BRINGING SUSTAINABLE DEVELOPMENT TO THE CORPORATE LEVEL: BOARDS’ COGNITIVE BIASES TOWARDS ESG AND RELEVANT DEBIASING INTERVENTIONS

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Abstract

The proposed research is an attempt to view how internationally recognised principles of sustainable development can be implemented at the corporate level, in particular, how the company’s board of directors should respond to climate and environmental challenges. Specifically, the paper examines the problem of reducing board members’ repeated cognitive biases towards such a mainstream governance concept as ESG (Environmental, Social and Corporate Governance). The research focuses on the five most well-known cognitive biases of a board towards ESG: over-optimism, status quo effect, confirmation bias, hyperbolic discounting, and groupthink. Subsequently, the paper draws recommendations for overcoming or mitigating these biases by introducing and describing several debiasing interventions and quality control tools. These tools are conditionally divided into three groups: changing incentives, optimising choice architecture, and debiasing training. The author believes that incorporating behavioural insights into an analysis of the board’s ESG commitment would bring a fresh perspective to this research area, which now is typically dominated by a rational choice framework. The paper combines theoretical analysis of the existing literature in law, behavioural economics and psychology with qualitative research application based on data obtained from first-hand observations, board empirical studies, questionnaires, and focus groups.

Key words

sustainable development, ESG, implementation, corporate governance, board of directors, cognitive bias


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Introduction

In recent years the term “ESG” has become the new buzzword and mainstream issue for listed companies, financial organisations, investors, customers, employees, and government regulators all over the world. They all pay nowadays increasing attention to the impact that a company has on the society, including carbon emissions, water stress, raw material sourcing, biodiversity and land use, and other ESG measures. This factor can present both risks and opportunities that influence a company’s ability to create long-term value.

The importance of ESG is emphasised in many domestic and international documents. For instance, target 17.16 of the UN Sustainable Development Goals is formulated as: “Enhance the global partnership for sustainable development, complemented by multi-stakeholder partnerships that mobilise and share knowledge, expertise, technology and financial resources, to support the achievement of the sustainable development goals in all countries...” As a part of development of this direction at the EU level a set of policy initiatives with the overarching aim of making the EU economy sustainable, commonly known as “The European Green Deal”, was taken by the European Commission in December 2019. This initiative is complementary to the Non-Financial Reporting Directive (hereinafter — NFRD), which requires large public companies to disclose their environmental, social, and governance policies and due diligence processes if they have them, or otherwise explain why they do not have any (“comply or explain” approach).

1 ESG criteria include a wide range of issues, such as the adequate disclosure of carbon emissions, the amount and conditions of compensation in incentive schemes, the approach to human rights compliance by a company’s suppliers, and the representation of various groups in a company’s governing bodies.


In a nutshell, the European Green Deal is a new growth strategy that aims to transform the EU into a fair and prosperous society, with a modern, resource-efficient and competitive economy where there are no net emissions of greenhouse gases by 2050 and where economic growth is decoupled from resource use. Reaching this target requires action from all sectors of the European economy, including investing in environmentally-friendly technologies, supporting industry to innovate, the usage of cleaner, cheaper and healthier forms of private and public transport, decarbonising the energy sector, ensuring buildings are more energy efficient, and so on. In particular, the European Green Deal sets out that sustainability (which means all ESG factors taken together) “should be further embedded into the corporate governance framework, as many companies still focus too much on short-term financial performance compared to their long-term development and sustainability aspects”.

In order to direct investments to the economic activities most needed for the transition, in line with the European Green Deal objectives EU Taxonomy for Sustainable Activities (hereinafter — Green Taxonomy) was adopted and came into force in July 2020. Green Taxonomy is a classification system that categorises economic activities as environmentally sustainable, aiming to prevent greenwashing and help investors make informed sustainable investment decisions. Alongside the Green Taxonomy the European Commission introduced the Sustainable Finance Disclosure Regulation (hereinafter — SFDR), which mandatory requires financial market participants to disclose ESG information. In particular, SFDR, which officially came into effect on 10 March 2021, requires all financial market participants in the EU to report ESG disclosures, with additional requirements for products that promote ESG characteristics or that have sustainable investment objectives. Finally, in November 2022 the EU Parliament adopted the Corporate Sustainability Reporting Directive (hereinafter — CSRD) which extends the current rules on sustainability reporting to all companies listed on an EU-regulated market, except for microenterprises. Specifically, there is no longer the possibility to publish non-financial information in a separate non-financial report as sustainability information is to be disclosed exclusively in the management report.

All these emerging regulations result in substantial transformation of all critical aspects of the corporate governance system, including corporate strategy, risk management systems, remuneration systems, information disclosure systems, and so on. For the board of directors, as the body that should implement the strategic management of the company, define essential principles and approaches to organising risk management and monitor the activity of the company’s executive bodies, paying attention to ESG is becoming crucial. Performance of the board’s functions today is no longer possible without considering material ESG-related risks, such as systemic financial stability, supply chain disruptions or environmental impact. It is also important to oversee management’s performance in other ESG-sensitive matters, including management of human capital, labour standards, consumer, and product safety.

However, as recent surveys and studies show, board members remain biased against ESG and focus too much on the company’s short-term financial performance compared to long-term sustainable development, perceiving ESG factors rather as part of a corporate charity or social responsibility. For instance, in 2020 just under half of the company directors surveyed (45%) said that ESG issues were regularly part of the board’s agenda.

According to the behavioural theory of a firm, this is because directors rarely base decision-making solely on rational principles and consider all possible risks and consequences of their decisions. Instead, directors base their decisions on different cognitive biases and heuristics, seeking a satisfactory rather than optimal solution. In other words, the effects of climate change and other ESG factors are diffuse, slow, and complex, whereas human cognitive processes evolutionarily developed to address concentrated, immediate and straightforward problems. A board’s cognitive biases towards ESG can

9 It is widely known that board names and functions vary among countries. Some countries, like Germany, have a two-tier board structure which separates the “supervisory board” (composed of nonexecutive board members) and the “management board” (composed entirely of executives). Other countries (like the US) have “unitary” boards which bring together executive and non-executive directors. Considering this, hereinafter we will use the single term “board of directors” to refer to all these/such structures for the sake of terminological uniformity.
create problems for the company such as short-termism, the adoption of suboptimal decisions, which are detrimental to the company and its stakeholders in the long-term, failure to see potential problems and identify ESG risks, lack of flexibility and creativity, and resistance to new ideas. It is therefore essential to understand the board’s dynamics in response to complex problems such as climate change, pollution, and other ESG risks, and to incorporate behavioural research into analysing its decision-making.

