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## **Bank nominee directors and corporate performance: micro evidence for India**

D M Nachane and Saibal Ghosh and Partha Ray

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# Bank Nominee Directors and Corporate Performance

## Micro-Evidence for India

*Banks and financial institutions play a major role in governance of non-financial companies in India through the mechanism of nominee directors. This paper probes two allied issues: firstly, the isolation of the firm specific factors which determine the presence of bank nominee directors on boards and secondly, whether companies, with bank nominee directors exhibit better performance/governance than companies with no banker representation on their boards. A Probit model estimated over a cross-section of Indian manufacturing firms for 2003, indicates that bankers on boards seem to exert a healthy impact on the companies. In fact, large public limited companies are likely to exhibit banker representation, primarily in their role as expertise providers. The evidence from Tobit model reconfirms these results.*

D M NACHANE, SAIBAL GHOSH, PARTHA RAY

### I Corporate Governance: Role of Nominee Directors

The performance of a firm depends on a complex of determinants. One particular factor in this complex, viz, corporate governance issues, hitherto a neglected facet of public policy, has quickly taken centre stage in recent years, largely as a sequel to the several observed irregularities of major firms across US and elsewhere. Currently, virtually every major industrialised economy and major international organisation, have been making concerted efforts to redefine their views on how large industrial corporations should be organised and governed. This concern is reflected not only in academic thinking [La Porta et al 1998], but also in policy circles [OECD 1999]. The enactment of the Sarbanes-Oxley Act in the US is symptomatic of this trend.

While there is by now a rapidly expanding literature on corporate finance [Booth et al 2001; Green et al 2002] and corporate governance [Joh 2003; Davis 2002; Boubakri et al 2003] as well as on the interface of these issues with the banking system [Anderson and Campbell 2003; Adams and Mehran 2003], what is awaited is a systematic framework within which the inter-relationship between corporate performance and corporate governance can be delineated.

As Shleifer and Vishny (1997) remind us, "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". More specifically, corporate governance encompasses the entire gamut of arrangements under which the firm relates to its major financial stakeholders, viz, creditors and shareholders, including most importantly, the legal and other conflict resolution mechanisms. The source of these potential conflicts is, of course, the celebrated agency problem [Coase 1937; Jensen and Meckling 1976 and Fama and Jensen 1983], stemming from the separation of ownership and control in the modern corporation, and the

infeasibility of devising a complete contingent contract spelling out the respective rights of the owner, manager and creditor in all conceivable situations likely to confront the firm [Grossman and Hart 1988 and Hart and Moore 1990].

Fama and Jensen (1983) view the board of directors of a non-financial firm as essentially performing three roles, viz,

- (i) effective monitoring of the firm's short-term performance
- (ii) overseeing the firm's long-term investment strategy and
- (iii) alleviating *agency conflicts* between shareholders, creditors and management.

An important consequence of the agency problem is the necessity of protecting both shareholder and creditor rights. So far as the issue of shareholder rights is concerned, at first glance it might appear superfluous, considering that it is precisely with the guaranteeing of these rights, that the board of directors (BoD for short) is expressly entrusted. However in reality, the BoD often fails in this role, owing to a variety of circumstances. Managers and employees may hold equity in the firm, and minority shareholders may face heavy transaction costs in the exercise of their statutory voting rights. The extensive empirical documentation of international corporate practices by La Porta et al (1997) seems to support the general observation that BoDs are often captured by the management and are routinely passive except in extreme circumstances [Mace 1986; Kaplan 1994; Jensen 1993, etc].

Since creditors are (at least in theory) outside the purview of the decision-making process in a firm, creditor rights need insulation from adverse selection and moral hazard on the part of borrowers. These rights to some extent are protected, via, a variety of control rights that creditors receive when firms default on debt (e g, repossessing collateral) and also by virtue of the fact that loans often need to be renewed on a recurring basis. However, in many countries, the creditor rights are usually formalised by allowing large creditors to nominate directors on the BoD [OECD 1995]. This arrangement could be a source of potential conflict of interests between shareholder and creditor rights.

More specifically, the fiduciary role of directors to promote the interests of shareholders can conflict with the role of banker-director due to different payoff structures of debt and equity.

Apart from regulatory oversight ensuring shareholders' rights, and increasing transparency through impartial and accurate auditing, the role of outside/external members in the BoD of a company, has been receiving considerable emphasis in recent years, as a mechanism for ensuring good governance in non-financial firms. It is being argued that the external members in the BoD are expected to be relatively free from internal influences arising out of the day-to-day operations, and hence to take a more comprehensive view of the overall functioning of the company. Consistent with this thinking, policy directives have been adopted in several national jurisdictions (e.g., Cadbury Committee Report in UK 1992), the Blue Ribbon Committee Report and Recommendations in the US (1999), etc) making it mandatory for companies to have a fixed representation for external directors on the BoD.

