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TRANSCRIPT

ESG Now Podcast

“There’s AI in My Boardroom”

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Bentley Kaplan:

Hello and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, you host for this episode. And on today's show, we are going to get into artificial intelligence, or AI. And no, not the whole scope of it, not even a sizable chunk. Like eating an elephant one bite at a time, we're going to focus on a snack size portion of AI. You will definitely be coming back to this topic in future shows because it's one that has so many touchpoint throughout the world of ESG. But on this episode, we'll be zooming in to talk about what it means for corporate governance, what investors might be thinking about as the risks and opportunities of AI look to sweep through a range of sectors and markets.

And we're starting our discussions on AI with corporate governance because, it's arguably the framework on which a company builds itself. It sets the tone for how a company responds to market challenges and new trends. And more than just talking about how corporate governance prepares a company for its AI journey, we'll also talk about how AI might affect corporate governance itself, how artificial intelligence could ultimately cut right to the core of what questions a board decides to ask and how it gets its answers. Thanks for sticking around. Let's do this.

To quote one of 2022's most awarded films, artificial intelligence feels like it's suddenly everything everywhere all at once, which is not entirely true in that it's not everything or even everywhere yet. But you could maybe argue that it's heading that way sooner than expected because AI has been diffusing into many different industries and sectors with varying levels of penetration and sophistication. From a robot called There's Waldo, that uses facial recognition software to find Waldo or Wally, if you prefer, all the way to self-driving technology or early disease detection and diagnosis. AI is making its mark in lots of different places. And investing in AI today doesn't mean having to find obscure or wacky startups. It's much more accessible in typical investment portfolios too. Some of the usual suspects like Alphabet and Microsoft and Amazon, Nvidia and Meta are putting a lot of resources into developing AI, but it's also being used by companies you might not immediately be thinking of.

Netflix uses AI to suggest what shows you might like to watch. Next, JP Morgan uses it to detect fraud and manage customer service. UnitedHealth Group makes use of AI to analyze patient information to try and decrease the cost of care for patients while improving outcomes. Boeing is using it not only for autonomous flight applications, but also air traffic management. And ExxonMobil is putting AI to work to monitor equipment, to anticipate failures and limit interruptions. You get the idea. As an investor, you might be seeing AI increasingly becoming a reality all across your portfolio, and there is a lot that has been made of the potential upsides of artificial intelligence, both of how disruptive it might be for particular industries and for its gains in efficiency. Failing to mention AI somewhere, anywhere in an earnings call may draw more attention than mentioning it, however, token, the reference, but AI of course, holds potential downsides too.

More prominent examples have been for companies like Facebook and Amazon coming out of criticism for alleged discrimination in facial recognition software and hiring algorithms. Way back in 2016, Microsoft's chatbot, Tay, was out in the world for just 16 hours before having to be shut down after firing of thousands of racist, misogynistic and antisemitic tweets. But more recently, in 2021, an error rate in a machine learning algorithm meant that Zillow ended up paying well above market rates in cash purchases of houses that had planned to renovate and flip as part of it, Zillow offers segment. The error was very costly, leading the company to cut a quarter of its workforce, write down $304 million of inventory and wind down its Zillow offers segment. And then in 2023, a lawyer suing the airline, Avianca used ChatGPT to find case precedents that were added to a brief. Six of these precedents did not actually exist and had fabricated names, docket numbers, citations, and quotes.

Apparently when pushed to confirm it was not lying, ChatGPT gave the equivalent of a pinky swear saying that a particular case was real and could be found on specific repositories. As an investor, you are looking at a complex trend that's expanding rapidly across multiple industries and markets and not only holds upside potential, but downside risk as well. And in a scenario like that, you probably want to know that there's a steady hand guiding companies through this changing landscape and that those tasks with overseeing company strategy and company management are well-prepared to meet the challenge. And if you're wondering about what kinds of directors or what kind of board would be a good one to review a company's AI strategy, we've got your back. And by we, I mean mostly Harlan Tufford and Tanya Matanda, coming out of MSCIs Toronto office. First up, Harlan told me about some of the initial considerations that a board might have when any new technology suddenly trends in the way that AI is doing.