1. Theoretical framework

1.1. Behavioural theory of boards and corporate governance

The chronology of the modern theory of the firm begins with the pioneering article of R. Coase “The nature of the firm”,11 where he states that firms arise when the transaction cost of producing through the market exchange becomes higher than producing within the firm. Coase's transaction costs theory laid down the basis for different contract theories (often called post-Coasian) developed in 1960–1970s. The most influential of those theories, prevailing in the corporate governance research literature, is the so-called “agency theory”. According to the agency theory, whose foundations were laid by the work of M. Jensen and W. Meckling,12 a rational maximisation of benefits guides managers (agents) and owners (principals), sooner or later, their interests will objectively diverge, since for the agent his interests will come to the fore. So, the main focus of this research is on how boards of directors may protect the owner’s interests from the manager’s opportunistic behaviour and reduce agency costs by finding appropriate incentives and control mechanisms motivating the agent to act in the principal's interest. These mechanisms are commonly categorised in literature into two subgroups, respectively, “regulatory strategies” and “governance strategies”.13

Alongside the contract theories, a number of studies, subsequently named “a behavioural theory of the firm”, claimed the need to pay more attention to intrafirm behavioural processes and decision-making. These studies arose in the 1960–1970s starting from H. Simon's article “A behavioural model of rational choice”14 and elaborated in the book by R. Cyert and J. March.15 However, although today behavioural studies of boards and corporate governance are primarily associated with Cyert and March, these studies are dispersed across a variety of schools and disciplines and employ different theories and methodologies.16 As some researchers claim, “the idea that the different behavioural theories provide complementary perspectives and that none of them can independently provide a complete explanation seems to have gained some ground in the field”.17 So, for consistency in the present research, the common conventional term “behavioural theory of the firm” is used for all these behavioural theories.

As in the case of the human model in economics in general, the concept of agency theory most criticised by behaviourists is the assumption that managers-agents are perfectly rational own-utility maximisers, seeking to act opportunistically by taking advantage of information asymmetry.18 In response, proponents of the behavioural theory of the firm argue that managers often have to act in a situation of uncertainty, with limited knowledge and the ability to anticipate the outcome.19 Respectively, the behavioural theory of the firm emphasises the importance of studying natural behavioural processes and dynamics in the firm's managerial bodies. This approach is based on such critical concepts as satisfying, routinisation, dominant coalition, and bounded rationality.20

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Under the satisfying concept, corporate actors tend to accept decisions that satisfy their current needs rather than search for optimal decisions.21 In other words, rather than making optimal decisions, directors tend to accept the ones that are readily available in current circumstances and address particular immediate problems. The concept of routinisation asserts that since most managerial activity consists of repetitive, stable, and relatively well-established patterns of action,22 managers tend to grossly simplify acute problems, applying ready-made routines to save time and mental resources.23 The concept of a dominant coalition states that organisations are not monolithic entities with a single goal, but rather complex political systems where different stakeholders may have conflicting interests and achieve their goals in the process of negotiation, participating in various coalitions.24 The board's task in this regard is to get the coalitions to cooperate or create a “dominant coalition”.25 The concept of bounded rationality, as mentioned earlier in the discussion on behavioural economic analysis of law, firstly, highlights the limitations in human information processing, especially when it comes to computation and prediction.26 Secondly, as being rational is too costly, people try to save cognitive effort by leaning on shortcuts or “heuristics”.27 Finally, due to these points and other factors such as the impact of emotions, our cognition and judgment allow for a wide range of recurring cognitive biases.28

As with the broader concepts of behavioural and traditional economics, it would be wrong to view the behavioural theory of the firm and agency/transaction costs theory as contradictory. The behavioural approach does not claim that corporate actors are not trying to maximise their utility. It only claims that they cannot do so because of some limitations of their cognitive abilities and, to some extent, serves as an essential building block in transaction costs theory.29 Therefore, at the present stage of corporate governance research, there are no signs of confrontation between the two approaches mentioned above, but rather their mutual convergence.

1.2. Cognitive biases and boards

The concept of human cognitive biases as systematic errors or deviations from rationality in thinking and judgment underlies the bounded rationality assumption and the behavioural theory of the firm in general. The foundation of the cognitive bias concept was laid in 1973 when A. Tversky and D. Kahneman stated that people rely on a limited number of heuristics which sometimes lead to reasonable judgments but occasionally result in systematic errors.30 Since then, psychologists and behavioural economists have thoroughly researched this phenomenon and identified numerous types of cognitive biases that differ from rational choice theory and lead to poor decision-making.31 In his best-selling book “Thinking, Fast and Slow”, D. Kahneman contributed to research on cognitive biases by introducing two co-existing systems that human cognition operates along: “System One”, a fast, emotional processing system that allows people to process information automatically and quickly with little or no effort, and “System Two”, introducing deliberation and logic into our thinking, allowing for reflective and effortful processing of information, including complex computations. System One is in charge most of the time and continuously deploys intuitions, shortcuts, and heuristics for System Two, which helps us navigate the world more quickly and efficiently but may also lead to cognitive errors and biases.32 Thus, while it allows us to make faster decisions, cognitive biases impede critical thinking and, thereby, the rationality of our judgments and conclusions.33

Almost simultaneously with the introduction of the cognitive bias concept, researchers began to investigate the impact of various biases on decision-making processes in policy-making groups and corporate managerial bodies.\(^{34}\) Biases frequently occur in corporate bodies because managers are often required to make decisions in a state of uncertainty. In particular, the study of cognitive biases in the corporation helps understand how corporate actors are subject to irrational decision-making in the interaction and processing of information.\(^{35}\) The ways that information-processing cognitive biases negatively influence group judgment and decision making, and the elaboration of tools needed to mitigate such effects remain one of the central research problems in psychological and behavioural literature\(^{36}\) and will be the subject of consideration in the following paragraphs of this study concerning boards and ESG.