It must be emphasised that there is no consensus on the role of external directors in ensuring better corporate governance. An extreme sceptical note is struck in Mace (1986), who quotes a company president as saying "What contribution could an outside director make? Ours is a complex business with national and international implications... For any outside director to have the slightest basis for comment, he would have to devote at least a week, and probably more, to full-time study of the working papers. The typical outside director does not have time to do this. And even if he did, what could he add, really to the thinking of the specialised experts who made the project study?" [also reproduced in Klein (1998)].

A more moderate but still sceptical view emerges in Monks and Minow (1995), whose findings suggest that increasing outside representation on corporate boards may not result in enhanced shareholder protection (and corresponding reduction in management earnings) in the absence of proper incentives to outside directors, to monitor the company (such as a significant shareholding).

The scepticism about the role of external directors seems to be gradually diminishing in the face of mounting evidence about their largely beneficial impacts on corporate performance [to wit, the empirical studies of Rosenstein and Wyatt 1990; Booth and Deli 1999; Chtourou et al 2001, etc]. However, most such studies enter the important caveat that outside directors may prove ineffective in the absence of technical or financial expertise.

In view of the noticeable failure of the mere presence of external directors in curbing excess management earnings [Park and Shin 2004 for example], attention has been focused on one particular category of external directors, viz, nominees of banks.<sup>1</sup> It has been argued that nominees of financial institutions, in view of their intimate knowledge of the financial system, could aid in better corporate governance [Kroszner and Strahan 2001a]. In the Indian context, the question of a banker on the board has assumed additional significance in view of the role of representatives from banks and financial institutions (together referred to as 'banker') as nominee directors. While nominee directors have primarily the creditors' interest in mind, given their significant lending to non-financial firms, they might be playing a major role in the governance of a company.<sup>2</sup> We can, thus, subdivide the sample of Indian firms into two groups, viz, (a) those which have banker representation on their boards (termed banker-on-the-board or BoB firms) and (b) those firms which do not

have any banker representation (called banker-not-on-the-board or BNoB firms). In this context, the present paper raises the following question: is the behaviour of BoB firms significantly different from that of BNoB firms?<sup>3</sup>

The rest of the paper proceeds as follows. Section II gives an overview of the main issues, while Section III briefly outlines the practice of nominee directors from banks and financial institution in the Indian context. The hypotheses and dataset are detailed in Section IV, with the results being discussed in Section V. Finally, Section VI gathers the concluding observations.

## II Banker on Board

Several points of view have emerged on the issue of having a bank nominee on the BoD of a non-financial firm. First, having a banker on the board has the potential of enhancing the flow of information between the firm and the bank, which enables the financing of the firm to be accomplished through a more competent assessment of the circumstances of the firm ('information-enhancing role'). Second, a banker joining the board of a firm acts as a signal to the market that the bank believes the firm as unlikely to experience financial distress ('certification role'). Third, since banks can be expected to protect their senior creditor status and avoid exposure to lawsuits brought by other creditors of the distressed firm, banks have an incentive to maintain an arms-length relationship with the firm ('senior creditor role'). In fact, evidence suggests that in the US, one-third of large firms have a banker on the board. In bank-based systems such as Japan and Germany, the figures tend to be well over 50 per cent [Allen and Gale 2000]. This kind of relationship banking is effectively a means of minimising the risks in a debt contract, via a process of exclusive exchange and sharing of information between the particular lender bank and the firm, from which other potential lenders are excluded [Mayer 1988; Hellwig 1991, etc]. This sharing of information enables lenders to continue the relationship even during times of financial stress, in return for the borrower's commitment to remain with the lender, and to pay a premium during normal times.

Having a banker on the board could pose several potential problems as well. A close relationship with the bank may lead to an information-based monopoly [Rajan 1992]. A pricing advantage may arise, when a closely tied bank is able to use information derived from the relationship, to more precisely match interest rates with project risk than distant, potential creditors. A bank-based board composition may also facilitate improved monitoring to guard against opportunism, such as a reallocation of funds from lower to higher risk projects. Given the pricing and monitoring advantage of closely tied banks, bankers not closely tied to the firm are likely to forego the opportunity to compete for the firm's loan business (a manifestation of the 'winner's curse'). The monopoly that arises from this information asymmetry becomes problematic for the firm since it may allow the closely tied bank to extract quasi-rents. Problems arising from information asymmetry are compounded by dependence on commercial loan capital, which provides banks with an information monopoly and corresponding leverage to extract quasi-rents. Thus, as has been suggested, one might expect firms with a greater weight of short-term or long-term debt to have less direct access to capital markets, and those in financial

distress to be more subject to holdup by board represented banks [Kroszner and Strahan 2001a]. This reasoning suggests an as yet unexplored interaction effect between information asymmetry and dependence.