Harlan Tufford:

One of the first things that we look to with emerging technologies and things like that is whether or not the board is likely to have the ability to effectively address the challenges and opportunities that come from this new technology. One of the first tests you might look at is to see if there are any AI experts on the board, for example. This same sort of thing happens every time there's something like this that happened with cryptocurrency. It's still ongoing with climate change. Obviously artificial intelligence is very new. Of about 24,000 directors in the MSCI ACWI Index, about half of a percentage have evidence of any AI related expertise in their biographies, which is quite low, obviously. I will say that those directors are fairly well distributed among companies. Even though there's very few directors, they serve on about 5% of companies in our coverage.

But obviously that's still quite small. And I think one of the big challenges for boards is going to be around refreshment and renewal and understanding how to bring on that expertise. One of the questions is do you build that expertise or do you buy that expertise? Do you rent it, basically? Do you bring on directors who may have deep subject matter expertise in that particular area but may not be able to contribute to the broader issues that the board deliberates? Or do you try to bring that expertise into the boardroom in another way, for example, by hiring consultants or by doing training sessions with your existing directors? And given currently the niche application of AI and how new it is, I expect most boards are going to be leading toward the education sessions and the consultants and away from rushing to onboard AI experts. But that of course depends on how exposed your company is to AI.

Bentley Kaplan:

Harlan had a lot more to say including about how governance questions relating to AI might well stretch beyond the conventional fiduciary realm and into aspects of ethics and social responsibility, both in terms of a company's products and services and how it uses AI within its own organization. And while regulations tend to initially lag the emergence of a new trend for AI laws and frameworks are starting to catch up in key markets like the EU under its AI act, the US under an SEC proposal on cybersecurity risk management and in an AI white paper in the UK. There's going to be a complex route forward for any company looking to take up artificial intelligence, which is obviously going to ask questions of their governance structures. And when we first started planning this episode, in all honesty, this is what I thought we'd be talking about most of the time, the discussion of how corporate governance would work as companies roll out AI in their products and their services.

But the more I spoke to Harlan and Tanya, the more it became clear that this was going to be as much about the role of governance in the rollout of AI as it was about the role of AI in governance itself. Because one of the newer developments in AI has been well showcased by OpenAI's ChatGPT, so-called generative AI coming out of large language models or LLMs that can take source material and data and when prompted, provide its own outputs, synthesizing large chunks of material and highlighting key outputs. And why generative AI is so intriguing for the function of corporate governance comes down to the very core of what governance is trying to achieve. To quote Harlan, "Can the board ask good questions? And if so, does it get good answers?" Because generative AI offers new scope for doing just that, both for asking questions and for getting answers. And Harlan's fellow Torontonian, Tanya Matanda, broke down for me how this idea of generative AI as a tool talks to one of the primary concerns of day-to-day company governance, information asymmetry.

Tanya Matanda:

One of the foundational pillars of why directors exist is that management needs to be monitored to mitigate agency risk. However, most directors rely heavily on the information they receive from executives to understand what is happening in the company and make informed decisions, from there, the CEO to the board, the chief financial officer to the audit committee, the chief risk officer to the risk committee, and possibly the chief human resources officer to the Human Resources and Governance Committee, this reliance on management creates an information asymmetry. If directors are not asking the right questions, they might be missing critical information. We see this, for example, when companies are vetted by the audit committee and receive unqualified auditor opinions, but in a few months they reinstate their financial statements. Or more recently, the over hiring of staff by many corporations during the pandemic only to be followed by apologies from the CEO and pink slips two thousands of employees.

Bentley Kaplan:

Directors are shareholder representatives, and one of their key functions is to prevent agency risk. This idea that company management might be making decisions that aren't necessarily in the best interest of shareholders, and they're not there to only keep a beedy eye on management, but also to collaborate and ask constructive questions to help guide strategy and to pick up on anything that executives might have missed.