2. Board’s cognitive biases towards ESG

2.1. ESG factors and cognitive biases

Increased attention of stakeholders to ESG factors, as it seems, make the company's board members undertake initiatives to improve performance on ESG issues, become more and more EGS aware, and begin to pose new ESG related topics in the agenda for board meetings. Moreover, on the basis of a review of the current literature it can be concluded that there are indeed both theoretical and empirical arguments that ESG factors are related to firm performance, although empirical evidence is ambiguous and contextual.\(^{37}\) However, there is enough credible evidence that directors still overlook sustainability in favour of short-term financial motives. In particular, the EU Study on directors' duties and sustainable corporate governance\(^{38}\) state a trend in the past 30 years for listed companies within the EU "to focus on short-term benefits of shareholders rather than on the company's long-term interests". Another credible source revealing the board member's attitude towards ESG is the 2020 Annual Corporate Directors Survey by PwC which examined the views of about 700 directors of public companies from across the United States on various corporate governance issues. According to this survey:

- In 2020, only 38% of directors said ESG issues have a financial impact on the company's performance.\(^{39}\)
- In 2020, just under half of the directors (45%) said that ESG issues are regularly a part of the board's agenda, and just 34% in 2019.\(^{40}\)
- In 2019, only 50% of directors said that ESG issues are linked to the company's strategy.\(^{41}\)
- In 2019, 56% of directors said that investors' focus on environmental/ sustainability issues is excessive.\(^{42}\)

Among all, there is ample evidence of the board’s biases towards particular aspects of ESG. For instance, in a 2015 Government Accountability Office report, almost half of the stakeholders surveyed listed unconscious bias as affecting the selection of women on boards.\(^{43}\) Another study found that 87% of women directors reported facing challenges based on their gender, including not being heard, not being accepted as part of the "in" group, difficulty establishing credibility, and stereotypes.\(^{44}\)

The above mentioned studies and surveys lead us to conclude that the director's short-termism and biases towards ESG still existed and manifested themselves. Hence, the aim is to reveal why it happens and its consequences for the quality of the board’s decision-making. According to Kahneman’s doctrine, cognitive distortions towards ESG occur because human's cognitive System One operates to address intuitive, immediate, and straightforward problems. In contrast, such ESG-related risks like climate

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\(^{39}\) PwC. 2020 Annual Corporate Directors Survey. P. 8.

\(^{40}\) Ibid.

\(^{41}\) Ibid. P. 20.

\(^{42}\) Ibid. P. 19.


change, carbon emissions, pollution, lack of diversity, and inclusion are latent, diffuse over time, slow and complex for intuitive evaluation. Moreover, many decision rules that characterise human judgment and choice under uncertainty take advantage of past personal experiences.\(^\text{45}\) In contrast, for such low-probability, high-consequence ESG risks as climate change, biodiversity loss, or deforestation, the board members, as a rule, have limited or no experience. In other words, ESG-related risks are often new and emerging or unexpected, making it less likely for directors to identify them.

Moving to a particular board's cognitive biases towards ESG, it is worth mentioning that in the psychological and behavioural literature, one can find dozens of cognitive, decision-making, and memory-related biases, many of which are relevant to the board's decision-making and dynamics and, to varying degrees, relevant to ESG related issues. As the scope of the current research is limited, it focuses on the five most well-known, often encountered and described conceptually in behavioural literature biases. However, the board's practices and quality control tools for overcoming or mitigating biases described in paragraph 3 could apply to a broader range of cognitive distortions.

2.2. Overoptimism

Even when people have information about the probability of a specific event occurring, their prediction that the event will happen to them is subject to overconfidence bias, that is the precondition that a favourable outcome is more likely than an unfavourable one.\(^\text{46}\) Similarly manifests itself an overoptimism bias — “the tendency of many people to overrate their abilities, contributions, and talents — and a tendency toward puffery and dismissal of risks”.\(^\text{47}\) Overconfidence and overoptimism are closely related, but whereas overoptimism relates to overall risk perception too optimistically, overconfidence is more related to self-perception. However, both are regarded in behavioural studies as systematic and genetically predetermined.\(^\text{48}\) For instance, experimental data have shown that people are unrealistically optimistic towards their driving abilities — almost 90% of drivers believe they drive better than average.\(^\text{49}\)

The tendency towards overconfidence and overoptimism is commonplace among managerial professionals, particularly corporate CEOs and board members. For instance, according to the 2019 Annual Corporate Directors Survey by PwC, directors shared a highly optimistic view of their companies' potential for future growth. Specifically, 90% of directors said they were confident about their company's prospects for growth over the next twelve months. An even higher percentage, 93%, were optimistic about growth over the next three years. Directors are often prone to over-optimism bias because optimism is considered essential for a leader's image, who thus motivates colleagues and instils confidence and optimism about the company's prospects.\(^\text{50}\) Moreover, managerial over-optimism becomes the norm in company communications with external stakeholders, thereby creating inflated expectations of future growth and profitability. As a result, the constant need to demonstrate “external” optimism can create a distorted picture of reality for board members and hinder their critical thinking. In such a case, the costs and risks of a particular board's decisions will tend to be underestimated and the benefits overestimated.

Board's overoptimism towards ESG factors leads to several negative consequences both for the company and stakeholders. First, the director's distorted perception of reality caused by overoptimism bias can involve more ESG risks, such as engaging in ecologically or socially risky projects and not taking precautionary measures to provide safety. Second, as a growing number of firms issue ESG reports, the board's overconfidence can harm the quality of ESG reporting and provoke greenwashing. The emergence of the “greenwashing” concept is associated with the facts when some corporations embellished their reporting, omitted the risks and sought to present themselves as an industry leader.\(^\text{51}\) For instance, various studies have presented evidence that the tone of corporate social responsibility


2.3. Confirmation bias

Another cognitive bias related to the board’s perception of ESG is the confirmation bias, “the term to describe the observation that actors often interpret information in ways that serve their interests or preconceived notions”. In everyday life, this bias allows a person to make fast and timely decisions in the face of danger or uncertainty. Empirical evidence supports the idea that confirmation bias is a systemic and persistent deviation and manifests itself in various areas of human activity. Among all, confirmation bias includes a propensity to overstate or even imagine correlations that confirm beliefs and to understate correlations that may contradict beliefs.

