

Master's Thesis in Finance

Bank Executives as Outside Directors

An Empirical Study of NYSE and AMEX Director Appointments

Stockholm School of Economics

Author: Sven Zetterqvist

Tutor: Renée Adams

Presentation: 8 June 2006 at 13:15 in room C437

Discussant: Alexander Norberg

Abstract

Corporate governance research concerning the board of directors has traditionally focused mainly on how effectively board directors monitor the firm's management. Less attention has been given to the second important function of the board: the provision of expertise and knowledge. In order to investigate how stock market participants value this function, Fich (2004) studies whether investors react differently depending on the appointed director's background. Previous wealth effect studies treating all appointees as a homogenous group fail to establish a significant stock market reaction. Fich, however, finds that the market does seem to discriminate between board directors. Specifically, she finds that investors generally favor financial executives over other directors from other professional backgrounds. She does not, however, set out to explore this phenomenon. In this study I will attempt to bring clarity to this matter. Using an event study, I investigate 39 director appointments where commercial bank executives are nominated to the boards of non-financial firms in the United States for the period 1990-2004. I find a significant effect on the share price of the non-financial firms on the announcement date; the average abnormal return is 0.80 % and significant at the 5 % level. Using cross-sectional regression analysis, I further investigate two potential explanations for the observed attractiveness of commercial bank executives— their specific debt market expertise versus a more general contribution as non-affiliated firm monitors. I find some support that the observed appreciation is influenced by the non-financial firm's need for debt market expertise.

Acknowledgement: I would like to thank my tutor Renée Adams for valuable comments and suggestions.

INTRODUCTION	4
PURPOSE.....	5
DELIMITATION.....	5
CONTRIBUTION.....	6
OUTLINE.....	6
THEORETICAL FRAMEWORK AND PREVIOUS RESEARCH.....	7
THE ROLE OF THE BOARD OF DIRECTORS.....	7
<i>Monitoring</i>	7
<i>Expertise</i>	8
WEALTH EFFECTS OF DIRECTOR APPOINTMENTS	8
<i>Rosenstein and Wyatt (1994)</i>	8
<i>Perry and Peyer (2003)</i>	9
<i>Rosenstein and Wyatt (1990)</i>	10
FINANCIAL EXECUTIVES AS OUTSIDE DIRECTORS	10
<i>Fich (2004)</i>	10
<i>Booth and Deli (1999)</i>	11
<i>Kroszner and Strahan (2001)</i>	11
HYPOTHESES	13
METHODOLOGY AND VARIABLE DEFINITIONS	15
EVENT STUDY	15
<i>Abnormal Return – AR</i>	15
<i>Cumulative Abnormal Return – CAR</i>	16
<i>Estimation Period and Event Window</i>	16
<i>Testing Average ARs and CARs</i>	17
CROSS-SECTIONAL REGRESSION ANALYSIS	18
<i>The Cross-Sectional Model</i>	18
<i>Variable Definition</i>	19
DATA DESCRIPTION	21
DATA SOURCES	21
DESCRIPTIVE STATISTICS	22
OMITTED DATA AND POTENTIAL DATA BIASES	23
PRESENTATION AND ANALYSIS OF THE RESULTS.....	25
EVENT STUDY RESULTS	25
CROSS-SECTIONAL REGRESSION RESULTS	26
CONCLUSION	28
SUGGESTIONS FOR FUTURE RESEARCH.....	30
REFERENCES	31

Introduction

The board of directors serves a critical role for a company's shareholders in monitoring firm management. Therefore, it is not surprising that board failures often have very dramatic consequences. Recent company collapses – such as Enron and Parmalat – have made the investing public harshly aware of the consequences of inefficient boards.

In view of this, it is not surprising that academic research has given much attention to the question to what extent the board of directors actually fulfills its monitoring function. A large number of board characteristics – such as, the number of directors, the proportion of outsiders, and the number of additional directorships per board member – have been studied to see to what extent they influence the firm performance.

Less attention, however, has been given to the second important function of the board – its advisory role. Fama and Jensen (1983) emphasize how important it is that the firm is able to nominate outside directors;

“...with relevant complementary knowledge: for example, outsiders with expertise in capital markets, corporate law, or relevant technology who provide an important support function to the top management in dealing with specialized decisions.”

A special kind of assistance that is of considerable interest to firms is help with financial issues. Most firms face an ongoing challenge in securing necessary financing needed to run everyday operations. In view of the fact that most companies rely on loan financing to some degree, it is reasonable to assume that debt market expertise is especially sought-after.

Purpose

The overruling purpose of this study is to investigate how shareholders value the contribution from having a commercial bank executive on the board of a non-financial firm. I will attempt to answer the question whether their debt market expertise makes these executives especially attractive.

Specifically, the purpose of this study is twofold:

- To study the stock market reaction to announcements that a bank executive will join the board of a non-financial firm and,
- to analyze to how the magnitude of this reaction is influenced by different characteristics of the non-financial firm that are typically considered important for its creditworthiness and its ease of access to loan financing.

I doing this, I will bring together two previously separated areas of research – the previous event studies measuring the general stock market reaction to director announcements and the previous cross-sectional studies investigating a firm's creditworthiness and its associated likelihood of having a bank executive on the board. In this study, I will take a new approach and attempt to relate the magnitude of the stock market reaction directly to the current credit situation of the receiving firm.

Delimitation

An important delimitation of this study is in terms of geography. I choose to study the U.S. market – all firms are listed on either the NYSE or the Amex. An alternative approach would be to carry out this type in a worldwide setting. However, by concentrating on the U.S. market I do not only gain easier access to news releases and stock price data – I also obtain a sample of firms that are more homogeneous in terms of accounting standards, regulatory framework and general market conditions.