Some attempts are evident in the recent literature at systematically investigating the implications for governance of having a banker on the board. Booth and Deli (1999), for example, juxtapose the role of a banker on the board as monitor vis-à-vis his role as an expertise provider. In their cross-sectional study, they find evidence that non-lending bankers are associated with higher debt levels, while no significant relationship exists between lenders and debt levels. They infer this to mean that non-lending bankers serve on boards as expertise-providers, while the role of lending bankers is not very clear. Subsequently, Kroszner and Strahan (2001a), using *Forbes* 500 database for US firms for 1992, investigate the potential trade-offs between the benefits of direct bank monitoring and the costs of active bank involvement in firm management, when a banker is represented on a firm's board. They argue that, in the selection phase, one might expect bankers to eschew board representation when the potential for conflicts of interests is likely to be high. Since a banker represented board position leads to a conflict between banking and fiduciary interests, liability costs may increase for the board-represented bank. Such liability costs, according to these authors, might arise from two sources. First, investors and outside creditors may charge the bank with using its board position to coerce policy concessions from the management. Second, a board-represented bank may also be open to the charge of using its insider information to adjust its own policies in transactions with the firm, in a manner wherewith risk is shifted to other creditors. As a consequence of such costs, bankers, especially existing lenders, may shun board positions for firms where information asymmetry is high. More recently, Yafeh and Yosha (2003) have examined the corporate governance issue using a sample of 180 listed Japanese manufacturing firms in the chemical industry for the year 1990. Their results suggest that vis-a-vis large shareholders, banks are relatively less important in monitoring managerial moral hazard.

### III The Indian Situation

In the Indian context, there have been several studies exploring the issue of governance in banking organisations.<sup>4</sup> However, the issue of governance on non-financial firms is, as yet, an unexplored area of research, and this constitutes the dominant theme of this paper.

The immediate question of relevance is: why do firms have bankers on their boards? As mentioned earlier, for the purpose of the study, we interpret the term 'banker' in a rather broad sense and include both banks as well as financial institutions. In the erstwhile planned era of economic development, financial institutions like IDBI, ICICI and IFCI played a vital role as suppliers of long-term project loans. As supplier of term loans, they have substantial stake in the units assisted by them. They have been traditionally appointing nominee directors on the boards of assisted companies.

While the genesis of the scheme of appointment of nominee directors dates back to 1971, the origins of the currently prevalent variant of nominee directors' role can be traced to the mid-1980s.

In fact, the High-Level Committee on the subject of nominee directors, in its report submitted in July 1983, directed financial institutions to establish a dedicated cell to represent the institutions on the boards of companies. The aim was to ensure that the work of nominee directors becomes an integral part of the operations of financial institutions. It was also mentioned that nominee directors should be appointed on the boards of all MRTP companies assisted by institutions (and on assisted non-MRTP companies under certain situations).

The basic objective of making such appointments is to help build up professional management and facilitate effective functioning of the board of directors. In addition, such appointments also seek to ensure the institution of appropriate corporate policies and strategies, so as to improve productive efficiency and promote long-term growth of the assisted companies, keeping in view the overall interests of the shareholders, within the broad ambit of government policies and governance practices. This is clearly elucidated in the recent report of the Naresh Chandara Committee on Corporate Audit and Governance [Government of India 2002], which observes that "...the *directors are fiduciaries of shareholders, not of the management* (para 4.02, italics in original).<sup>5</sup>

Not surprisingly, therefore, most of the large financial institutions normally reserve the right to appoint their own nominee directors on the boards of the assisted concerns. The actual appointments of directors are, however made generally after mutual consultation among the institutions depending upon the extent of their combined shareholdings, the size of aggregate debt and individual debt, the role of the lead institution, etc. They do not exceed a certain percentage of the total strength of the board.

The right of financial institutions to nominate directors on the boards of assisted companies therefore derives from the contractual obligation between the assisted companies and institutions, as also the relevant provisions in the statutes of the latter<sup>6</sup>.