Board members also display this bias when they select information and interpret ambiguous evidence in a way that supports their entrenched attitudes and beliefs. Confirmation bias towards ESG factors can negatively influence the quality of the board’s decision-making in two directions. First, the absence of ESG related problems in the past, for example, lack of environmental accidents in recent years, can lead directors to overconfidence that everything goes well. As a result, they will overvalue the evidence that supports their optimistic attitude and undervalue or ignore signals supporting “inconvenient truth”, including cases of pollution, human rights violations, hazardous waste, and many others. Conversely, suppose the director has entrenched views vigorously against some ESG factor, for instance, biased against the presence of women on the board. In that case, he will support evidence that confirms his sceptical position and reject arguments and even research findings that challenge it.

2.4. Status quo effect

According to the status quo effect, “individuals have a strong tendency to remain at the status quo because the disadvantages of leaving it loom larger than advantages”. The status quo effect is a consequence of two other well-known cognitive biases, loss aversion and the endowment effect. It occurs when the individual prefers to stay with the status quo because he evaluates the potential losses from changing the status quo more strongly than the potential benefits. There is a large body of empirical research confirming that status quo bias is evident in both hypothetical choice situations and in situations where participants in an experiment are financially responsible for the consequences of their decisions.

Knowing that legislators and policymakers are widely using the status quo effect by choosing a different default rule in laws, thus creating a different perceived status quo and nudging people to a more desirable choice. Among the examples are contract law default rules, default on employee participation in retirement savings plans, and organ donation defaults within the European Union.

Status quo bias in the board’s activity can hinder the implementation of ESG in a way that directors will be reluctant to engage in projects and practices involving substantial changes simply because it brings too many risks of the unknown. As with confirmation bias, reliance on intuitive processes for making decisions under uncertainty will likely lead directors to focus on the recent past and thus maintain the
status quo. For example, as the 2020 Annual Corporate Directors Survey by PwC showed, boards are reluctant to adopt rules or laws that are likely to limit their discretion. Even though most directors believe that board diversity is beneficial, they do not support laws that would require boards to change the composition, because they prefer to implement these practices gradually. On top of that, as behavioural studies claim, people often tend to suppress cognitive dissonance by maintaining an illusion of normality (the so-called "illusion of control effect"), interpreting new data as consistent with the status quo, rather than seeing it as a sign of impending danger. In other words, status quo bias can push directors to accept non-rational or suboptimal decisions, for instance, dismiss suggestions to correct a proven strategy despite changes in circumstances or key metrics, to maintain cognitive consistency. However, research has shown that top managers are different in the extent of status quo bias and that different individual, firm, industry, and even national characteristics can affect the degree of status quo bias.

2.5. Hyperbolic discounting

A substantial amount of research shows that human economic preferences are dynamically inconsistent. Graphically, they tend to look hyperbolic rather than the standard exponential curve. Generally, humans' hyperbolic discounting is featured by “relatively high discount rate over short horizons and a relatively low discount rate over long horizons, which sets up a conflict between today's preferences and the preferences held in the future.” Although everyone’s level of hyperbolic discounting varies and depends on a variety of factors, including age, experience, and the degree to which rewards are distributed over time, in general, humans are “present-biased”, i.e. having an opportunity to get two identical prizes, they tend to prefer the one they get earlier rather than later. This happens mainly because assessing the likelihood of future satisfaction, the individual feels a subconscious threat of uncertainty about that prospect.

As research shows, corporate managers also often have overly short time horizons and a bias for immediate gratification and hyperbolic discounting. The most critical consequence of hyperbolic discounting for boards is that it creates temporary preferences for short-term decision-making rather than orientation on long-term sustainable development goals. Such a short-term way of thinking is referred to in the literature as “short-termism”, defined as “decisions and outcomes that pursue a course of action that is best for the short term but suboptimal over the long run”. Corporate short-termism is one of the most severe problems facing companies and society today because it undermines the idea of long-term corporate sustainability, discourages innovation, and harms society's long-term social and environmental interests. For boards of directors, as bodies supposed to set and focus on long-term strategic goals and create a compensation system that encourages long-term success, such a short-term approach is exceedingly dangerous. Board's hyperbolic discounting and short-termism can be the reason to keep out the discussion on ESG factors and thus provoke detrimental consequences for companies and the broader social, environmental, and economic systems in which they operate.

2.6. Groupthink

The term “groupthink” was introduced by the American psychologist I. Janis in an article on the role of group decision-making in the foreign policy mistakes of the US and defined as “a mode of thinking that people engage in when they are deeply involved in a cohesive in-group when the members’ striving for
unanimity overrides their motivation to realistically appraise alternative courses of actions”.\textsuperscript{74} Later studies confirmed that groupthink possesses a significant threat to the quality of collegial decision making.\textsuperscript{75} Stated differently, groupthink stands for an “excessive form of concurrence-seeking among members of high prestige, tightly knit policy-making groups”.\textsuperscript{76}

Corporate boards are perfect examples of such groups, so they are prone to groupthink, especially when faced with controversial and complex issues like ESG and sustainable corporate development. Ultimately, as with every cognitive bias, groupthink is a psychological defence mechanism for overcoming group conflict and stress when making challenging decisions.\textsuperscript{77} It would be wrong to assert that it is always detrimental to group decision-making. For instance, as I. Janis pointed out, it could be helpful when a group is making routine decisions because it saves time. In total, Janis identified eight symptoms of groupthink, among them stereotyping and disregarding of alternative perspectives, excessive optimism and risk-taking, self-censorship of group members, an illusion of cohesion among group members, pressure to be loyal and conform with the group position, and the presence of “mind guards”.