Contribution

Historically, one issue that has received special attention in academic research concerns the motive for the presence of bank executives on boards of non-financial firms. Initially many researchers claimed that bank executives merely sat on the boards of non-financial firms to monitoring the bank's lending relationships. According to this view, bank executives were only concerned safeguarding money lent to these firms. Increasingly, however, other researchers began to argue that the bank executives were not primarily concerned with the interests of their employers but rather performed a genuinely important function for the non-financial firm by providing debt market expertise that could be used in negotiations with *any* potential lender. Hopefully, the results of this study will help to bring clarity to this controversy.

The effectiveness of board directors selected from outside a company versus directors selected from within is a topic that also has received much attention in academic studies. Most of these studies have concluded that outsiders, being non-affiliated with firm management, are able to monitor firm management more efficiently than insiders. As a consequence of this observation, I also have to control for the possibility that stock market participants react positively solely due to the fact that an 'outsider' will join the board of directors – rather than focusing on the special debt market expertise of this individual. By controlling for this possibility, I hope to better discern the true attitude of the investing public towards debt market professionals as outside directors.

Outline

Initially, the theoretical framework and the relevant previous research will be presented. Proceeding in a top-down fashion, the reader will first be introduced to the general theoretical framework for the board of directors and then there will be a presentation of previous studies that have investigated the topic of finance professionals as outside directors specifically. Thereafter, I will present the hypotheses of this study as well as the methodology used to test them. The next section presents the empirical findings – the general stock market reaction results and the impact of the receiver firm's creditworthiness. Finally, I will discuss these empirical findings and suggest potential topics for future research.

Theoretical Framework and Previous Research

This section will introduce the reader to the role of the board of directors. Thereafter, it presents the most influential empirical findings on how the stock market views the work of the board of directors. Special attention will also be given to previous studies that have examined the special case of finance professionals as outside directors.

The Role of the Board of Directors

In accordance with Fama and Jensen (1983) and Booth and Deli (1999), I will distinguish between two general functions of the board of directors – monitoring and expertise.

Monitoring

In the classical market environment as described by Adam Smith (1776), monitoring of firm management is not a major concern. In Smith's model of the economy, persons representing both the owner and the manager – so-called 'owner-managers' – ensure efficient use of resources. Acting out of self-interest, managers will automatically attempt to maximize firm profit since this will also maximize their personal wealth as the principal owners. As a consequence, there can be no conflicts of interest.

In a modern setting, however, the situation is quite different. Jensen and Meckling (1976) note that the management of modern corporations is generally carried out by professional managers that are not the principal owners of the firm. This separation of ownership and control inevitably leads to a risk of a 'principal-agent' conflicts, since the objectives of the managers (the 'agents') may not necessarily coincide with those of the owners (the 'principals').

Adding to the problems, Fama (1980) notes that modern corporations also generally do not have a dominant shareholder. Rather, modern corporations are frequently characterized by a diffuse ownership structure and are therefore inescapably plagued by the so-called 'free-rider' problem – no individual shareholder has sufficient incentives for engaging in direct monitoring of firm management. Consequently, there is a risk that the

firm may suffer from insufficient internal management control which could lead to a situation where managers are pursuing personal objectives rather than profit maximization.

To overcome this problem, modern corporations have invented the construction of the board of directors as a low-cost method of disciplining management. Hermalin and Weisbach (2001) consider the board of directors to be a ‘second-best solution’ – that is, the board represents a market solution to an organizational design problem.

Expertise

Much of the academic research on board effectiveness has focused on examining how successfully the board performs its intended monitoring function. Fewer researchers, however, have investigated to what degree board directors provide expertise that could help managers run operations more effectively.

Nevertheless, there are some studies that have looked into this advisory role performed by outside directors. Vance (1978), for example, studies a sample of manufacturing firms and observes that outside directors regularly supply valuable technical skills and related know-how. Kesner (1988) emphasizes that outsiders, as compared to directors appointed from within the company, typically bring a broader range of experiences thanks to their contact with other companies and industries and their regular interaction with other management teams.

Wealth effects of director appointments

Rosenstein and Wyatt (1994)

Using an event study methodology, Rosenstein and Wyatt (1994) examine the wealth effects of board overlap announcements for firms listed in the United States. They examine the stock market reaction to 124 announcements in the *Wall Street Journal* for the period 1981-1985 in which an officer of a public corporation joins the board of another.

Generally, they find that the sender firms whose executives are being appointed directors of other firms suffer significant negative abnormal returns immediately following the announcement. Rosenstein and Wyatt interpret the results as an indication that market participants believe that the added duties of taking on an outside directorship is likely to distract corporate officers from running the daily operations of their employers. Rather, these officers are viewed as signaling their value and availability to other firms.

Rosenstein and Wyatt then continue by studying the receiver firms that receive these outside directors. For these receiver firms they are unable to find any noticeable stock market reaction – the abnormal returns following the appointment announcement are insignificantly negative.

Perry and Peyer (2003)

Drawing on the findings of Rosenstein and Wyatt, Perry and Peyer (2003) investigate the stock market reaction to announcements of new directorships between 1994 and 1996. The sample used in this event study consists of a total of 349 announcements for sender and receiver firms whose shares are publicly traded in the United States. Perry and Peyer also examine if the stock market reactions are different depending on the perceived risk of agency problems.

Their findings suggest that investors generally react negatively when executives accept outside director appointments and the executive's primary employer has a high perceived risk of agency problems – for example, if the executive has low share ownership, if the board of the sender firm does not have a majority of independent directors, or if the executive already holds multiple directorships. According to the researchers, investors view this type of situation as representative of the executive maximizing his or her personal gain rather than the wealth of the company's shareholders.

In contrast, they do not find that agency problems influence the stock market reaction of the receiver firm in a similar fashion. Instead, they find that the stock market reaction is mainly influenced by the receiver firm's own characteristics. Similar to findings of

Hermalin and Weisbach (1988), they find that shareholders react more favorably to an addition of an outside board member when the firm has experienced low prior performance.

