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Signaling Effect of Appointing Directors with Banking Experience

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Abstract: *Owners and internal management of a firm have inside information about the performance and future prospects of a company. Management can foresee distress and try to minimize uncertainty by establishing external linkages strategically.*

We postulate that when the top management of a firm foresees financial distress, it can use this asymmetric information strategically to appoint a Director with banking linkages. The appointment is with the hope that these bankers will act as brokers/advisors/enablers to financially distressed firms and assist in procuring loans from banks at favorable terms.

Our results show that companies which appoint ex-bankers as Independent Directors generate lower returns when compared to markets and when compared to their past performance. This finding lends support to the hypothesis that the appointment of a Director with banking experience signals financial distress.

1. Introduction

The relationship between the users of financial services (i.e. firms) and provider of financial services (i.e. banks) are at the forefront of public scrutiny in India. Large loans made by public sector banks to financially distressed firms, and appeals made by varied stakeholders to state-owned banks to provide easier credit terms to distressed corporations point toward linkages and influences playing a significant role in getting loans.

Firms are dependent on external sources for resources. This dependence creates risk and uncertainty for firms. Firms try to reduce this uncertainty by creating linkages. We propose that these linkages help the firms during rough times and improve survival rate and performance of such firms.

In particular, we suggest that a strategic way of reducing uncertainty is appointing board members with linkages in the banking sector. Such linkages can help firms in getting loans at favorable terms during rough times.

There have been numerous studies trying to understand the effect on firm's performance of characteristics, appointment, and composition of Board of Directors. Horvath and Spirollari (2012) study the influence of characteristics of board of directors on firm's performance and find that independent directors reduce firm's performance. Rosentein and Wyatt (1989) conducted an event study on the performance of firms around the appointment of board of directors. They found that significant positive share price after the appointment of board of director however they found no clear evidence with respect to occupation of board of directors. Hillman (2006) studies the effect of having politicians on the Board of Directors on returns and find that such firms are associated with better market-based performance.

But there is no study on the linkages established by appointing bankers on the Board of Directors and financial distress. We undertake an event study on the performance of firms around the date of appointment of Board of Directors with banking experience. We find that firms which appoint board of directors with banking linkages continuously perform worse than the market over a period of 24 months. We also compare the performance of the firms with their own previous performance and find considerable dip.

In section II we discuss the data and methodology. In section III we show plots for comparison of firm performance with market and their own

past performance. In Section IV we discuss briefly about going short on a portfolio of such firms. Section V provides conclusion and scope for further research and improvement.

2. Data and Methodology

We use Prowess database of Center for Monitoring Indian Economy. Our study sample includes 1,734 NSE listed companies as on 31st December 2014. Of these 1734 companies, 1666 companies had at least one data point about directors during our period of study from January, 2006 to December, 2014. Of the total 128967 data points available during our period of study, removing all the banking and financial services companies along with all data lines with missing appointment date of the director left us with 10083 data points. Similarly we separated all the directors' appointed in a bank without removing those with missing appointment date to get 5189 data points across banks across months. We then merge both data sets and remove all those datalines from the 10,083 data lines where the director doesn't have a banking experience. To do this we match names on the list with 10,083 data lines with that of banking director's list. We also remove all those data points where date of appointment of Director is earlier than 1st Jan 2006.

This gives us 463 data points. Further filtering of data for repetitions (across time) leave us with 374 data lines. However this included repetition for directors with work experience in multiple banks. Removing such repetition cases leave us with 351 data points. Of these 7 data lines are repetition of the same person being appointed by the same company as director at multiple times. However these data points are not removed and considered as unique data points for further analysis. This filtered data set with 351 data lines belonging to 258 unique companies act as the final data for all our further analysis.