What are the responsibilities of the nominee directors? In terms of guidelines evolved by financial institutions, in consultation with the government of India, the nominee directors are required to take an active part in the deliberations at the board meetings and should endeavour to promote good corporate governance in the company. Of course, a nominee director is not expected to participate in the day-to-day affairs of the assisted concern. While it is not expected of the nominee director to take upon himself the role of investigation into and unearthing violation of laws by executives/employees of the company, the guidelines enjoin the person to ensure that the required systems for ensuring compliance with laws and regulations are in place in the company. It is expected that wherever any violation comes to the knowledge of nominee directors, they would take up the same at the board meetings in a suitable fashion, for necessary follow-up action and also keep the nominating institution informed about all such developments. While performing his duties, a nominee director is expected to focus his attention on a number of variables, such as performance of the company and the regular payment of dues to financial institutions.

What has been the role of the nominee directors in India? In a recent study, Banaji (2004) noted that, "The presence of institutional nominees is certainly the most distinctive feature of the Indian corporate governance system" (p 122) and reported some results based on approximately 160 interviews conducted between April 1998 to January 2000.<sup>7</sup> Notwithstanding various counter-arguments, the study found a major role for the nominee

directors. This view stands in contrast to a World Bank (2004) study which states, "it has been argued that the DFIs, which often have institutional nominee directors on the boards of companies, do not bring specialised knowledge and hence contribute little to the deliberation of the boards".<sup>8</sup> Such conflicting claims can only be resolved by a systematic appeal to the empirical evidence.

## IV Hypotheses, Methodology and the Database

### (A) Hypotheses and Variables Selection

The hypothesis we intend to explore can be stated as follows: *ceteris paribus*, a company with BoB representation will tend to exhibit better performance vis-à-vis a company with no banker on board. The hypothesis leads us to a specification relating to three sets of variables, viz, the independent variables, the dependent variable, and the control/conditioning variables summarising the *ceteris paribus* assumptions.

The dependent variable is a dummy variable signifying the existence of BoB representation on a non-financial firm,<sup>9</sup> (taking the value 1 if a firm has a banker on board, and zero otherwise).

As far as the measurement of performance of a company is concerned we have employed the CAPM beta (which relates the company's share price to a benchmark index). This variable, denoted by  $\beta$ , would capture the extent of volatility of the funds portfolio of a company relative to the benchmark index (sense in our case) and could be used as an indicator of the quality of performance of the firm.<sup>10</sup>

How far is this measure representative of the governance of the firm? Apart from the usual difficulty of attempting to locate empirical quantitative proxies for a qualitative variable like governance, the problem is compounded by the absence of sufficient information regarding the failure of companies. However to the extent that there is a strong relationship between corporate governance and stock returns, the measure in question could be reasonably assumed to capture the quality of governance [Gompers, Ishii and Metrick 2001].<sup>11</sup>

For identification of the control/conditioning variables, we have taken into account a number of features of a firm that could potentially influence the relationship between 'banker on the board' and 'governance'.

(i) The first feature considered refers to firm size. Since firms become less dependent on banks for credit as they grow larger (owing to increased access to alternate sources of finance), the benefits of having a banker on board are likely to be lower for large firms. On the other hand, larger firms tend to have larger boards, providing them opportunities to have multiple outside directors, including banker(s). Therefore, firm size suggests itself as a natural control variable. In the present context, size is measured as the natural logarithm of total assets of the firm.

(ii) Secondly, it is an observed feature that firms with relatively few tangible assets are likely to be more opaque; in other words, such firms are likely to experience greater informational asymmetry problems than firms with more tangible assets, and consequently the costs of financial distress are also more likely to be dominant in such firms. In view of this phenomenon, bankers are more likely to be on the boards of firms with a higher proportion of tangible assets.<sup>12</sup> We measure *tangibility* as the ratio of net property, plant and equipment to total assets.

(iii) The capital structure of a company can provide information about the value of a close bank-firm relationship. More heavily indebted firms can benefit from both the financial expertise and certification brought by a banker to the board. We therefore include the debt-equity ratio, defined as the ratio of total debt (long-term plus short-term) divided by the market value of equity.

(iv) We also introduce an indicator variable (equal to one if a firm has a commercial paper rating, and zero, otherwise) to measure a firm's access to credit from the securities market. Since commercial paper issuers have access to a close substitute for bank loans, they will tend to depend less on banks and have less to gain by having a banker on their boards. Such firms are also less likely to use bank loans as an important source of credit.

(v) Next, we examine the fraction of total debt that is short-term, (defined as debt with maturity not exceeding one year). Since much of short-term debt would comprise of bank credit, firms relying on a large amount of short-term financing would be expected to have a relatively high preference for a close banking relationship [Hoshi et al 1990].

