Chapter 9
Independent Directors' Roles in Banks

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ABSTRACT

The chapter deals with how the busyness of independent directors moderates their influence on the performance of banking firms in India. Using a two-step system generalized method of moments on an unbalanced panel of 42 Indian banks during 2005-2018, the chapter indicates that bank boards with a higher proportion of busy directors experience higher performance up to a threshold level of 20 percent, favoring the reputational hypothesis. However, the bank's performance gets deteriorated after more than 20 percent of independent directors are busy. It thereby produces evidence of an inverted U-shaped relation, favoring the busyness hypothesis. Further, the results display that busy independent directors who are not participating in at least 75 percent of board meetings exert a detrimental impact on bank performance. The findings of the chapter are strengthened by the alternative econometric method of propensity score matching. The findings of this chapter would be of great interest to policymakers to initiate effective governance provisions related to the busyness of independent directors.

INTRODUCTION

Independent directors are viewed to be a solution to various governance issues and agency conflicts, as they act as the fiduciaries of the shareholders and provide oversight over the actions and decisions of the management. In the last decade, in the aftermath of the financial crisis, the role of independent directors in attaining effective decisions without undue managerial influence has gained significant attention. Indeed, most of the regulatory guidelines worldwide require the board to be composed of at most the majority of independent directors. However, the task of defining independent directors has always remained challenging. The most usual way to categorize independent directors is any person who does not have any material relationship with the organization, other than being its director. However, this definition has evolved over a period of time. For instance, according to Clause 49 of SEBI, an independent director "*is a person who apart from receiving remuneration, does not have any material pecuniary*

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relationship or transactions with the company, its promoters, its management, or its subsidiaries, which in the judgment of the board may affect the independent judgment of the director". The requirements prescribed under the Companies Act 2013 seem to be much more stringent than that of the listing agreement as it incorporates various factors, including education, expertise, and voting power, among others to categorize the independent director.

The empirical literature also seems to be burgeoning on analyzing the efficacy of independent directors in mitigating agency conflicts. It is asserted that there exist strong incentives for independent directors such as signaling their reputation and competence to make decisions independently (Johnson et al., 1996; Dalton et al., 1998; Hermalin & Weisbach, 2003). Additionally, independent directors have greater contact with outside resources, which might aid them in attaining their goals (Johnson *et al.*, 1996). Nevertheless, there is no consistency in the relationship between independent directors and bank performance. For instance, Bhatia and Gulati (2020), Nyamongo and Temesgen (2013), Liang et al. (2013), Dong et al. (2017) concluded a positive impact, while Aebi et al. (2012), Pathan and Faff (2013) and Mollah and Zaman (2015) found a negative impact of independent directors on the bank performance.

In this context, the literature highlights the role of different institutional settings (Van Essen et al., 2012; Kumar & Zattoni, 2013; Sheikh et al., 2018) and different measures of performance and independent directors (Bhatia & Gulati, 2021). But another plausible reason for this inconsistency can be the "multiple directorships held by independent directors". It is asserted that different characteristics of independent directors moderate their impact on the bank decisions (Sharma, 2011; Ferris et al., 2003). The role of busy directors has indeed become a matter of debate in recent years and seeks attention from researchers to empirically assess their impact on various firm outcomes. On the positive side, it is argued that holding directorship in multiple boards provides a certification to the directors of their efficiency in monitoring and advising (Fama & Jensen, 1983), which is referred to as the "*reputation hypothesis*". Therefore, they exert a positive influence on the firm monitoring and supervisory outcomes. On the negative side, busy directors are likely to be over-committed and would devote lesser time and effort to monitoring management (Fahlenbrach et al., 2010), referred to as the "*busyness hypothesis*". Therefore, busy directors adversely affect the supervisory outcomes.

However, most of the prior studies have focussed on non-financial firms, and lesser is known about the banking firms (Elyasiani & Zhang, 2015). Nonetheless, the opaque nature of banking activities (Levine, 2004); the higher information asymmetries and agency problems (Becht et al., 2011); the more specific role of debt governance in banks (Hopt, 2013); high leverage (Mülbert, 2009); and the conflicting impact of regulators, investing and non-investing shareholders (Adams & Mehran, 2003) make the governance of banks distinguished from those of non-financial firms. Moreover, higher scrutiny from the regulators diminishes the likelihood of engaging in the shirking behavior of the directors. Thus, the findings from the non-financial sector cannot be directly extrapolated for the banking firms.

Therefore, against this background, this chapter aims to investigate the influence of the busyness of independent directors on the performance of banking firms. In particular, the chapter attempts to answer the following questions: whether the multiple directorships of independent directors (busy independent directors) moderate their monitoring and advising abilities? Are busy independent directors performing their fiduciary duties diligently or are they over-committed? The perspective of busy directors as "inefficient monitors" is generally adopted in the regulatory guidelines for 'best practices' that ultimately emphasize the need for a lesser number of busy directors. Accordingly, the most acceptable definition of busy directors is the directors with three or more directorships (Cashman et al., 2012; Elyasiani & Zhang, 2015; Méndez et al., 2015). However, unlike the other nations, the RBI (2014) allows non-executive

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