Rosenstein and Wyatt (1990)

Rosenstein and Wyatt (1990) investigate the subject of board independence. They note that although there is no law requiring firms to have independent boards, the NYSE and the NASDAQ require companies whose stock is traded on their exchanges to have at least two outside directors on their corporate boards. This requirement suggests that some unaffiliated monitoring is considered necessary to safeguard or advance shareholders' interests.

Rosenstein and Wyatt find support for this conjecture – investors generally prefer outside directors to those nominated from within the company. Using event study methodology, they find that there is a significant 0.2% increase in the stock prices following the announcement of an outside director appointment. They note that this finding is in line with the theoretical framework presented by Jensen and Meckling (1976) and Fama (1980) which emphasizes the importance of board independence for efficient monitoring of firm management.

Financial executives as outside directors

Fich (2004)

Fich (2004) uses an event study methodology to study whether some outside directors are more favorably perceived than others. She stresses the fact that earlier studies have largely treated all appointees as a single group without recognizing differences with regard to profession, age, rank, etc.

Fich finds that there is indeed a difference in the stock market's reaction depending on the board candidate's background. Most relevant for this study's purposes, Fich finds that executives from commercial banks are perceived to be more valuable than executives from other organizations. The cumulative abnormal returns for the receiver firm are

found to be significantly positive around the time of announcement that a commercial banker will join the board of directors.

Booth and Deli (1999)

By examining how the presence of commercial bankers on the board of directors is related to borrowing, Booth and Deli (1999) attempt to provide insight into the services commercial bankers provide to the non-financial firms. For their study they use a LOGIT regression model with the likelihood of having a banker on the board as the dependent variable.

They find that the presence of commercial bankers on the board is positively related to aggregate bank debt. Further, they also make a distinction between ‘affiliated’ and ‘non-affiliated’ bank directors. Affiliated bankers are those whose employer lends money to the non-financial firm while non-affiliated bankers are those whose employer does not lend money to the non-financial firm. Having made this distinction, they find that while the presence of non-affiliated commercial on the board is positively related to bank borrowing, the number of affiliated commercial bankers on the board is not.

This result suggests that commercial bankers sit on the boards of non-financial firms to supply debt market expertise rather than to monitor lending relationships. Since bankers are experienced in building relationships, gathering information for credit evaluation and monitoring the evolution of credit markets over time, there is an understandable advantage for a non-financial firm to have a bank executive on the board even if it borrows from a bank different from the employer of that director.

Kroszner and Strahan (2001)

Kroszner and Strahan investigate the importance of ‘connected lending’ in the United States – with connected lending being defined simply as lending by affiliated banks to non-financials. In view of previous empirical findings highlighting the fact that connected lending is common in Asia (see Rajan and Zingales, 1988), Russia (see Laeven, 2001), and South America (see La Porta et al, 2001), Kroszner and Strahan set out to further investigate why connected lending only rarely occurs in the United States.

They reach the conclusion that U.S. banks generally consider the risk of potential conflicts of interest too high to engage in connected lending. Specifically, banks fear the risk that the bank executive – being a member of the board of the borrowing firm – might feel pressure to help the firm obtain too favorable lending terms. When the firm experiences financial distress, this pressure is likely to intensify. Consequently, there is an apparent risk that the connected bank will provide funding when it is not economically sound. So even though banks in the United States do not face any direct legal restrictions on board relationships between them and borrowing non-financials, they generally *avoid* lending to these firms because of the risk of agency problems.

Hypotheses

In this section, three hypotheses will be presented that will be used to further explore the role of commercial bankers on the board of non-financial firms.

The first hypothesis relates to the general stock market reaction following the announcement that a bank executive will join the board of a non-financial. Rosenstein and Wyatt (1994) did not find a significant stock price reaction for receiver firms in general. Fich (2004), however – differentiating between different backgrounds of the new appointees – found that the stock market’s perception of commercial bank executives is, on average, considerably more positive. This leads to my first hypothesis:

Hypothesis 1: General stock market reaction

The stock market reacts positively to non-financial firms announcing that a bank executive will join its board of directors.

Secondly, the influence of the bank executive as a simple ‘outsider’ is examined. In light of Rosenstein and Wyatt’s (1990) finding that shareholders generally prefer outside directors to insiders, is it important to control for any stock price reaction that merely communicates a general appreciation of outside directors rather than a specific appreciation of debt market specialists. A number of past studies have measured the impact of the proportion of outsiders on firm performance. This study, however, has its focus on the stock market impact following the director announcements rather than the subsequent firm performance and will therefore take a somewhat different approach. It is plausible to believe that the addition of an outsider will be regarded as more advantageous if the current board is currently dominated by insiders. My second hypothesis attempts to control for the proportion of insiders of the boards and thereby examine to what degree the market is simply reacting to the fact that the bankers are ‘outside’ directors:

Hypothesis 2: Impact of insider proportion on the board

The stock market reaction will be more positive for firms previously dominated by insiders.

Finally, I will examine in detail the stock market's appreciation of the debt market expertise provided by bank executives. This dimension is of highest importance since the findings of Booth and Deli (1999) and Kroszner and Strahan (2001) indicate that connected lending is a rare phenomenon in the United States and that monitoring of lending relationships is not a major reason for the presence of bank executives on the board of non-financials. Supposedly, firms facing difficulties in obtaining loan financing should be particularly appreciative for this kind of assistance. My final hypothesis examines what impact firm characteristics – and specifically those that influence the firm's access to loan financing – have on the stock market following the director announcement:

Hypothesis 3: Impact of firm creditworthiness

The stock market reaction will be more positive for firms whose credit characteristics make them hard for outside lenders to evaluate.