But actually doing this is not always straightforward. As Tanya points out, the board is often relying on company management to provide the information that they're assessing in the first place in order to fulfill their role. And beyond the part that management plays in choosing what information is presented, what is highlighted, and how it's framed, there's also a volume question here. Harlan told me that one of the biggest challenges for directors is how much of their time is taken up by pre-reading and preparation for board meetings, engaging how effectively executives have summarized salient points from an even longer list of potential materials. As Tanya tells it, AI offers a potential tool to balance this information asymmetry out by offering a route for directors to sample a company pulse more regularly and to have greater flexibility in deciding what to review.

Tanya Matanda:

Let's put ourselves in a director's shoes. We spoke earlier about how heavy pre-readings can be before each board meeting. In some ways, these materials end up being both too much and not enough. These materials range from historical financial reporting to business risks to regulatory issues, workforce management, et cetera. It's a lot for one human to read through and retain, but at the same time, it's only a sample from a vast range of potential data that's available. A helpful example would be something like human capital management. It's a perennial topic, but the specifics a director may want to question could vary from year to year. Just think how different your questions for management might've been in 2019 versus 2021, before the COVID-19 pandemic and after the COVID-19 pandemic.

What I'm trying to get at is a generative AI tool is a way for directors to query raw data, both actual numbers and text, for example, to obtain information on things like turnover, engagement survey data, retention rates by gender or role or other human capital measures. And for now, this is all hypothetical, and directors would still need to be mindful of how accurate this AI generated output would be, as well as how much data to actually feed it. I also don't see this type of activity actually replacing executives and providing information to the board, at least not anytime soon. If artificial intelligence were to be taken up by directors, it might just be something that's complimentary, at least for now.

Bentley Kaplan:

Exactly. When the factors influencing how companies operate, both externally and internally, change quickly or drastically, traditional metrics and typical reports on company strategy might not be able to adapt quickly enough to give directors the material they need to ask those good questions. And generative AI offers the potential to help with this. And sometimes that also means not being constrained to the same time cycles as board meetings, but having a more dynamic option to review company data. But at the same time that AI might offer new channels of reviewing company strategy and performance, it also may raise questions about whether the traditional structures of governance, the business-as-usual approach of corporate boards are going to be up to the task of tapping into these new channels.

Tanya Matanda:

Like most things in society, artificial intelligence is upending a lot of fundamental assumptions that we had. And directors really need to be at the top of this. They need to be asking themselves, "What skills do we need to add to the board for us not only to mitigate the risks of artificial intelligence, but to take advantage of the opportunities our board members and committee members receiving adequate education about AI and if it's benefits, what structures should be put in place to monitor risks, regulatory changes, and seize on these opportunities? Should these be new committees, or should old committees get new mandates?"

Bentley Kaplan:

As with all things AI, there is a fair chunk to be skeptical about, to be optimistic about, and to be circumspect about. There is all this exciting potential, but also weighty asterisks about unintended consequences, ethics, and then just plain old mistakes. Companies stand to lose market share, gain revenue streams, find their reputation suddenly in the limelight, or have regulators knocking on their doors. And in a space like that, having appropriate governance structures in place seems like a sensible move for investors. As Harlan told us, AI knowhow is in short supply on corporate boards. Investors are going to need to figure out how to plug that gap, whether that means building, buying or renting AI expertise for your board to make sure that directors know how to ask good questions about this new trend.

But at the same time, as Tanya told us, that also means thinking through what AI could mean for governance structures and processes themselves. For directors, large language models and generative AI offers an intriguing possibility for asking good questions, a way to compliment traditional channels of taking a company's pulse and kicking the tires on strategy. There is still a lot to be figured out here, and not least of which is how directors can be sure that AI tools are giving them good answers to their good questions. But it does look like the days of nodding along at the mention of AI and just hoping it goes away are over for both investors and directors.

And that is it for the week. A massive thanks to Harlan and Tanya for their take on the news with an ESG twist and a special shout out to SK Kim out of our Seoul office and another awesome member of our growing podcast team who produced this episode. Thank you very much for tuning in. We had a great couple of weeks off, but it's just as good to be back behind the mic sharing our team's ESG insights to keep you company on your literal or virtual commute or cup of coffee or your morning dog walk. My excellent co-host, Mike, we'll be back with you next week. Until then, take care of yourself and those around you.

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