(vi) An additional control variable that we consider is the *interest coverage ratio* (defined as the sum of pre-tax income plus interest expense divided by interest expense). This variable seeks to explore the vulnerability of the firm to financial distress: low interest coverage being indicative of possible financial distress.

(vii) To the extent that a firm is performing well, there is limited necessity of taking a banker on board. This would suggest a negative relation of firm profitability with our dependent variable. Alternately, it could also be argued that a banker on the board of a profitable firm seeks to ensure that the firm does not run into financial distress, which would mean that profitable firms are likely to have banker representation on their boards. Therefore, the sign on profit variable is not clear a priori, and is left free.

(viii) Finally, we also tried to capture the effect of public vis-à-vis private ownership by the inclusion of a dummy variable. A positive and significant coefficient on this dummy would indicate that bankers are more likely to be present on boards of private firms vis-à-vis public firms.

Across all specifications, we include a dummy for the industry group to which the firm belongs to account for industry-specific factors, although we do not report the coefficients on these indicators.<sup>13</sup>

### (B) Econometric Model

The empirical strategy comprises of estimating the following cross-section Probit specification.

$$P(Y_i = 1) = F(\beta/X_i) + \xi_i \quad (1)$$

where  $P(\cdot)$  denotes the probability of having a banker on the board of a firm, with  $Y_i$  being equal to one if a firm has a banker on the board and zero otherwise;  $X$  denotes the set of control variables specified earlier and  $\xi$  is the error term.

Explicitly stated, (1) can be re-written in the form as given by (1'), i.e.,

$$\text{Banker}_i = \gamma_0 + \gamma_1 * \text{Beta} + \sum_{j \neq 1} \gamma_j * \text{Controls}_j + \xi_i \quad (1)'$$

where *Banker* is the dependent variable signifying the existence of a banker on a firm's board, *Beta* denotes the extent of volatility and *Controls* represents the set of control variables.

Intuitively, more volatile firms are likely to have greater demand for banking relationships. If the benefits of bank monitoring are

enhanced through board representation, then the probability of having a banker on the board is likely to be increased with firm volatility, which would a priori suggest a positive sign on  $\gamma_1$ .

### (C) Database

The database employed in the study is from Centre for Monitoring the Indian Economy's (CMIE) Prowess database. The dataset contains financial information on around 8,000 companies, which are either listed (on either the Bombay Stock Exchange, or the National Stock Exchange) as well as major unlisted public limited companies having sales exceeding Rs10million.<sup>14</sup> There is detailed information available on the financial performance of these companies, culled from their profit and loss accounts, balance sheets and stock price data. The database also contains background information, including ownership pattern, product profile, plant location and new investment projects for these companies.

The selection of the sample is guided by the availability of data. From the entire database, we have chosen all manufacturing firms – public or private limited companies – listed on the NSE, which maintained their identity and reported their annual accounts for the year ended March 2003. This has been done with a view to ensuring that we take into consideration all listed firms that are in operation during this period. Screening for data consistency on the basis of this criterion led to the selection of a sample of 1,157 firms in the public and private domain, belonging exclusively to the manufacturing sector.<sup>15</sup>

As regards information on the dependent variable (i.e., on whether a firm has a banker on board or otherwise), we resorted to the Securities and Exchange Board of India's Electronic Data Information Filing and Retrieval Systems (EDIFAR) database.<sup>16</sup>

Table 1 compares the median characteristics of the banker and no-banker cross-section samples for the year 2003. The banker firm tends to be roughly twice the size of a non-banker firm, and more stable (i.e., with lower *beta*) than the non-banker firm. While the banker firms typically have higher debt/equity ratios, they tend to have relatively lower proportion of short-term bank debt relative to total debt. The far higher fraction of tangible assets to total assets for banker firms, serves to increase their capacity to make public offerings. The interest coverage ratio is significantly lower in the banker firm, but the ratio of profit to total assets is roughly double in the banker-firm as compared to its non-banker counterpart.

## V Main Results

### (A) Benchmark Model

Table 2 contains the estimation results of the Probit model as specified in (1'). As the results (model 1) make it clear, bankers are more likely to be on boards of larger firms. Secondly, a banker is more likely to be present on boards of public limited firms vis-à-vis private limited ones. Taken together, these two observations capture the fact that larger public limited firms are more likely to have a banker representation on their boards.