To sum up, the first hypothesis will look into the general attitude of stock market participants towards bank executives as outside directors by studying the general stock market reaction following the director appointment. The second hypothesis controls for the event that bank executives are not seen as distinctly different from other professionals but are merely appreciated outside directors. The last hypothesis examines in detail the degree to which the market does appreciate the debt market expertise and for which companies stock market participants view this help to be most advantageous.

Methodology and Variable Definitions

In this section I present the methodology employed to test the previously stated hypotheses. The first part deals with the event study methodology that tests the general stock market reaction. The second part introduces the cross-sectional regression methodology that will be used to analyze if and how different firm characteristics of receiver firms influence this market reaction.

Event Study

For the time-series analysis of the stock market reaction I use the event study methodology introduced by Fama et al (1969), and further discussed in Fama (1976) and Brown and Warner (1980). The essence of an event study is to assess if there are any abnormal returns associated with an event, that is, returns beyond those deemed normal according to a predictive formula.

Abnormal Return – AR

As the predictive formula I will use the risk-adjusted market model proposed by MacKinlay (1997). This model is a bit more complex than the two alternative models – the constant-return model and the market-adjusted-return model (see Brown and Warner, 1980). It does, however, yield results that are better adjusted to individual security volatility.

The daily *abnormal return* (AR) for a security i , at time t , is defined as the forecast error for that day:

$$AR_{i,t} = R_{i,t} - \hat{\alpha}_i - \hat{\beta}_i R_{m,t}$$

The values for $\hat{\beta}_i$ and $\hat{\alpha}_i$ are extracted from the estimation period as:

$$\hat{\beta}_i = \frac{Cov(R_{i,t}, R_{m,t})}{Var(R_{m,t})}$$

$$\hat{\alpha}_i = \bar{R}_i - \hat{\beta}_i \bar{R}_m$$

For each day in the event window, I calculate the average abnormal return for the sample, $\overline{AR}_t$. This measure will be used to examine if and how the market generally reacts to these director appointments.

Cumulative Abnormal Return – CAR

To see if there are any longer-term effects I also calculate *average cumulative abnormal returns* (CARs). The cumulative abnormal return for a security is found by simply adding up the daily abnormal returns for the event window:

$$CAR_i(t_1, t_2) = \sum_{t_1}^{t_2} AR_{i,t}$$

The average CAR for all securities over the event window will be a sign of whether there is a durable change in market valuation in response to the announcements.

Estimation Period and Event Window

The estimation period is set to begin 130 days before the announcement date and end ten days before the announcement date. This estimation period length of 120 days corresponds to the time interval suggested by MacKinlay (1997) when using daily returns and should be long enough to yield reasonably stable estimates to be used in the risk-adjusted market model.

The event window is set to 5 days, beginning two days before the announcement date and ending two days after the announcement date. Hopefully, this event window will be able to capture any immediate information leakage before the announcement date as well as delayed reactions following the announcement.

Testing Average ARs and CARs

The first hypothesis, concerning the general market reaction, will be tested by examining whether abnormal returns and cumulative abnormal returns are significantly different from zero. Here, I will make use of a one-sided t-test since previous research studies have observed a positive market reaction following the appointment of a financial executive to the board.

Specifically, for the abnormal returns the following hypotheses will be used:

$$H_0 : AR_t = 0 \quad , \text{against} \quad H_1 : AR_t > 0$$

, and the following t-statistic will be used:

$$t = \frac{\overline{AR}_t}{\hat{\sigma}_{AR}}$$

The corresponding hypotheses and t-statistic for the cumulative abnormal returns are:

$$H_0 : CAR_{t_{-2}, t_2} = 0 \quad , \text{against} \quad H_1 : CAR_{t_{-2}, t_2} > 0$$

$$t = \frac{\overline{CAR}_{t_{-2}, t_2}}{\sqrt{\text{Var}(CAR_{t_{-2}, t_2})}}$$

The testing of abnormal returns will indicate on what day or days, if any, the market generally reacts to the news. Signs of any information leakage in the two days before the announcement or any slow adjustments in the two days following the announcement may also be detected by studying daily abnormal returns. The test of the cumulative abnormal return will indicate the significance of the market reaction over the whole event window.

Cross-Sectional Regression Analysis

The stock market reaction to the director announcements can also be studied from a cross-sectional perspective. For my purposes, this is a good way of further examining why investors react in a certain way.

The Cross-Sectional Model

In the cross-sectional regression equation used here the dependent variable will be served by the announcement date abnormal return, and the independent variables will be represented by the different characteristics of the receiving firm. In particular, the independent variables will attempt to capture firm's characteristics deemed important for its creditworthiness and its access to loan financing. As a control variable, a variable indicating board independence will also be included in the regression model to control for the 'outsider effect'.

Rosenstein and Wyatt (1994) made use of a similar cross-sectional regression model to study the impact of firm characteristics on the announcement date abnormal returns. However, they studied the impact of *general* firm characteristics – such as profitability and firm size – and did not focus particularly on factors assumed to be important for loan financing.

In contrast, the LOGIT regression analyses of Booth and Deli (1999) and Kroszner and Strahan (2001) include such factors as independent variables – but the dependent variable in their models, on the other hand, represents the likelihood of the presence of a commercial banker on the board of the non-financial firm rather than the announcement date abnormal return at the time of appointment.

To my knowledge, no previous study has examined if and how factors deemed important for a firm's credit situation influence the stock market reaction to the announcement that a bank executive will join its board.

Variable Definition

The independent variables to be used in the regression analysis all relate to the firm's creditworthiness and therefore, hypothetically, to the firm's need for debt market assistance.

SIZE is an important factor since firms become less dependent on banks for credit as they grow. Consequently, the benefit of having a banker on the board is likely to be lower for large firms (Houston and James, 1995). In contrast, small firms are not only more likely to use bank loans for credit; they are also more likely to experience financial distress and therefore more risky borrowers. Further, Kroszner and Strahan (2001) observe that small firms tend to be younger and less well-known and therefore more difficult for outsiders to value. As a consequence, I expect small firms to appreciate debt market expertise more than large firms (i.e. an inverse relationship between size and announcement date abnormal return). Size is measured as the log of total assets.