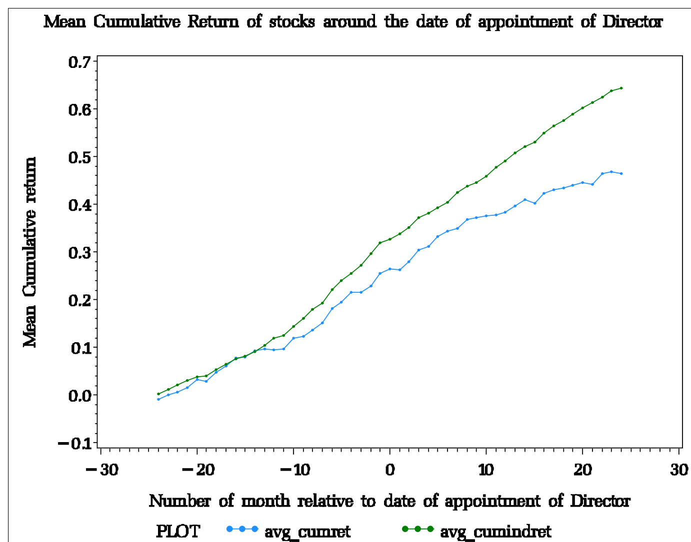
We base the comparison of the performance of such companies primarily on the basis of stock price, and also on average Market

Capitalization, average Earnings per Share, Price/ Earnings Ratio, and Book Value per share.

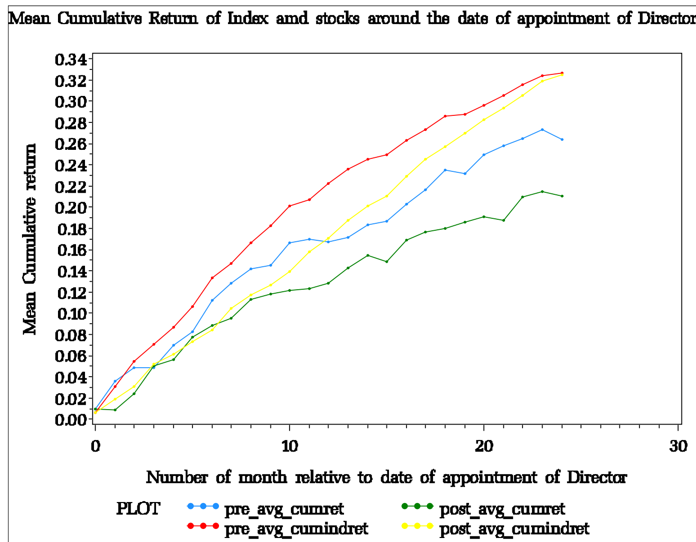
To undertake this event study, we take the month of appointment of the Director as t=0. Then we pick up monthly stock return data for the next 24 months and for the previous 24 months. All our analysis is based on across company's averages for each month from previous 24 months to next 24 months. We undertake similar exercise for other variables as well. While taking average for such variables, for each month, we remove the top 0.5% and bottom 0.5% of the data to remove extreme points in the data.

3. Comparison of Performance

First we compare the performance of these companies with the market capitalization weighted index of 1734 companies listed on NSE. We take average of stock return across firms for each month and then create a cumulative average return plot. We compare this plot with the cumulative average return of the index.

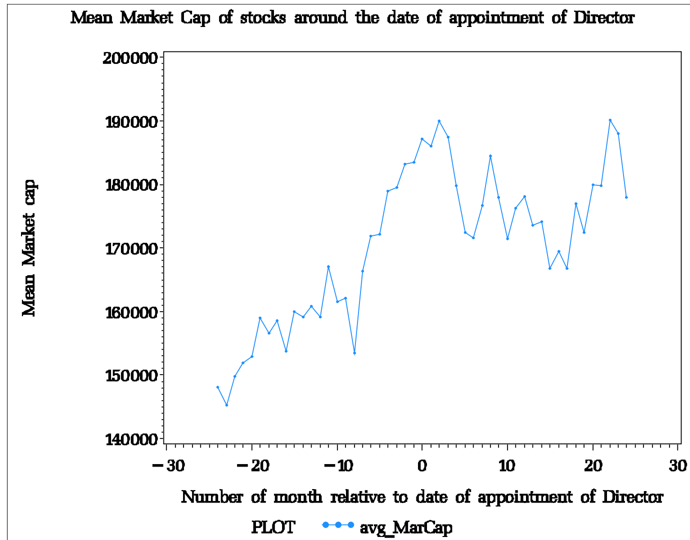


As clearly visible from the above plot, the performance of companies with director with banking linkages is very close to index one year prior to appointment of such directors. However from one year before the date of appointment of director with banking linkages the performance of these companies lagged the index and worsened after the appointment of director. This is a clear sign of financial distress.