The impetus for groupthink research concerning the boards was caused by the series of corporate scandals and failures in the early 2000s, specifically, the high-profile bankruptcy of the American energy company Enron in 2001.\textsuperscript{79} In particular, M. O’Connor, based on the analysis of the materials of the work of the Enron’s board, concluded that there were almost all above-mentioned symptoms of groupthink in the Enron’s board along with others like homogeneity amongst board members, lack of impartial leadership, loss of independence and presence of various gatekeepers, such as auditors, lawyers, etc.\textsuperscript{80} Further, A. Howard found that groupthink was prevalent in Citigroup’s board before the financial crisis of 2008,\textsuperscript{81} and A. Hermann and A. Ramall researched the detrimental role of groupthink in the collapse of Swissair, a Swiss airline company.\textsuperscript{82} The negative role of groupthink for board performance has subsequently been emphasised both at the doctrine level and in corporate governance codes.\textsuperscript{83} Despite this, the problem of groupthink remains relevant for boards. For instance, according to the 2020 Annual Corporate Directors Survey by PwC, 36 % of directors said that “it is hard to voice a dissenting view on at least one topic in the boardroom.”\textsuperscript{84}

Regarding ESG, the board’s groupthink can lead to the adoption of suboptimal strategic decisions due to failure to identify ESG risks, lack of independent and critical thinking, the dominance of a leader’s (chair or CEO) individual entrenched positions over the board, and so on. Boards suffering from groupthink are prone to dismiss ESG factors as they are usually incapable of reacting to warning signs or new information in their decision-making process due to self-censorship and reluctance to see uncomfortable truths. Moreover, groupthink in boards can increase other cognitive biases towards ESG, particularly overoptimism and confirmation bias, reinforcing the director’s tendency to be unreasonably self-assured in his decisions.\textsuperscript{85}

3. Relevant debiasing interventions

3.1. Debiasing interventions

As previously mentioned, over the last 40 years, considerable scientific efforts have been made in the behavioural research literature to elaborate tools and methods to improve the quality of decision-making

\textsuperscript{84} PwC. 2020 Annual Corporate Directors Survey. P. 16.
in groups. These tools are primarily referred to in the literature as debiasing interventions or quality control tools. Generally, debiasing refers to a “procedure for reducing or eliminating biases from the cognitive strategies of the decision-maker.” At least three types of debiasing interventions have been elaborated in behavioural research to mitigate the influence of cognitive distortions on decision-making: changing incentives, optimising choice architecture, and debiasing training.

3.1.1. Changing incentives

Changing incentives refer to debiasing individuals by creating certain stimuli to behave in ways aligned with private or public interests, mainly by providing financial rewards and punishments, bonuses, grants, subsidies, etc. An example could be tax deductions for companies using energy-saving technologies or providing bonuses for the company’s CEO to achieve specific performance targets. Debiasing by creating incentives mainly refers to the classical rational agent model, discussed in paragraph 1 of this paper. However, in recent decades, behavioural insights brought a new perspective to motivation management. They highlight how people subjectively interpret various stimuli, and conclude that monetary incentives may not be sufficient to achieve desired behaviour without careful consideration of how they are designated, described, and understood. On top of that, debiasing incentives could be too costly or even backfire when they are not aligned with human’s intrinsic motivation, so for proper debiasing, careful calibration and implementation of incentives is needed.

3.1.2. Optimising choice architecture

Optimising choice architecture refers to debiasing decisions by improving the way how information is reported and how choices are promoted. This specific type of regulation, also referred to as “soft paternalism”, was promoted as a “nudge” by a best-selling book by R. Thaler and C. Sunstein “Nudge: Improving Decisions about Health, Wealth, and Happiness”. It is defined as “any aspect of the choice architecture that alters people’s behaviour in a predictable way without forbidding any options or significantly changing their economic incentives”. Debiasing nudge is supposed to be a cheap, easily scalable, non-obtrusive way to improve the quality of an individual’s decision-making while maintaining the libertarian ideal of freedom of choice and placing no significant burden on those who are already acting in a desired way. Within the organisation, the application of nudges gave rise to such a phenomenon as “nudge management”. It is as a “management approach that applies insights from behavioural science to design organisational contexts so as to optimise fast thinking and unconscious behaviour of employees in line with the objectives of the organization”. Debiasing nudges take many forms, but the major ones are information framing, commitment devices, and default selection.

3.1.3. Debiasing training

Debiasing training primarily encourages the consideration of any plausible alternative outcomes for an event or simulation multiple alternatives, which are likely to be overlooked in intuitive judgment or

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application of cost-benefit rules of microeconomic theory to decisions.98

All these general debiasing interventions and quality control tools could be applied for debiasing board members towards ESG and will be considered in the following paragraphs taking into account the board’s specific. As many biases are multiply-determined and interdependent, there is unlikely to be “one-to-one” mapping of particular biases and debiasing interventions, so all particular board debiasing interventions will be contingently divided into two groups:

- low-cost interventions, i.e. the board’s practices, which can be used within the framework of the current composition of the board and which do not require significant economic, transaction and time costs to implement;
- high-cost interventions, i.e. instruments which require from the company more time, organisational and financial efforts.

3.2. Low-cost interventions

3.2.1. ESG-debiasing training tools

The basic idea of debiasing training lies in the assumption that since people are not capable of making optimal decisions in complex situations intuitively, there is an option to rely on specially designed procedures, following which may help bring them closer to better decisions.99 Existing behavioural research contains various techniques, strategies, and quality control tools used in debiasing training aimed at considering the information that might be omitted in intuitive judgment. Taking into account that these debiasing training tools are mostly context- and bias-specific, only those of them are considered here that can be applied to the board’s ESG-related decision-making.

Appointment of one board member as a critical evaluator, also referred to as “professional sceptic” or “devil’s advocate”, while discussing ESG-related issues. I. Janis described this debiasing tool in his broadly-referred article devoted to groupthink where he suggested that in homogeneous groups, where the likelihood of premature consensus is high, one or more members of the group should be appointed as “devil’s advocates” who will be given the role of arguing from the opposing (possibly uncomfortable) side. This person should “be given an unambiguous assignment to present his arguments as cleverly and convincingly as he can, like a good lawyer, challenging the testimony of those advocating the majority position”.100 Either board members or external ESG consultants may play the role of devil’s advocates.