PROPORTION TANGIBLE ASSETS is included to measure the effect of the nature of assets held by the firm. Tangible assets such as plants and machinery generally constitute more reliable collateral for loan financing than intangible assets such as goodwill or patents. In addition to the increased risk of "manipulation" of values for intangibles, firms with high levels of intangible assets may be difficult or even impossible to liquidate. Firms with a low proportion of tangible assets therefore find it more difficult to obtain external loan financing (see for example Himmelberg and Morgan, 1995) and are expected to benefit more from a close relationship with a loan expert (i.e. an inverse relationship between proportion of tangible assets and announcement date abnormal return). Proportion of tangible assets is measured as the ratio of net PPE to total assets.

LEVERAGE is also included as an independent variable since the capital structure of the firm can provide information about the value of loan financing assistance. More heavily indebted firms generally benefit more from the debt market expertise as well the certification brought by the presence of a commercial banker on the board (see Kroszner and Strahan, 2001). Therefore, shareholders of heavily leveraged firms are expected to

react more positively to the announcement of a bank executive director appointment than less leveraged firms (i.e. a positive relationship is expected between leverage and the announcement date abnormal return). The leverage ratio is defined as the book value of total debt divided by the market value of equity plus the book value of total debt.

INTEREST COVERAGE measures a firm's likelihood of facing financial distress and represents an important variable in traditional credit analysis. Firms with low interest coverage ratios are considered risky borrowers and therefore have more difficulty in obtaining loan financing. These firms should find the aid of a bank executive particularly advantageous in when negotiating with potential lenders (i.e. an inverse relationship is expected between interest coverage and the announcement date abnormal return). The interest coverage ratio employed here is defined as earnings before interest and taxes (EBIT) divided by total interest expense.

INSIDER PROPORTION is the variable included to control for the event that bank executives are seen as just 'outside' monitoring officers rather than experts of debt financing. The higher the proportion of insiders, the more advantageous shareholders should perceive the addition of a non-affiliated member to the board (i.e. we expect a positive relationship between insider proportion and announcement date abnormal return). Here, I define 'insiders' as directors employed by the firm and 'outsiders' as those directors that are not.

Including all independent variables, I end up with the following regression equation to be estimated:

$$AR_{i,0} = \beta_0 + \beta_1 (Size_i) + \beta_2 (Proportion\ Tangible\ Assets_i) + \beta_3 (Leverage_i) + \beta_4 (Interest\ Coverage_i) + \beta_5 (Insider\ Proportion_i)$$

Data Description

This section gives insight into the process used to retrieve the sample of director appointment announcements and the data for the involved firms. It also presents a summary of characteristics for the final sample.

Data Sources

To obtain a sample of announced banker appointments to non-financial firms, I turn to the Wall Street Journal's "Who's News" column (see also Rosenstein Wyatt, 1994). The Wall Street Journal is one of the most influential financial newspapers in the world and the 'Who's News' column is especially suitable for my purpose since it presents a large number of first-hand announcements in a concise manner. Using the Factiva database and specifying the source as Wall Street Journal's 'Who's News' column I scan the announcements for appointments of commercial bankers to the board of non-financial firms during the 15-year period from 1990 to 2004.

The following selection criteria are applied to retrieve the sample:

- 1) Character of companies:
 - a) The sender firm must be a commercial bank or a financial institution with considerable lending operations, and
 - b) the receiver firm must be a non-financial firm and cannot previously have a bank executive on its board.
- 2) Other events:

No other major events should be reported during the event period surrounding the announcement date
- 3) Stock return data:

The receiver firm's stock must be publicly traded on the NYSE or the AMEX and

stock return data must be available for the estimation period and the event period, without any missing returns.

Stock return data is gathered from Reuter's database and total stock returns are used to include the effect of dividends. Stock returns have also been adjusted to compensate for any stock splits or stock dividends. As a market proxy I use the S&P 500 Total Return Index since this is a corresponding total return index that is frequently used to capture the movements of the U.S. stock market.

Accounting data needed for the receiver firms are taken from their annual and quarterly reports, with the main source being the SEC's EDGAR database.

Descriptive Statistics

The final sample consists of 39 announcements that are further presented in Appendix 1. As can be seen, the receiving firms operate in a wide range of different industries. It is worth noticing that no receiving firm is involved in more than one appointment whereas many of the banks are involved in two or more appointments – appointments that sometimes concern the same individual. Table 1 presents key financial characteristics of the receiver firms. As can be seen are there apparent differences between the sample firms.

	Mean	Median	Max	Min
Average sales growth	9.2%	8.7%	27.7%	-15.6%
Profitability	6.5%	9.5%	31.2%	-56.2%
Interest coverage	5.1	4.4	26.0	-20.0
Total assets (\$ mn)	6,401	1,395	55,272	6
Proportion tangible assets	0.40	0.30	0.97	0.05
Leverage	0.49	0.53	0.97	0.03
Market value equity (\$ mn)	4,465	512	30,141	141
Proportion insiders	0.87	0.88	1.00	0.71

Table 1. Financial characteristics of the firms in the sample.

Clearly, the Wall Street Journal presents new director announcements for a broad spectrum of firms. The largest company in terms of market value of equity is oil giant

Texaco Inc with a total market value of over \$ 30 billion. In terms of book values, however, the largest firm is capital-intensive AT&T Corp with total assets exceeding \$ 55 billion. In contrast, the smallest company appears minuscule: fiber-optic lens maker LightPath Technologies Inc has a market value of equity of \$ 141 million and the book value of assets is only \$ 6 million. Also in terms of the other firm characteristics are there vast differences between the sample firms and it is therefore hard to talk about an 'average' sample firm. Only in terms of the proportion of insiders do the sample firms appear alike: insiders dominate the boards, representing between 71 and 100 percent of all board seats. Considering this high proportion of insiders on the boards of the receiver firms, it appears even more important to control for a potential outsider effect since shareholders reasonably would be quite eager to see any outsider join the board.

