged it.

**Suzanne Nimocks:** No question about that. Two of the boards I'm on are in the energy industry, which was hit by the perfect storm of a decrease in demand due to COVID-19 and the Russian-Saudi detente, which put further pressure on oil prices. It completely wiped out any planning, so we have been in all-out crisis mode since [last] March. Those boards have been meeting weekly since there was a clear risk of financial distress and therefore it was critical for the board to be closely attuned to the implications of the situation. In other industries, the frequency is lower but board engagement has still never been higher.

**Aaron De Smet:** Those high demands mean it is important for the board to engage on the right decisions at the right time in the right way. One of the lessons we have learned about decision making is that you can't treat all decisions the same. Bylaws may require management to notify the board of certain things but that does not mean the board has to be involved in those issues. If you are satisfied that management is taking care of them, you can reserve your time for decisions that need board engagement.

One board I worked with could not get through any agenda because they were spending time on everything. It was a large healthcare system whose bylaws required that the board be notified of any patient death where human error might have been involved. The board would discuss these issues for 45 minutes and change nothing, make no decision other than the management team should continue on its path. Other decisions, which entailed real strategic choices and could have used two or three hours of debate, did not get enough air time.

**Suzanne Nimocks:** That is where committee structures and clarity around what should be decided within committee versus the full board become very important. There needs to be real discipline in how committees operate.

**Frithjof Lund:** Leigh, you and Aaron recently did research on effective decision making. Can you share some insight that particular matter today?

**Leigh Weiss:** We were interested in finding out what organizations that make both fast and good decisions do differently and whether that had performance implications. The research showed that those organizations outperform their peers by two times. The findings most germane for boards are around the big-bet, high-consequence decisions that are not made frequently. There, as we discussed, diversity of perspectives plays a big role. But how do you do that and move quickly? The second insight is that you need to distinguish between those with a vote and those with a voice. You can bring in diverse voices as long as you don't leave the impression that anybody who is sitting around the table also has a vote.

**Suzanne Nimocks:** I agree. The quick, agile decisions the management team can make. The big-bet decisions should not be made quickly and normally are made over a series of meetings and discussions. Most savvy CEOs know never to surprise their boards with a need to make a quick decision around a big bet.

**Leigh Weiss:** There are a number of best practices that can help with that, both in what is done ahead of a board meeting and during the meeting. Sometimes we see pre-syndication or a road show of a decision that needs to get made—and that's not helpful because it undermines debate. Instead, it's useful to consider multiple options during the board meeting, maybe assigning devil's advocates to different positions and exploring assumptions. We also found that higher-functioning boards tend to have trust between the board members and management, a degree of psychological safety where the executives feel comfortable bringing up mistakes.

**Suzanne Nimocks:** That last point is very important. You cannot be a high-functioning board without the management team feeling comfortable so that they feel safe to raise bad news. When doing post-completion reviews on major capital projects, for example, boards should recognize that the reason for these reviews is not to poke management in the eye about things that went wrong but ensure that management teams are learning from mistakes.

**Aaron De Smet:** Even how you manage the board agenda and what you engage on and with whom matters. The agenda would typically have a set of items you need to inform the board about and give them a chance to ask questions, but the trick is to not spend a lot of time on that. A second type of agenda item is where you need approval but you don't need debate—bylaws, regulations, governance. To create more time for the other issues, we often use a consent agenda that is sent out in a pre-read and the chair of the board would just ask in the meeting, "Does anybody disagree?"

That frees up time for discussion and guidance. Before bringing any big decision to the board, you need to have several conversations, as Suzanne mentioned, so these discussions and guidance shape where you are headed and what options you consider.

**Suzanne Nimocks:** The other thing I would add is that you need to make sure there is enough time set aside, both at the front end and the back end of the board meeting, to have executive sessions with just the directors, because you are much more likely to get an open dialogue in that environment. Normally, that executive session is saved for the end, but I find it helpful to start with an executive session, as a way to foreshadow where the more difficult debate is likely to be, and end with another.

**Aaron De Smet:** I have applied those very guidelines for senior executive teams, for the same reason. Most decisions and analysis are being brought in by people lower in the organization. The executive committee might not be close enough to the data and that committee operates, in many ways, like a board, so you get the same dynamics. A more junior team closer to the business or operational issue briefs the committee, asking for approval, and can make the same mistakes of not separating the rubber-stamp areas from those that need debate or not bringing in multiple options for the committee to consider.

**Frithjof Lund:** On the need to bring in different perspectives, how do you practically do that?

**Aaron De Smet:** There are quite a few ways. A board could request a red team/blue team type of debate happen around a potential merger or acquisition, and those individuals don't have to be in the room when the decision is made, you just want to bring in their perspectives. Or you can appoint a panel of external experts with different points of view, hash it out, and then excuse the folks who are not decision makers from the room, letting those decision makers reach alignment.