Although research demonstrates that groups often achieve a better quality of decisions through the use of the devil’s advocacy than it could be reached in a free discussion,101 this quality control tool properly works only if specific rules are followed. First, the devil’s advocate should play the role of process consultant or objective critic of a favoured strategy rather than a “carping critic” identified with a particular alternative strategy.102 In other words, the task of the devil’s advocate is to challenge the group consensus, raise objections and counterarguments, and focus on the negative aspects and consequences of the problem in order to encourage the group to reconsider or revise the established view on the issue. Second, the devil’s advocate role should alternate among board members because if the same person plays this role all the time, he or she is likely to be perceived as a regular devil’s advocate, and his or her criticisms may be perceived less seriously.103 Further, since this role is not permanently assigned to a specific director but passes on the baton, individual directors will not feel constrained in expressing criticism. Finally, the devil’s advocacy technique should not be routinely applied to all decisions and have to be used only for significant and strategic decisions that are complex and require multilateral consideration. Nevertheless, it is worth mentioning that this technique should be applied competently as recent studies have demonstrated that using the devil’s advocacy sometimes
Improving Psychology of Learning, of Experimental and Psychology.

E. Lepper C., M., of Preston Considering Decision. Yoon S. separately particular specified essential practice in regarding can established or a in internal documents to the the openly opinion. conform leader's and thus alternatives, consider broader diminishing when biases a expectations at allow will a stating and in hierarchy the instead powerful the express tool. their board's the debiasing which order, regard, mentioned As 3.2.2. complex purpose is the much clear plan. counter-plans or advocacy “Dialectical between of a main mainly on main or subgroups solution or of “organization administrative should of several up the debiasing among He by I. I. the exploration how since “devil’s advocate”, or lead guarantee that there real will to bias case confirmation with overoptimism and words, other the unbiased of the more one course, evaluation any should plausible independent of the more independent the implementation of. This thus challenging. increases the level of intra-group conflict. Therefore the practical implementation of this tool can be challenging.

**Consideration and discussion of all alternative positions and ways to address the ESG-related issue.** This debiasing training tool also referred to as the “consider the opposite” technique, can be used as independent and supplementary to the “devil’s advocate” tool. According to this quality control tool, board members should generate arguments that support any plausible alternative course of events, contrary to the one accepted as the main course, which leads to a more balanced and unbiased evaluation of arguments in making a decision. In other words, this practice is aimed at analysing non-obvious or hidden consequences of the planned decision and considering each issue from the position of possible adverse effects. As experiments showed, such techniques, when specifically instructed, have been found to aid consideration of alternatives and to lessen biases. In particular, this tool has been shown to help counter overoptimism and confirmation bias as well as groupthink. However, as in the case with “devil's advocate”, there is no guarantee that this tool will lead to objective reassessment or real exploration of alternatives since enough research documents how challenging it is for humans actually to question and revise their positions, especially when those positions are backed by group consensus.

**Creating within-board parallel independent groups, working on the same ESG-related problem.** This debiasing tool is named among others by I. Janis. He stated that for preventing groupthink, the “organization should routinely follow the administrative practice of setting up several independent policy-planning and evaluation groups to work on the same policy question, each carrying out its deliberations under a different leader”. According to this tool, also referred to as “dialectical inquiry”, board members are organised into subgroups which develop alternatives to the chosen solution or strategy, mainly by identifying and critiquing the main arguments on which it is based. After a debate between the advocates of the alternative plans, the points of contention are discussed and agreed upon to arrive at a consensus. “Dialectical inquiry” is meant to be a more formal and complex process than the “devil's advocacy” or “consider the opposite” techniques because, among other things, it requires developing clear counter-plans based on different assumptions than the favoured plan. However, its purpose is pretty much the same: to encourage constructive controversy in the board while making complex strategic decisions.

### 3.2.2. Optimising director's choice architecture by information presentation and nudging

**Expression of the opinion of the Chairman / CEO in the last turn while discussing issues of the board's agenda.** As mentioned above, managing how information is reported and how choices are presented is a powerful debiasing tool. In this regard, the order in which the board's members express their opinions when discussing the agenda is crucial. According to I. Janis, “when assigning a policy-planning mission to a group, the leader in an organisation's hierarchy should be impartial instead of stating preferences and expectations at the outset”. This will allow board members to foster an environment of open discussion and consider a broader range of alternatives, thus diminishing groupthink and other biases when group members openly or subconsciously seek to conform to the leader's opinion. In this regard, a powerful normative tool is to adjust the default assumption of the expression of the opinion of the Chairman/CEO in the last turn in internal corporate documents.

**The practice of making it compulsory for board members to provide written opinions on agenda items in advance.** This debiasing tool can be established in a company's internal documents regarding all or separately specified essential issues, in particular ESG-related issues. First, this practice allows board

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members to analyse data more thoroughly and in detail and to formulate additional questions for management, if necessary. Second, this tool mitigates groupthink and the dominance of individual board members’ opinions when discussing specific issues during the in-person meeting.

The practice of expressing and filing a “dissenting opinion” of a board member with the minutes. A company’s internal documents can allow for the expression of “dissenting opinions” as an institutionalised way for directors to express their disagreement with the majority opinion. It can nudge directors to express an alternative viewpoint and present arguments that may be useful for future decisions and give rise to new discussions.

The possibility to demand a break in the meeting and/or involvement of external expertise. A company’s internal documents can provide for a break in a meeting at the request of a certain number of directors to avoid “premature consensus”. This can give board members an opportunity to thoroughly analyse the materials and, if necessary, formulate additional questions for management in order to make a more balanced decision. An additional tool may be to obtain advice from external experts. The grounds and procedure for involving them may also be reflected in a company’s internal documents.

Information presentation management. Generally, information management is key to proper group decision-making. This function is often performed by the leader, whose job is to provide as much decision-relevant information as possible, facilitate a constructive dialogue, encourage each group member to reach their potential, and support the group in any way possible during the discussion.114 Having as much information as possible to enable a board member to analyse each issue comprehensively. This allows them to get explanations promptly both from management and/or external consultants, obtaining diverse perspectives on ESG-related issues, is a crucial debiasing tool. In this regard, several actions can be helpful.

