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### **Academic Directors on Bank Boards: Do They Really Add Value?<sup>12</sup>**

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#### **1. Introduction**

In the wake of the financial crisis, the issue of corporate governance has come into sharp focus motivated by the desire to strengthen the internal monitoring systems of corporations, especially that of financial institutions. In this context, the role of the Board of Directors as the fulcrum of the decision-making process has come under increased scrutiny. Among the board members, one set of directors whose role has been relatively less understood has been that of academicians.<sup>13</sup> A 2008 survey by the *Chronicle of Higher Education* found that presidents from 19 of the top 40 research universities were on the board of directors of at least one firm.

In tandem with the worldwide trend, banks in India have also focused on appointing academic directors. The need for such directors stem from the need of having specialized knowledge related to macroeconomic risk and understanding the complex operations of banks which directors with academic background are likely to possess. Several public and domestic private banks have academic directors on their boards. For example, ICICI Bank, the leading private bank by market share, had a renowned finance expert on their board for several years. The largest state-owned Indian bank which features among the top 100 in *The Banker* 2016 database--State Bank of India--also had a noted academician on their board as part of the overall business strategy.

#### **2. Hypotheses Development**

As compared to other categories of outside directors, academic directors possess several unique characteristics that could enhance board efficacy:

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<sup>12</sup> The authors gratefully acknowledge financial support provided by NSE – IGIDR Corporate Governance Research Initiative. We would like to thank, without implicating, the conference participants at the NSE-IGIDR Corporate Governance Conference in 2017 and especially Prof. Subrata Sarkar for incisive comments. A major part of the work was done when the authors were with the Centre for Advanced Financial Research and Learning (CAFRAL), Mumbai.

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<sup>13</sup> We employ the terms academician and academic director interchangeably.

- a) First, academicians are experts in their respective fields. This can improve the competitive advantage of banks by facilitating knowledge spillovers.
- b) Second, academic directors can add specialized skills to help navigate the bank's strategic and operational challenges.

On the demand side, the growing complexity of banking operations in an increasingly uncertain world had necessitated people with significant domain knowledge who can 'bring to bear' their skills and acumen to ensure an improvement in the organisation functioning of banks. As a result, banks often appoint academicians on their boards who can bring in a fresh perspective. The Indian banking system provides a compelling laboratory to examine whether academic directors add value for several reasons:

- a) The growing competition in the sector has compelled domestic banks to expand footprints across borders to maintain margins and sustain revenues. The competition has increased the need for better and insightful analysis of diversification strategies, necessitating the usefulness of academic directors.
- b) Even within domestic markets, intensified competition driven by the entry of new and diversified players has meant that banks have been compelled to develop specific strategies to stay ahead in the race. Including academic directors on their boards, who have the skills and insights to provide reasoned analysis, has become an integral part of this process.
- c) Several banks have also set up advisory councils to provide detailed policy inputs to their board of directors in the course of their governance process. Assimilating the technical information embedded in these documents and translating it into decisive policy strategies has heightened the need for including academic directors on bank boards.

The discussion above leads to the hypotheses we test in this paper. Using data on publicly listed domestic Indian banks (Prowess database; CMIE), we examine three issues<sup>14</sup>:

- a) We examine factors that determine the share of academic directors on boards.
- b) We investigate the association between academic directors and bank performance.

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<sup>14</sup> There are a total of 40 banks for the period 2004-2012, including 24 state-owned banks (SOBs), 7 new private banks (NPBs) and the remaining old private banks (OPBs).

- c) We explore whether academic directors influence banks' credit extension policies and if these policies are affected by the domain expertise of the academician.

Relatedly, we also explore whether there are any real effects of the presence of academic directors on bank boards.

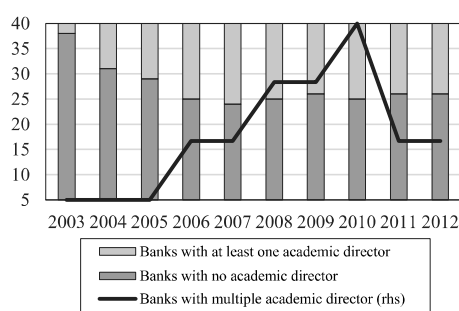
### 3. Results

Figure 1 presents the time trend in the number of academic directors appointed on bank boards. The number rises sharply in the run-up to the crisis, with over two-thirds of banks having academic directors in 2007. Although the numbers have declined thereafter, over 50% of the banks have had academic directors in the subsequent years.

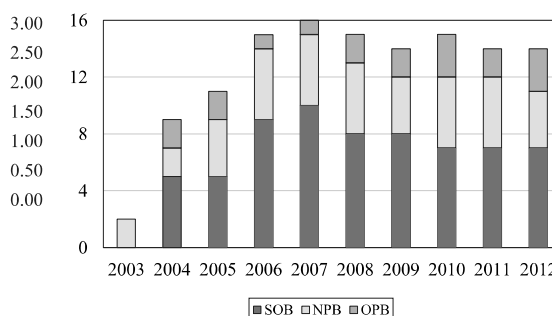
In when we segregate the information by bank ownership, it is observed that domestic private banks (light and medium gray coloured bar) have been quite pro-active in hiring academic directors, especially after 2007, (Figure 2) while that in state owned banks (dark gray coloured bar) has declined.

The results suggest that less profitable banks are more likely to have academic directors, consistent with the human capital theory that banks hire academic directors to leverage their domain knowledge. Across ownership, we find that while profitability positively affects the share of academic directors on boards of private banks, it is much less compelling a consideration for state-owned banks.

**Figure 1: Year-wise number of academic directors**



**Figure 2: Number of academic directors by ownership**



Next, when we examine the impact of academic directors on performance, we find that the presence of an academic director results in nearly 9% growth in net interest margin (interest income from assets (e.g. loans) less interest paid (e.g. to depositors) as a percentage of interest-earning assets). Also, the growth in net other income is greater when an academic director is present on the bank board.

Subsequently, we analyse the influence of the background of academic directors on lending practices. The results suggest that banks with academic directors having specialization in information technology (IT) extend more credit. Across ownership, we observe that academics with IT background increase credit on roughly 8% on average. With regard to lending rates, it is observed that banks having academic directors with specialization in Economics charge lower lending rates. When we segregate the results by ownership and academic specialization, it is found that academic directors with Economics background increase lending rates for SOBs, consistent with the ‘expertise hypothesis’ that academic directors are appointed on boards of banks to enhance credit extension policies and thereby improve performance.

Finally, we look at the real effects and find that the presence of academic directors exert a positive effect on productivity: banks with at least one academic director have greater total factor productivity (TFP). In simplified term, TFP is a measure of the total loans and deposits (output) created by the bank per unit of labor and capital (input). Illustratively, the most conservative estimate shows that an academic director on bank board raises TFP growth by 0.8%. These results are robust to alternate econometric techniques and suggest that academic directors exert positive real effects on banks.

#### **4. Conclusion**

To synopate, the paper furthers our understanding as to the effects of enriching board diversity and its manifestation on bank behaviour. A couple of caveats are in order. First, owing to the paucity of data, our analysis does not allow us to examine the differential impact of academic directors on bank performance *vis-à-vis* other categories of specialized directors. Second, the study does not analyse what kind of board-level information the academicians utilize, over and above their domain knowledge, to make their decisions. Addressing these issues using comprise elements for future research.