Omitted Data and Potential Data Biases

The initial sample consisted of 49 announcements. Five announcement events were excluded because the firms were privately held. Further, one company had to be excluded from the sample due to missing stock price data for the estimation period. Finally, four firms were eliminated from the sample due to missing accounting data for the time of announcement. Studying the ten excluded firms, I find no significant clustering in terms of time or industry.

The exclusion of the ten firms is unfortunate, however, since the final sample is reduced to 39 events which will require higher critical values for the rejection of the study's null hypotheses. On the bright side though, most sample firms have high trading volumes and therefore yield more stable regression estimates to be used in the estimating of AR and CAR.

A potential bias relates to the selection of news for publication in the Wall Street Journal. It would be reasonable to assume that the editors prefer to publish director announcements involving large corporations since news concerning these companies generally interest a majority of the readers. This selection could lead to a sample size bias since a lot of director appointments involving smaller-size firms might be excluded.

Studying the ranges for sample firm size, however, it is hard not to notice the wide range of values. Indeed, it appears like both large and small firms are included in the sample.

Presentation and Analysis of the Results

The presentation of the results will proceed in a top-down fashion. The first section will present the results of the event study conveying the message of the general stock market reaction to the director appointments. Thereafter, this observed behavior will be further explained in light of the findings from the cross-sectional regression analysis.

Event Study Results

The event study attempts to capture the sentiment of the investing public surrounding the announcements that bank executives will be joining the board of the non-financials. The average abnormal returns in the event window are presented in Table 2 below.

Day	-2	-1	0	1	2
Average AR	0.24%	0.22%	0.80%	-0.27%	0.43%
t-value	0.587	0.535	1.998	-0.650	1.027

Table 2. Abnormal returns for the event window.

As can be seen in the table above, the market reacts favorably to the news of the new director. The non-financial firms' shares gain on average 0.80 % on the announcement date. The corresponding t-value for this increase is 1.988, indicating that the gain is significant at the 5 % level.¹ There are no significant abnormal returns for the other days in the event windows, which could be interpreted that there is no significant information leakage before the announcement date or delay in the market's reaction for the days following the announcement. The abnormal return for day 2 is rather high though but is not high enough to be significant.

The average cumulative abnormal return over the whole event window is 1.41 %. This average CAR is not significant at the 5 % level but it's close: the p-value equals 7.0 %. In view of the significant abnormal return at the announcement date it appears that investors

¹ The critical value for the 5 % significance level is 1.687 (df=37, one-sided test).

react quickly to the news and that the length of the event window used here may be overly cautious thereby detracting from the power of the test. Further, this observation of a quick market reaction justifies the use of the announcement date abnormal returns as the dependent variable in the cross-sectional regression analysis that will follow next.

Cross-Sectional Regression Results

The event study results concluded that investors generally react positively and quite quickly to the news of the addition of a bank professional to the firm's board of directors. Thus, it certainly seems like investors value some feature in these directors. We are faced, however, with two alternative explanations. One explanation, drawing on the specific background of these professionals, is that shareholders expect their firm to benefit from the bankers debt market expertise. Market participants probably envision lower costs of financing for the firm. The alternative explanation is simply that market participants react to the fact that an outsider will be added to the board and expect that the future monitoring function of the board will be improved.

In case the second alternative explanation is correct we would expect that the no independent variable except Insider Proportion would be significant. That is because all the other independent variables relate to the firm's credit situation and market participants do not consider this dimension when evaluating the contribution of the new directors. If, on the other hand, the first explanation is correct we would expect one or more of the other independent variables to be significant. The result of the cross-sectional regression is presented in Table 3 below.

Variable	Coefficient	(t-statistic)
Constant	0.0200	(0.3635)
Size	-0.0002	(-0.0665)
Prop.Tangible Assets	-0.0321	(-1.7933)*
Leverage	0.0272	(1.3270)
Interest Coverage	0.0002	(0.2799)
Insider Proportion	-0.0735	(-0.7439)
Adjusted R ²	0.2173	

Table 3. Cross-sectional regression results. (* significant at the 10 % level; two-sided test)

From the table above it can be seen that the coefficient for Proportion Tangible Assets has a value of -1.7933, corresponding to a p-value of 8.5 %, which gives some support to the hypothesis that investors consider the firm's creditworthiness in evaluating the director appointment. The sign of the coefficient corresponds to the theory that loan financing expertise is more valuable for firms with a lot of intangible assets. Still, the coefficient is not significant at the 5 % level. With regard to the signs for the other creditworthiness dimensions we find that the signs for Size and Leverage correspond to theory while the sign for Interest Coverage does not. Nevertheless, none of these variables reach any noteworthy significance level and, all in all, the model does a rather poor job in explaining the observed market reaction.

It is worth observing also that the coefficient for the variable Insider Proportion does not show any significance and its sign does not correspond to theory. This would imply that investors are not concerned with the monitoring aspect when evaluating the new board members.

Conclusion

The results of the event study show that investors react positively to the news that a non-financial firm has appointed a bank executive to its board of directors. This result is different from Rosenstein and Wyatt's (1994) general results for the share price of a receiver firm, but is consistent with the findings of Fich (2004) who studied commercial bankers specifically.

On average, I find that the non-financial firms' shares gain 0.80 % on the announcement day. Further, it seems that these sample announcements are relatively unexpected by the investing public, but that market participants react quite quickly once they receive the news.