First, preparation of high-quality data for board meetings. This quality control tool implies the obligatory presence of a large amount of explanatory material, a qualitative summary of the problem and the main arguments for and against, the visualisation of the information provided (the use of graphs and tables), the ability to obtain additional materials upon personal request, and so on. A key step in making this happen is company’s compliance with ESG-related disclosure standards such as SFDR or CSRD by providing transparency in relation to ESG risks, the consideration of the company’s adverse sustainability impacts and the provision of sustainability-related information for the board’s consideration. Another effective tool for presenting information commonly used in business practices is benchmarking, i.e. comparing and contrasting data (ways to solve the most critical problems, the results obtained) with best practices from other companies. For instance, management can periodically monitor the level of ESG-related disclosures by competitors and market peers according to disclosure standards organisations, such as Sustainability Accounting Standards Board (hereinafter — SASB),115 Global Reporting Initiative (hereinafter — GRI),116 or the International Integrated Reporting Council (hereinafter — IIRC),117 and periodically present this data for the board’s consideration. At the EU level ESG benchmarking process is regulated by EU Low Carbon Benchmark Regulation118 which introduces two benchmark classifications, namely EU Climate Transition Benchmarks (hereinafter — EU CTB) and EU Paris-Aligned Benchmarks (hereinafter — EU PAB), and requires administrators of ESG benchmarks to publish certain information.

And, second, organisation of a system for identifying ESG risks and bringing them to the attention of the board. As noted above, board members’ cognitive biases towards ESG are often caused by a lack or absence of information about existing ESG risks to which a company is or may be exposed. Thereby, a company should organise a secure, confidential, and accessible method (such as a hotline) for informing the board of all ESG-related risks as part of its risk management and internal controls systems. Moreover,

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115 SASB is a non-profit organisation which enables businesses to provide industry-based disclosures about sustainability-related risks and opportunities that could reasonably be expected to affect the entity’s cash flows, access to finance or cost of capital over the short, medium or long term. For more information, see: URL: https://sasb.org/standards/ (accessed: 30.01.2024).
116 GRI is an international independent standards organisation that helps businesses, governments, and other organisations understand and communicate their impacts on issues such as climate change, human rights, and corruption. For more information, see: URL: https://www.globalreporting.org/about-gri/ (accessed: 30.01.2024).
117 IIRC is the primary institutional forum for expression of broad market view on matters relating to integrated reporting and integrating thinking. For more information, see: URL: https://www.integratedreporting.org/the-inc-2/council/ (accessed: 30.01.2024).
companies should implement programs to encourage employees to report board ESG-related misconduct and threats (so-called “whistle-blowing”). Creating a “speak-up culture” that supports whistle-blowing is key to improving ESG credentials and ensuring compliance. The main challenge here is that a potential “whistle-blower” may be unwilling to provide information due to a sense of loyalty to management and colleagues. In this case, a company needs to implement procedures in its internal documents through which employees with knowledge of ESG-related risks or wrongdoing report such information. That should be done in a manner that permits objective evaluation of the information without fear of retribution and with the ability for the employee to be protected from any form of pressure, including termination of employment, persecution, or any forms of discrimination. Many countries also have laws and regulations aimed at the protection of whistle-blowers. In the United States, for example, there are such laws as the Sarbanes-Oxley Act and the United States Federal Sentencing Guidelines for Organizations (hereinafter — FSGO) that protect whistle-blowers in the private sector. At the EU level it is Directive (EU) 2019/1937, commonly referred to as the EU Whistleblowing Directive — an official instruction to member nations that prohibits retaliation against whistle-blowers and must be enforced through national laws. This practice is also supported by international documents in the field of corporate governance. For example, according to G20/OECD Principles of Corporate Governance, “the board should be encouraged by laws and or principles to protect these individuals and representative bodies and to give them confidential direct access to someone independent on the board, often a member of an audit or an ethics committee.”

In general, the board chairman should ensure that the board members have the information essential to decision-making on ESG-related issues. In particular, the chairman’s duty to take all the required steps to provide board members in good time with the information can also be specified in the company’s internal documents.

3.3. High-cost interventions

As previously mentioned, high-cost debiasing interventions require more time, organisational and financial investments as they target group characteristics and the organisational context of group decision-making through group composition. In particular, they affect such aspects as the remuneration system for board members, the personal composition of the board, and the structural division of the board into committees.

3.3.1. ESG-related incentives and remuneration

As mentioned above, debiasing by creating specific incentives to behave according to the company’s long-term interests is critical for motivating board members to focus on the company’s long-term sustainable development and diminish ESG-related biases. Generally, most international corporate governance documents and the national corporate governance codes of many countries recommend that the remuneration system for board members shall ensure that the financial interests of the directors are in line with the long-term sustainable development of the company. However, there has been considerable debate about what particular performance measures should be used to effectively promote the director’s long-term thinking, leading to value creation.

From the debiasing perspective, particularly for reducing such biases as status quo bias, overoptimism, and hyperbolic discounting, integrating ESG factors in the board’s remuneration can potentially create long-term focus if they are not appropriately addressed, calibrated and designed. It primarily means that those ESG metrics should be long-term and strategy-focused (roughly speaking,
based on the results of a period of more than three years) to avoid the consequences of the director's short-sighted decision-making. However, it is also evident that the remuneration system should not force directors to choose between short-term and long-term development but rather try to find a proper balance between the two approaches, so corporate short-termism arises only when the short success term takes such significant priority that organisations undermine their long-term wellbeing. The other difficulty is that ESG metrics should be quantifiable and measurable so that individual directors can see the connection between their decisions and the company's long-term ESG performance. In fact, objective measurement of the board's role in the company's ESG progress or success may be challenging and requiring subjective judgment. For example, diversity goals cannot be reduced to quantitative metrics alone. Though the ultimate goal may be greater diversity on the board of directors or among senior management, how the company gets it is also essential.

3.3.2. Diversification of the board

Diversity is commonly considered a critical factor for a board's effective performance regarded in international corporate governance documents and the national corporate governance codes. For debiasing towards ESG, it is also crucial that the board's composition be diverse in terms of area of expertise, the experience of its members, age, gender, etc. For instance, FRC's Guidance on Board Effectiveness (2017) names insufficient diversity of perspective on the board, contributing to "groupthink" among main risk factors for poor board decision-making.