**Suzanne Nimocks:** In a couple of situations where we were evaluating whether or not we should make an acquisition, we brought in a broad set of voices but individually, not together, and asked them, what is investor reaction likely to be? What is the customer reaction likely to be? The competitor reaction, the employee reaction? We found that helpful to get more comfortable with a decision that initially we were not all aligned on.

**Frithjof Lund:** Aaron and Leigh, one thing you have studied in particular is high-stakes, low-likelihood decisions. What type of decisions are these typically?

**Aaron De Smet:** There are two flavors. One is things we think of as unlikely but if they do happen, the result would be catastrophic. These are often managed by a board risk committee that looks closely at such potential events and actions that could mitigate them. Because people do not have much experience with these situations, there is a lot of scenario planning, looking at trends, imagining what-ifs. The flipside, which boards tend to engage with less, are low-likelihood, high-consequence *positive* decisions. For example, an investment may be very unlikely to pay off, but if it did, that payoff could be so big that it would be worth a small investment. From a strategic perspective, boards should be more involved in these types of decisions.

**Leigh Weiss:** British investor Adam Sweidan coined the term "black elephants." They are a cross between black swans, which are highly unlikely and could not be predicted, and the elephant in the room, where there has been talk of something—like the global pandemic or the 2008 financial crisis—but it was seen as low-probability. When those happened, they did not come out of nowhere.

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**Suzanne Nimocks:** We all had pandemics on our risk registers, right? But how many companies and boards had thought about the implications for supply-chain disruption from border closures, having employees stuck in various places, and needing to quickly rework budgets? How deeply had anyone thought through the second- and third-order implications of these things?

**Leigh Weiss:** What makes it hard is the high number of potential low-likelihood, high-consequence predictable surprises, or those black elephants. How does a board prioritize which ones to pay attention to? You need to think through, on one axis, the scope of potential impact, then on another axis consider the level of certainty that this impact would happen. The degree of certainty will affect where boards need to get involved, because if the event has a lower certainty and would not be existential for the company, the board can leave that to the management to deal with.

**Aaron De Smet:** I will give you an example that highlights this. Some boards may have covered pandemic strategy in 2019, although that was probably luck because you would never know when a pandemic could hit. Some boards did not meaningfully engage on pandemic strategy until March or April. And then there were some that saw the news in January and jumped on planning then. At that point, the likelihood of large impact had risen. Some of those boards knew of mining companies in Africa during Ebola outbreaks and brought in people who had helped the organizations deal with those crises and asked them what they learned and how they wish they had prepared. And those boards started shaping pandemic preparations with management in January. Most boards didn't. When did your boards start pandemic planning, Suzanne?

**Suzanne Nimocks:** Two of the boards I am on engaged in early February. Interestingly, one had been through the Ebola experience and recognized the signposts. The other had many people in China and the management team saw the signals, knew this was a big risk, and so started talking to the board about preparation strategies. These management teams briefed the boards—here is what we don't know, here is what we would do if this happens, here are the remaining uncertainties—and asked for input or things they might have missed in terms of possible implications.

**Aaron De Smet:** What a great relationship to have with the board if the management values the board's engagement enough to approach them for input that

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early! Most boards I am aware of had those conversations a month later, and there is a lot you can do in a month. What you describe, Suzanne, strikes me as management inviting the board to help shape the decisions by asking questions. In a period of great turbulence and uncertainty, probably the best way the board can help shape better actions that will have to be taken on the fly is to prepare the management team by posing different scenarios.

**Frithjof Lund:** The past nine months have changed the dynamic between boards and management in many organizations. How do you see that relationship evolving in the future?

**Suzanne Nimocks:** I think we will see an increased frequency of communication. Historically, boards met six times a year in person. I think we will see a hybrid model of some meetings via videoconference and some in person, and boards will think through both the right frequency and mode of interaction. I must say, I see a degradation in the quality of the discussion in the virtual format. While it's been fine for this period, it is difficult to onboard new directors effectively or build trust with management this way. I think the frequency of interactions has to be at least four times a year, but with more frequent virtual discussions that are shorter, to communicate and update. The current pace is not sustainable.

**Aaron De Smet** is a senior partner in McKinsey's New Jersey office, **Frithjof Lund** is a senior partner in the Oslo office, and **Leigh Weiss** is a senior expert in the Boston office. **Suzanne Nimocks** is a board member of ArcelorMittal, Owens Corning, Ovintiv, and Valaris, as well as an alumna of McKinsey's Houston office.

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