Judging from the share price reaction on the day of the announcement, investors clearly appreciate something in their new directors. The cross-sectional analysis model applied aimed to find out what this attractive feature was – debt market expertise or superior monitoring. The poor result of the analysis gives no support for any hypothesis though. Some support is found for the theory of debt market expertise: investors expect firms relying to a large extent on intangible assets, generally not a very useful source of collateral, to gain more from the assistance of a bank professional. Still, no other variable measuring the firm's credit situation yields any noteworthy results.

Likewise, it is not possible to relate the stock market reaction to the general theory that outsiders perform more rigorous monitoring of firm management. The variable used to control for this more simplistic market reaction does not provide any support.

Let us consider some potential explanations for the observed results. To start with, the credit situation could be inappropriately reflected by the variables I have chosen for my study. That could lead to unsatisfactory regression results even though investors actually are concerned with the firm's loan financing situation and appreciate the help from a

bank executive. Maybe the perceived credit situation is better reflected in terms of other key ratios. Alternatively, investors may not care about the profession of the new directors and focus solely on the fact that they are outsiders. The monitoring theory could still be true even though the included control variable lacked significance. I assumed that investors would appreciate outsiders more when the board was dominated by insiders, i.e. I used a relative approach. In fact, it could be that all outsiders are appreciated equally much irrespective of how many of them are already on the board. Finally, let's consider a last potential explanation for the obtained results: investors may appreciate a totally different trait among these new directors. For example, they could simply be impressed by the reputation of the appointee or the size of his or her employer.

To sum up, the results of this study have confirmed the findings of Fich (2004) that financial executives on average are appreciated by stock market participants but my further examinations failed to provide any significant clues behind this behavior.

Suggestions for Future Research

The topic of financial executives as board members is largely unexplored but is a topic that is worth looking into more carefully. During my work with this study I have reflected on some possible extensions and alternative approaches that would be interesting to investigate.

First of all, it could be interesting to investigate the stock market reaction of the sender bank at the time of announcement. For my study there were just too few sample banks with available data to do this. Still, if the scope of the study is expanded in terms of geography, and possibly an even longer time span, it may give some interesting results. For example, a worldwide setting could be interesting.

Another interesting area of research concerns connected lending and the potential conflict of interest that may arise when a bank executive sits on the board of a non-financial firm. The director may feel pressured to help the non-financial firms obtain more than usually favorable loans from his or her employer. Some studies have examined how the bank's shareholders react to these appointments, but more detailed studies regarding this situation could be interesting.

Finally, it would also be interesting to replicate this cross-sectional element in this study, but with other proxies representing the credit situation of the firm. Maybe alternative key financial could better capture the firm's financing situation as perceived by shareholders.

References

- Booth, J.R., and Deli, D.N., (1999), "On executives of financial institutions as outside directors", *Journal of Corporate Finance*, Vol. 5, 1999, pp.227-250.
- Brown, S. J., and Warner, J. B., (1980) "Measuring Security Price Performance", *Journal of Financial Economics*, 8, 1980, pp. 205-258.
- Fama, E.F., (1976), "Foundations of Finance", New York, Basic Books, 1976.
- Fama, E.F., (1980), "Agency problems and the theory of the firm", *Journal of Political Economy* 88, 1980, pp. 288-307.
- Fama, E.F., and Jensen, M.C., (1983), "Separation of ownership and control". *Journal of Law and Economics* 27, 1983, pp. 301-325.
- Fama, E.F.; Fisher, L.; Jensen, M.; and Roll, R., (1969), "The Adjustment of Stock Prices to New Information", *International Economic Review*, 10, 1969, pp. 1-21.
- Fich, E., (2004), "Are Some Outside Directors Better than Others? Evidence from Director Appointments by Fortune 1000 Firms", *The Journal of Business*, 2004 forth.
- Hermalin, B., and Weisbach, M., (1988), "The determinants of board composition", *Rand Journal of Economics* 19, 1988, pp. 589-606.
- Hermalin, B., and Weisbach, M., (2001), "Board directors as an endogenously determined institution: a survey of the economic literature", Working Paper, 2001.
- Himmelberg, C., and Morgan, D., (1995), "Is bank lending special?, In: Peek, J., and Rosengreen, e., (Eds.), *Is Bank Lending Important for the Transmission of Monetary Policy*, Conference Series No. 39. Federal Reserve Bank of Boston, 1995, pp. 15-36.
- Houston, J., and James, C., (1995), "Banking relationships, financial constraints, and investments: are bank dependent borrowers more financially constrained?", Unpublished Working Paper, University of Florida, Gainesville, 1995.
- Jensen, M., and Meckling, W., (1976), "Theory of the firm, managerial behavior, agency costs and ownership structure", *Journal of Financial Economics* 3, 1976, pp. 305-360.
- Kesner, L., (1988), "Directors' characteristics and committee membership: An investigation of type, occupation, tenure, and gender", *Academy of Management Journal* 31, 1976, pp. 66-84.

Kroszner, R.S., and Strahan, P.E., (2001), “Throwing Good Money after Bad? Board Connections and Conflicts in Bank Lending”, Working Paper, University of Chicago and Boston College, 2001.

Kroszner, R.S., and Strahan, P.E., (2001), “Bankers on Boards: Monitoring, Conflicts of Interest and Lender Liability”, *Journal of Financial Economics*, 2001, forth.

Laeven, L., (2001), “Insider Lending and Bank Ownership: The Case of Russia”, World Bank Group, Working Paper, 2001.

La Porta, R.; Lopez-de-Silanes, F.; and Zamarippa, (2001), “Insider Lending in Mexico”, Unpublished Working Paper, Harvard University, 2001.

MacKinlay, A.C., (1997), “Event Studies in Economics and Finance”, *Journal of Economic Literature*, Vol. 35, 1997, pp. 13-39.