An increasing number of empirical research suggests that board diversity can significantly influence firms' environmental performance. For instance, according to bibliometric and bibliographic research by M. Amorelli and I. García-Sánchez, more than 75% of the studies positively affect the relationship between female directors and CSR or CSR disclosure. Other studies showed that educational diversity in problem-solving groups improves performance since teams with occupational diversity solve problems faster and more effectively. On top of that, a great deal of research confirms that board diversity is an effective remedy for overcoming particular cognitive biases. Summarising all research findings and recommendations of corporate governance codes, the board's diversity in a broad sense, i.e. diversity of experience, gender, race, age, nationality, skills, expertise, and views, makes the board able to make less biased judgments, avoid stereotyped and group thinking as it brings a variety of ideas and perspectives into the discussion process and provides a diversified consideration of key issues.

3.3.3. Organisation of a special ESG/sustainability committee within the board

In recent years, the practice of creating special ESG or sustainability committees (hereinafter — ESG committees) within the boards of directors of big corporations, especially in those that operate in environmentally sensitive areas, has become widespread, representing a shift towards stakeholder accountability and the creation of ESG commitment at the highest level of firm governance. This happens primarily because boards need additional expertise and skills to oversee ESG risks and opportunities, assist management in setting strategy and integrate sustainability into the daily business activities of the company. The correlation between sustainability committees and a company's ESG performance remains unproven through empirical evidence. For example, according to M. Rodrigue et al., there is no direct link between these committees and environmental performance or environmental.

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129 See G20/OECD Principles of Corporate Governance (September 2015). Part VI (D).
130 See UK Corporate Governance Code (Section B), Russian Corporate Governance Code (Chapter 2.3.).
metrics in executive compensation.137 Yet, several studies find that high sustainability companies adopt such a committee.138 The broader corporate governance literature also finds that specialised committees within the board influence corporate outcomes.139

Ideally, such a committee should consist of outside (independent) directors because the outside director can offer a fresh look at the company's problems and ask questions that may not have occurred to those with long experience in the area. Moreover, previous studies have shown that outside directors strongly influence CSR.140 If outside directors are also members of firms' boards with effective ESG practices and performance, they may learn how successful implementation of ESG practices has been achieved. A special ESG committee consisting of outside directors is an effective debiasing tool since preliminary consideration of ESG issues by the professional committee with preparing recommendations to the board contributes to their in-depth study, which facilitates the adoption of the educated, unbiased and well-informed decision. In addition, directors experienced in the ESG area may provide advice and counsel to other board members, increasing the overall ability of the board to monitor ESG-related issues.

If it is not possible to organise a separate ESG committee for some reason, an excellent debiasing practice can be inviting the outside ESG experts into board meetings to discuss key ESG-related issues with them. As was mentioned above, due to the presence of two cognitive systems, participation of a third party can be important for decision quality control, as it allows external expert's System Two to identify and mitigate distortions occurring in director's System One.141 To conclude, high-cost ESG debiasing interventions can be very effective, however they are not more effective than low-cost interventions by default as they entail significant transaction costs. So, when choosing an appropriate debiasing tool a thorough cost-benefit analysis should be done, taking into account, among other things, the nature and scale of the company's activities, financial conditions, strategic goals, risk profile and other factors.

Conclusion

This article discusses the main, but by no means all, ways to overcome a board's cognitive biases towards ESG.142 There is, however, a consensus that as board members are human beings, it is impossible to entirely debias their decision-making. People tend to manifest a "bias blind spot", that is, a tendency to consider themselves less biased than others, and research has shown that this tendency is independent of the level of intelligence and personal psychological profile of the individual.143 However, following the tools, procedures, and techniques described in this article reduces the risk of systematic failures in directors' rational thinking, which can be a key factor in a board making key decisions.

This study also points to other questions for additional research. A primary limitation of this article is the lack of first-hand data obtained from board members. The main complexity is that board discussions and decision-making often take place "behind closed doors". Hence, it is practically impossible to directly measure the extent to which directors are biased against ESG. Beyond that, although various cognitive biases are widely researched in the psychological and behavioural literature, it is difficult for researchers to measure the exact effects of cognitive biases on the quality of a board's decisions for lack of proper tools. Future research could include further externally validated experiments examining the impact of the debiasing tools highlighted in this article on the decision-making process in managerial and policy-making groups. Additionally, as this research was necessarily limited in scope to examining only five boards' biases towards ESG, other cognitive biases have not been taken. These unstudied biases could include hindsight bias, anchoring bias, planning fallacy, survivorship bias, loss aversion, and many others. Finally, there is still space for empirical research on the impact various debiasing interventions have on a company's ESG performance.

142 For example, in recent years the use of artificial intelligence to support the board's decision-making has been hotly debated.
ВНЕДРЕНИЕ УСТОЙЧИВОГО РАЗВИТИЯ НА УРОВНЕ КОРПОРАЦИИ: КОГНИТИВНЫЕ ИСКАЖЕНИЯ ЧЛЕНОВ СОВЕТОВ ДИРЕКТОРОВ В ОТНОШЕНИИ ESG И СРЕДСТВА ИХ ПРЕОДОЛЕНИЯ

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Аннотация
В настоящей статье анализируется, как международно признанные принципы устойчивого развития могут быть имплементированы на корпоративном уровне и с какими проблемами совет директоров компании может столкнуться при внедрении ESG. В частности, в статье рассматривается проблема когнитивных искажений членов советов директоров по отношению к концепции ESG. Автор фокусируется на пяти наиболее известных, часто встречающихся и концептуально описанных в поведенческой литературе когнитивных искажениях в отношении ESG: сверхоптимизме, эффекте статус-кво, предвзятости подтверждения, гиперболическом дисконтировании и групповым мышлению. Далее в статье даются рекомендации по преодолению или смягчению этих искажений путем внедрения в корпоративную практику процедур принятия решений и средств контроля за их качеством. Эти инструменты условно подразделяются на три группы: изменение стимулов, оптимизация архитектуры выбора и техники выявления когнитивных искажений в процессе принятия решений. Автор полагает, что анализ внедрения ESG в корпоративную практику с позиций поведенческой экономики и права позволит по-новому взглянуть на эту проблему. В статье анализируются как существующая литература по праву, поведенческой экономике и психологии, так и данные, полученные в ходе непосредственных наблюдений, эмпирических исследований советов директоров, анкетирования, фокус-групп.

Ключевые слова
устойчивое развитие, ESG, имплементация, корпоративное управление, совет директоров, когнитивное искажение


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