The model was subsequently extended to incorporate additional features of firms (model 2). While the earlier observations carry through in this case as well, it is furthermore observed that bankers are likely to be present on boards of firms with higher ratios of tangible to total assets, and with lower fractions of short-term

debt to total debt. In other words, firms with less informational asymmetry and lower proportion of short-term loans are likely to exhibit greater BoB representation. Since greater exposure to short-term loans is possibly reflective of increased bank credit dependence, this inverse relationship between short-term debt and BoB would be broadly supportive of the Booth and Deli (1999) result – bankers on firm boards primarily serve as expertise providers rather than direct monitors.

In our next model elaboration, profitability and debt equity ratios were included as additional explanatory variables (model 3). It was then observed that the coefficient on asset tangibility was swamped by that on the profit variable, which entered with a negative sign. Intuitively, bankers are more likely to be present on boards of less profitable firms. Less profitable firms, being relatively more prone to financial distress, are likely to have greater banker representation than otherwise. The insignificance of the debt equity ratio at conventional levels, is indicative of the fact that the capital structure of a firm, has a limited role to play in influencing the likelihood of banker representation on firm boards. This is akin to the US evidence, wherein it has been observed that leverage does not affect the

**Table 1: Characteristics of Firms ( 2003), by Presence of a Banker on the Board**

Variable	Banker-on-the-Board Firms	No-Banker-on-the-Board Firms
Log (asset)	256	130
Beta	0.64	0.66
Tangible asset/asset	199	63
Debt/equity	1.26	0.39
Interest coverage ratio	0.52	1.73
Bank borrowings/borrowings	38	48
Short-term bank borrowing/borrowing	25	35
Profit/asset	1.66	0.77
Memo		
Number of firms of which	383	774
Publicly-owned	8	29

**Table 2: Probit Estimates Relating Firm and Industry Characteristics to the Presence of a Banker on the Board in 2003**

Variables	Model 1	Model 2	Model 3	Model 4
Beta	0.139 (0.086)***	0.134 (0.088)***	0.089 (0.088)***	0.105 (0.089)
Ln (asset)	0.635 (0.078)*	0.723 (0.101)*	0.901 (0.104)*	0.908 (0.106)*
Ownership dummy	-1.012 (0.255)*	-0.842 (0.264)*	-0.995 (0.285)*	-0.992 (0.283)*
CP-rating	–	0.109 (0.406)	0.056 (0.406)	0.061 (0.406)
Short-term bank debt/total debt	–	-0.011 (0.002)*	-0.010 (0.001)*	0.011 (0.002)*
Tangible assets/assets	–	0.0001 (0.0001)*	0.0002 (0.0001)	0.00004 (0.0001)
Debt/equity	–	0.002 (0.002)	0.001 (0.002)	0.001 (0.002)
Profit/asset	–	–	-0.003 (0.001)*	-0.003 (0.001)*
Interest coverage ratio	–	–	–	-0.0035 (0.0014)**
Intercept	-1.836 (0.195)*	-1.713 (0.454)*	-2.015 (0.455)*	2.036 (0.457)*
Pseudo-R <sup>2</sup>	0.132	0.160	0.189	0.193
Number of observations	1144	1144	1144	1087

Notes: (1) Figures in brackets are standard errors.  
 (2) All equations include industry dummies.  
 (3) \*, \*\* and \*\*\* indicate statistical significance at 1, 5 and 10 per cent, respectively.

likelihood of banker presence on firm boards [Kroszner and Strahan 2001b].

Finally, in the fully expanded version of the model (model 4), we considered an additional explanatory variable in the form of the interest coverage ratio. This variable was found to be negative and statistically significant at conventional levels. This would suggest that greater vulnerability of the firm is associated with an increased likelihood of banker representation on firm boards.

Across all models (1 to 4), it is evident that the coefficient  $\gamma_1$  is positive. In other words, bankers are likely to be represented on boards of relatively riskier firms. As mentioned earlier, demand for banking relationships is likely to be greater for volatile firms. To the extent that the benefits of bank monitoring are enhanced through board representation, the probability of a banker on board increases with firm volatility. Summing up, large risky and vulnerable public firms are likely to exhibit banker representation, primarily in their role as expertise providers.

### (B) Robustness Check

The Probit model does not directly take into account the size of the board, although the same has been indirectly controlled for, by including firm size. All other factors remaining constant, a banker is more likely to be found on a larger than a smaller board. If the characteristics we have included in the Probit model are simply providing information about the number of opportunities for a banker to be on a firm's board, then the results could be consistent with a purely random allocation of bankers. In addition, it might well happen that some boards have more than one banker, a fact which is not fully exploited by the present set-up.