Perry, T., and Peyer, U.C., (2003), “Board seat accumulation by executives: A shareholder’s perspective”, Working Paper, Insead and Arizona State University, 2003.

Rajan, R., and Zingales, L., (1998), “Which Capitalism? Lessons from East Asian Crisis”, *Journal of Applied Corporate Finance*, 11, Fall 1988, pp. 40-48.

Rosenstein, S., and Wyatt, J., (1990), “Outside directors, board independence, and shareholder wealth”, *Journal of Financial Economics* 26, 1990, pp. 175-190.

Rosenstein, S., and Wyatt, J., (1994), “Shareholder wealth effects when an officer joins the board of directors of another”, *Managerial and Decision Economics*, 15, 1994, pp. 317-327.

Smith, Adam, (1776), “An Inquiry into the Nature and Causes of the Wealth of Nations”, The Modern Library, New York.

Vance, S.C., (1978), “Corporate governance: Assessing corporate performance by boardroom attributes”, *Journal of Business Research* 6, 1978, pp. 203-220.

Appendix A. Director Appointments

Announcement date	Sender bank Firm name	Name officer	Receiver firm Name	Industry
8/Oct/1991	BankAmerica Corp.	Michael J. Halloran	Foundation Health Corp.	Operator of health maintenance organizations
3/Dec/1991	Deutsche Bank	Ronaldo H. Schmitz	Rohm & Haas Co.	Specialty-chemical maker
6/Feb/1992	Lloyds TSB Group	Edward Anthony Parkes	Tyco Laboratories Inc.	Medical supplies
9/Mar/1992	Citicorp	Rozanne LeJeanne Ridgway	Boeing Co.	Aerospace concern
27/Aug/1992	Citicorp	Richard Braddock	Lotus Development Corp.	Computer software concern
10/Nov/1992	Zions Bancorp.	Harris H. Simmons	Questar Corp.	Energy company
14/Jan/1993	Bank of New York	J. Carter Bacot	Woolworth Corp.	Retailing concern
29/Jan/1993	Integra Financial Corp.	Leonard M. Carroll	Quaker State Corp.	Maker of motor oils and lubricants
2/Mar/1993	Wells Fargo & Co.	Carl E. Reichardt	ConAgra Inc.	Packaged-food concern
29/Jun/1993	Fleet Financial Group	Anne Szostak	Central Maine Power Co.	Utility
20/Aug/1993	Citicorp	Richard M. Cashin	Levitz Furniture Inc.	Furniture retailer
18/Nov/1993	Marshall & Ilsley Corp.	Dennis J. Kuester	Modine Manufacturing Co.	Maker of heat-transfer technology
4/Feb/1994	Bank of New York	Robert E. Allen	Chrysler Corp.	Auto maker
27/Apr/1994	Wachovia Corp.	John G. Medlin Jr.	Burlington Industries Inc.	Textile company
4/May/1994	BankAmerica Corp.	Richard M. Rosenberg	Pacific Telesis Group	Telecommunications company
26/Oct/1994	New York Bancorp	Michael A. McManus Jr.	National Wireless Holdings Inc.	Wireless-cable-systems holding company
22/Feb/1995	Wachovia Corp.	John G. Medlin Jr.	Nabisco Holdings Corp.	Food company
9/Jun/1995	Citicorp	H. Onno Ruding	Corning Inc.	Specialty-materials and communications
20/Jul/1995	Fleet Financial Group	Robert M. Van Degna	ACC Corp.	Telecommunications
27/Sep/1996	Citicorp	Beth L. Bromner	Oak Industries Inc.	Communications components concern
16/Oct/1996	Wachovia Corp.	G. Joseph Prendergast	Willamette Industries Inc.	Forest-product concern
29/Oct/1996	Fleet Financial Group	Terrence Murray	Melville Corp.	Drugstore operator
4/Nov/1996	Bank of Ireland	David M. Kennedy	Trans World Airlines	Airline
22/Nov/1996	Bank of New York	J. Carter Bacot	Time Warner Inc.	Media and entertainment company
6/Mar/1997	PNC Bank Corp	Richard L. Smoot	Aqua America Inc.	Water-utility company
28/Apr/1997	Citicorp	Mary A. Cirillo	Quest Diagnostics Inc.	Provider of diagnostic laboratory testing
24/Jun/1997	KeyCorp	M. Thomas Moore	Lubrizol Corp.	Chemicals
16/Sep/1997	Credit Suisse Group	Alan H. Howard	Movado Group Inc.	Maker and distributor of watches
23/Dec/1997	Barnett Banks Inc.	Charles E. Rice	Post Properties Inc.	Developer of upscale apartment communities
15/Jan/1998	Synovus Financial Corp	James D. Yancey	Shoney's Inc.	Restaurant chain
28/Jan/1998	Fleet Financial Group	Anne Szostak	New England Business Service Inc.	Maker of business forms
5/Oct/1998	UBS AG	James Reilly	Daisytek International Corp.	Distributor of office-automation supplies
28/Oct/1998	Credit Suisse Group	Katherine E. Dietze	Lightpath Technologies Inc.	Fiber-optic lens maker
15/Dec/1998	Toronto-Dominion Bank	Charles Baillie	Texaco Inc.	Oil company
1/May/2001	Zions Bancorp.	David Blackford	M.D.C. Holdings Inc.	Homebuilding concern
20/Aug/2002	Canadian Imperial Bank	Jill Denham	Global Payments Inc.	Electronic-transaction-processing services
22/Jul/2003	HSBC Holdings PLC	William F. Aldinger III	AT&T Corp.	Telecommunications
19/Aug/2003	Credit Suisse Group	Geraldine A. Ferraro	Goodrich Petroleum Corp.	Oil-and-gas producer
3/Feb/2004	Bank of America	O. Temple Sloan Jr.	Lowe's Cos	Retailer of home-improvement products

Appendix B. Scatter Plots