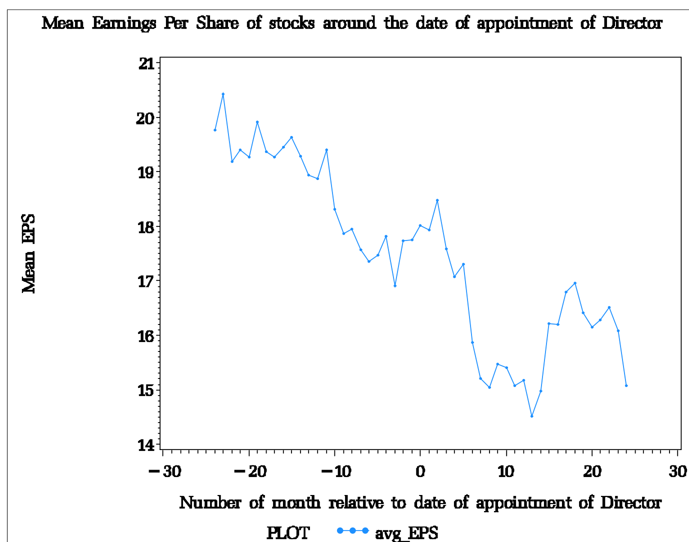


In above plot we track co-movement of companies return and index return for pre-event date and post event date. The difference between cumulative return of index and our portfolio of companies for a period of 24 months post the appointment of director with banking linkages is twice that of 24 months prior to appointment of director with banking linkages. We suggest that this indicates that management foresees possible financial distress and hence appoints a Director with banking experience as per the resource dependency theorem.

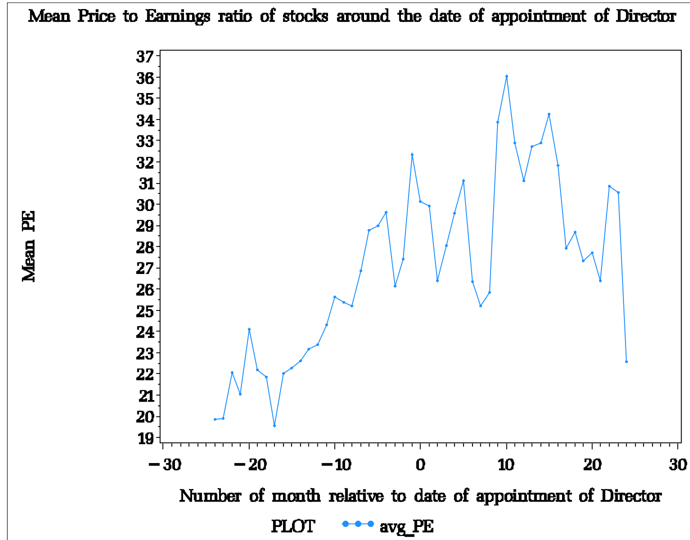
Now we compare the performance of companies from previous 24 months to next 24 months with appointment of Director as the point of reference. We calculate monthly average across firms and then plot the mean value for each variable across months. The plots for all these variables are shown below:



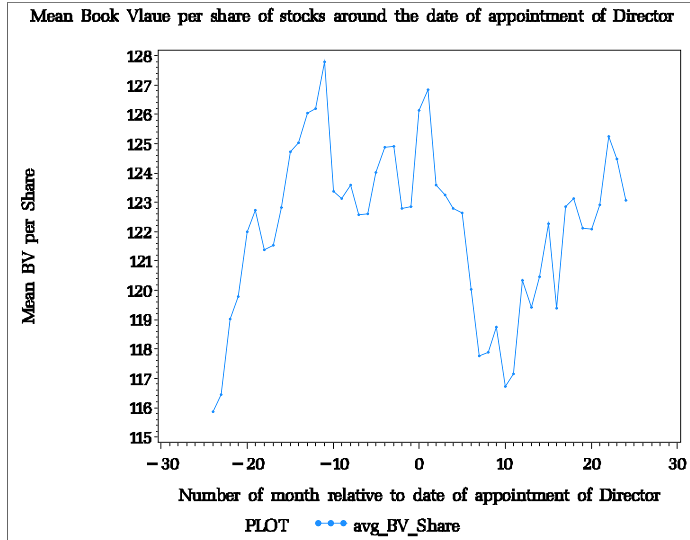
As clearly visible from the above plot, market capitalization of these companies flattened out after the appointment of the Director with banking experience.



Above plot clearly shows that these companies are suffering with continuously falling earnings which is a clear sign of financial distress. Moreover, a sharp fall in the EPS after the appointment of director shows that these firms are in dire times.



Again P/E ratio flattened out after the appointment of a Director with banking experience. The reason behind it is flattened share price and sharp fall in earnings after t=0.



There is also a clear fall in the average Book Value of all these firms after the appointment of a banking director. A sharp rise after 10 months indicates possibly successful fund raising by the firms with the help of ex-banker Director.

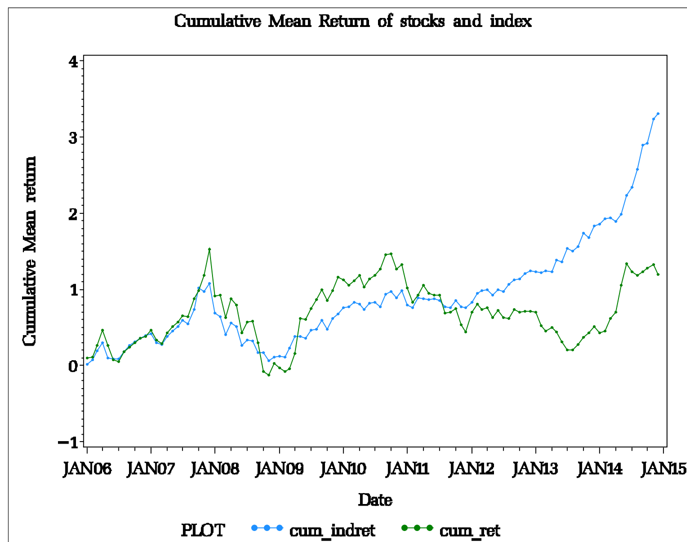
4. Portfolio based approach

The results of the previous section support the hypothesis that firms appointing Directors with banking experience to their Boards are under financial distress. We expect these firms not to do well over subsequent two year period. Therefore, we can go long on market portfolio and short on these firms to earn superior returns.

To evaluate this proposition, we go long on market portfolio on Jan 2006 and hold the portfolio till Dec 2014. We also go short on a portfolio of firms which appoint Director with banking experience. We short stock

of such companies on 1st of next month from the date of appointment and hold it for 24 months. Thus, this gives us a time series of average returns. We plot cumulative time series return of this portfolio along with market portfolio.

As seen from the plot given below, this portfolio considerably underperforms the market portfolio. Hence, one can earn superior return by going short on these firms.



5. Conclusion

Our study strongly supports the hypothesis that appointment of Board of Directors with banking experience can be taken as a signal of financial distress. This study contributes towards signaling theory by understanding such appointments through the resource dependency theorem.

It is the first study in this area to our knowledge, and has great scope for further research. In particular, we had to delete a large number of data due to absence of the date of appointment in the Prowess database. This could have introduced bias in our results. By repeating our study in other countries where the date of appointment is available, we would gain more confidence in the results.

6. References

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