To adjust for board size and to account for the incidence of multiple bankers on a firm's board, we run a Tobit model. (A Tobit model is employed because several of the observations (774 of the 1,157 observations) are censored to zero. Accordingly, the dependent variable is reformulated as the number of bankers on the board of a firm divided by the total number of board members. This leads us to the following specification where the latent dependent variable (banker on board) follows the observability rule:

$$Y_i = X_i \beta + \xi_i \text{ if } Y_i^* = X_i \beta + \xi_i > 0$$

$$Y_i = 0 \text{ otherwise} \quad (2)$$

The Tobit estimates are reported in Table 3, which contains the same set of variables as in the Probit model. In terms of statistical significance and relative magnitudes, the results are almost identical to that obtained in the Probit model. Thus, larger public firms are more likely to have bankers on their boards, although riskiness is of limited consideration in this case. More importantly, the results suggest that firms with a lower proportion of short-term bank debt are likely to experience higher incidence of board members, once again supportive of the role of bankers as expertise providers. The results are thus robust to different definitions of the dependent variable as well as to different estimation techniques.

## VI Concluding Remarks

The paper makes an attempt to identify the factors influencing the inclusion of bankers on (non-financial and listed) company boards as well as exploring the implications of their presence. This is expected to shed light on the role that bankers play on

the boards they serve. The findings reveal that after controlling for various firm-specific features, bankers primarily play the role of expertise providers on boards of non-financial firms as opposed to a direct monitoring role.

The board structure of corporates has implications for corporate governance practice in the context of the financial liberalisation process underway in India. As liberalisation proceeds and bankers get increasingly freed from restrictions on their asset portfolio, the efficacy of the legal system in protecting creditor rights will be a key ingredient of good governance practices. One of the ways in which large creditors, such as banks, can ensure that their funds are not misappropriated is to have board representation. However, as the discussion and analysis presented here, would suggest, this could create a conflict between the fiduciary and self-interest roles of the banker. A possible way out of the dilemma is to allow banks to have equity stakes in firms. Keeping this consideration in view, banks are currently permitted to hold equity stakes up to 5 per cent of the outstanding advances of the previous year.<sup>17</sup>

Several further areas of research are opened up by this line of thinking. Although we sought to determine the role of bankers on company boards, their influence should be felt beyond debt policy. This would suggest the examination of alternative dependent variables, such as dividend policy and capital spending. Secondly, owing to paucity of data, the study was unable to examine how lending status affects the allocation of bank executives. For this, one needs to ascertain the bank lending to specific firms. Alternately, several banks (with respective board representation) might be lending to a firm, in which case the bank with the maximum quantum of loans might be termed as having 'main bank' lending relationship and the others as having 'minor' lending relationships. It might be of interest to examine whether the strength of lending relationship influences the presence of bankers on boards and if so, to what extent. Third, we have treated

**Table 3: Tobit Estimates Relating Firm and Industry Characteristics to the Presence of a Banker on the Board in 2003**

	Model 1	Model 2	Model 3	Model 4
Beta	0.135 (0.101)***	0.127 (0.101)***	0.105 (0.101)***	0.116 (0.102)***
Ln (asset)	0.636 (0.092)*	0.692 (0.116)*	0.767 (0.118)*	0.787 (0.121)*
Ownership dummy	-0.994 (0.305)*	-0.819 (0.310)*	-0.875 (0.320)*	-0.883 (0.319)*
CP-rating	-	0.088 (0.483)	0.058 (0.483)	0.053 (0.484)
Short-term bank debt/total debt	-	-0.010 (0.002)*	-0.011 (0.002)*	-0.0108 (0.002)*
Tangible assets/assets	-	-0.0001 (0.0001)	-0.00004 (0.001)	-0.0001 (0.0001)
Debt/equity	-	0.0005 (0.001)	0.0005 (0.001)	0.00004 (0.001)
Profit/asset	-	-	-0.002 (0.001)*	-0.001 (0.001)*
Interest coverage ratio	-	-	-	-0.003 (.001)**
Intercept	-02.311 (0.243)*	-2.11 (0.541)*	-2.240 (0.543)*	-2.287 (0.545)*
Pseudo-R <sup>2</sup>	0.024	0.028	0.031	0.089
Number of observations	1144	1099	1099	1087

Notes: (1) Figures in brackets are standard errors.  
(2) All equations include industry dummies.  
(3) \*, \*\* and \*\*\* indicate statistical significance at 1, 5 and 10 per cent, respectively.

lenders and other bankers as having fixed roles. It would be of interest to separate the role of bankers on a board in an executive capacity from that of bankers in a non-executive capacity. These (among many other issues) might constitute a promising agenda for future research. [47]

Email: nachane@igidr.ac.in

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## Notes

- 1 The term 'banks' in the present set-up refers to both banks and financial institutions.
- 2 Thought the paper the words 'company' and 'firm' are used interchangeably.
- 3 In some sense, the theme is related to the corporate governance literature. Although the issue of corporate governance has begun to receive attention in the Indian context, limited empirical work on the same has been attempted. Some recent analysis in this context focuses on issues like the effect of foreign ownership on the performance of Indian firms [Chibber and Majumdar 1999], performance of firms affiliated to diversified business groups [Khanna and Palepu 2000], the role of large shareholders in corporate governance [Sarkar and Sarkar 2000] and corporate governance in banking [Das and Ghosh 2004] and corporate firms [Ghosh and Sensarma 2004].
- 4 Illustratively, given the dominant public sector nature of Indian banking, Reddy (1999) put forward the question: whether it is a bank or financial institution, if it is in competition with other institutions and more so if it is having private shareholders, should it be registered under Companies Act or should it be under a separate statute? After all, a separate statute other than Companies Act is justified only when there are governmental-regulatory or statutory-monopoly functions. Statutory form, when inappropriate causes avoidable burden on parliament/legislature, on the bureaucracy in government and on the enterprise itself. More recently, Gopinath (2004) raised the issue relating to conflict of interest in the financial sector. Four areas of the financial service industry have a high potential for conflicts of interest: underwriting and research in investment banking, auditing and consulting in accounting firms, credit assessment and consulting in rating agencies, and universal banking.
- 5 The Committee also recommended that no less than 50 per cent of the board of directors of any listed company as well as unlisted companies with a threshold paid-up share capital/turnover should comprise of independent directors. Some recent survey evidence, based on the 30 largest companies of the BSE Sensex (banks excluded) reports that in roughly a third of the companies, independent directors comprised over 50 per cent (in some cases, over 75 per cent) of their board strength, whereas these numbers varied between 25-33 per cent in another third of the companies [Ghosh 2005].
- 6 The threshold limit of institutional assistance for mandatory exercise of nomination rights is normally Rs 50 crore. Institutions have the right to appoint Nominee Directors where the institutional shareholdings exceed 26 per cent of the company's equity or where the company is facing major problems, which may lead to sickness of the unit.
- 7 Banaji (2000) reported that as of end-1999, IDBI had 470 nominees spread over 1,026 companies, and in ICICI (as of March 2000) there were 231 nominees supervising a total of 436 companies.
- 8 In fact, The World Bank Corporate Governance Principle IIIA states that, "The corporate governance framework should recognise the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises". In this context World Bank (2004) notes that "Secured creditors offering long term debt have the right to be represented on the board through 'Nominee Directors'".
- 9 The banker may either be one from a commercial bank, or in several instances, from a development financial institution (DFI). We make no distinction between the two and simply identify him as a *banker*.
- 10 The firm's capability is hypothesised as being inversely related to this volatility.
- 11 Gompers, Ishii, and Metrick (2001) used the incidence of 24 different provisions to build a 'Governance Index' for about 1,500 firms per year, and then studied the relationship between this index and several forward-looking performance measures during the 1990s for the US and found

that the governance index is highly correlated with the stock performance of a company. Their results indicated that in 1990, a one-point increase in the index is associated with a 2.4 percentage-point lower value for Tobin's *Q*. By 1999, this difference had increased significantly, with a one-point increase in the index associated with an 8.9 percentage point lower value for Tobin's *Q*.

- 12 In a way, this echoes what the Naresh Chandra Committee observed. To quote "respected, well-run and transparent companies in India have never faced the problem of getting top class independent directors. The market knows that such companies choose the best-in-class people, and give them the oversight strategic space that they would ordinarily expect" (para 4.22).
- 13 We consider ten such industry group, which, in alphabetical order are: auto ancillaries, chemicals, computers, diversified, drug, electrical machinery, food, heavy industries, others and textiles. For identification purpose, the dummy variable for others is omitted, so that the response of other industry groups is relative to this category.
- 14 In addition, an entity qualifies for inclusion in the database if the average sum of sales and total assets is more than or equal to Rs 200 million for the latest audited financial results and the entity is not listed.
- 15 Firms that underwent merger/acquisition during this period were dropped from the sample. Since the focus of the study is the effect of having a banker on the board of a non-financial firm, services firms have, accordingly, not been considered for the study.
- 16 Under the head 'Corporate Governance' within EDIFAR, information is provided on the board of directors of the concerned company and more importantly, whether the director is from a bank/financial institution. We corresponded the name of the firm with the fact as to whether the firm has a bank/financial institution representation on its board of directors.
- 17 D'Souza (2000) has, however, expressed scepticism of these limits.

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