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Well-connected directors: When do they really matter?

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A director in India serves on the boards of an average of five firms in a financial year. This number is higher if the director is female. Serving on boards of multiple organizations helps directors network with experts from different industries. It also leads to the formation of various indirect connections which can be utilized eventually. This article discusses the evolution of the role of directors, the rationale behind directors occupying multiple board positions, the benefits of better-connected directors, on both the individual and firm level, and the various factors which may limit the incremental benefits of well-connected directors.

The evolution of the role of directors

The separation of ownership and control in firms is intimately associated with problems of agency. Examples of agency problems include managers absconding with firms' funds, squandering them on non-profitable projects or drawing unjustified executive remuneration. Agency issues lead to the improper utilization of the firm's resources and reduce the overall efficiency and profitability of the firm. Corporate governance mechanisms such as establishing the board are considered effective solutions to the agency problem. Members of the board are appointed by shareholders through a voting process and perform multiple tasks such as reducing and eliminating agency problems through managerial oversight, corporate decision making, and resource provision for firms. The role of investor protection is particularly true for an independent director, who is an "outsider" to the firm and is considered responsible for improving corporate credibility and governance standards.

However, with time, the definition of stakeholders has evolved, businesses have transcended geographical boundaries, and the overall industry requirements have changed. With this, traditional forms of governance are also being challenged. Boards are now under pressure to develop a broader mind-set and newer skills to deal with the changing strategy requirements. The shift in expectations from the board is further intensified by the market context in which these firms function. We elaborate on this further.

Market context is a crucial aspect of the business environment which needs consideration when making firm-level decisions. Countries like the USA or UK, labelled developed economies, have relatively lower levels of information asymmetry. They also have in place strong lending systems that help supplement access to information with easy access to credit and capital. On the other hand, emerging markets like India, Italy and China are marked with information voids i.e., barriers when trying to access information, as well as capital

voids, implying firms facing a paucity of capital when funding new projects. This causes firms in developing nations to intensify information search and optimize their allocation of capital, occasionally also forcing them to forego healthy projects.

Overcoming these gaps is crucial for business development. Firms that operate in markets with voids adopt various channels of doing so. The directors also continually adapt to the requirements of the firms and accept a more resource provision based role. This extended role involves providing information, access to technical know-how, and identifying potential sources of capital, thereby ensuring access to credit and information, in addition to their usual task of monitoring. In most emerging markets, directors, by performing the additional function of a resource provider, ensure access to resources that are crucial in shaping the strategic bent of the firms.

At this point it becomes critical to understand the potential sources through which directors gather resources. One possible way is to channel their connections and utilize their position in formal and informal networks. Informal connections include alumni contacts and affiliations with industry associations, and examples of formal networks include connections established while providing contemporaneous service to different boards. Being better connected (being embedded deeper into these networks) adds to the ability of directors to arrange for resources and information when needed. These benefits are well-documented in the networks literature (Omer *et al.,* 2014; Benson *et al.,* 2018).

For example, owing to their position in networks, well-connected directors receive information faster; the relative cost of procuring this information is also low (Onal, 2023). Second, rich discussions within networks provide connected directors better industry-wide knowledge and improve their understanding of market trends, improving their ability to forecast industry-relevant changes and the overall market demand (Srinivasan *et al.,* 2018; Ke *et al.,* 2019). A connected director thus provides information-based advantages to the firms he serves while simultaneously improving his skill set and the ability to contribute to the strategic development of firms. Investors also perceive this trait as valuable. Firms with better-connected directors display better market performance in general as well as during heightened uncertainty (Larcker *et al.,* 2013; Carney *et al.,* 2020).

Being embedded deeper into the networks also has various resource-based benefits. For example, firms with better-connected directors enjoy an easier access to capital. This happens through multiple ways. First, directors utilize their contacts with lenders, analysts and banks (which they gain when serving as directors of various firms), their connections help them raise capital at lower rates (Houston *et al.,* 2014; Zhang and Truong, 2019). Second, better-connected directors carry a positive market perception. This helps firms establish legitimacy, especially when raising funds through IPOs (Chen *et al.,* 2016). Additional resource-based benefits include acting as a connector between firms and improving their quality of mergers and research

and development (Faleye *et al.,* 2014; Kang *et al.,* 2018). Another often overlooked but crucial advantage of a well-connected director is his indirect connections. Indirect connections augment a director's ability to arrange expertise in case he lacks the necessary expertise himself (Andersen *et al.,* 2022).

The potential of well-connected directors to contribute towards a firm's development explains the demand for such directors in director labour markets. Firms actively seek better-connected directors for their boards in hopes of bridging various institutional voids (Brown *et al.,* 2019). To maintain and improve their position in networks, directors also avoid associations with firms that may harm their reputation and lead to an eventual loss of board seats. They also supplement their attempts to maintain the reputation of the firms they serve by demanding strong external governance mechanisms such as high audit quality (Kalia et al., 2023).

While the role of networks in knowledge and information transfer cannot be disregarded, connected directors are not the only mechanism an economy has to overcome various voids. Another common mistake in literature is generalizing the results of one market for another. For example, Indian businesses function in a unique market. In terms of ownership structure, a significant number of firms here are business group affiliates or family firms. India also has a different overall governance context and multiple market participants who perform the role of informal channels. For example, there exist alternate channels such as promoter networks and lender networks, information asymmetry is reduced through analyst coverage and forecasts as well, in addition to the information transmission between business groups. Under such circumstances, do director networks carry the same incremental value in India as in other developed and emerging markets? We discuss the potential factors that may affect the value of director networks in India.

1. The domination of business groups

The Indian market consists of multiple business groups. More than half of the Nifty 500; an index that represents more than 96% of the Indian market, comprises of firms that are business group affiliates. This affiliation has a multi-fold impact. First, information transfer between business group affiliates is faster, and second, business groups are known to channel funds when one of their affiliates faces a capital crunch. For example, internal capital markets are an alternate source of capital that is frequently tapped by business groups to gain short-term and long-term capital. Alternate sources such as business group affiliations thus restrict the dependence on connected directors and the firm's structure ensures that gaps in the business environment get bridged without bearing any additional monetary costs (Mukherjee *et al.,* 2018), thereby making highly networked directors less lucrative.

2. Presence of alternate informal channels

Second, high-growth economies like India frequently face a credit crunch and rely on venture capitalists, promoters, underwriters and bankers to meet their credit requirements[10]. Often various firms (both standalone and business group affiliates) tend to share the same set of promoters and bankers. These capital providers have access to both financial and non-financial information of firms and frequently act as brokers of information should any of these companies face informational voids. Their motivation to share this information often includes vested interests in the firms themselves. For example, banks seek to recover the investments made in a firm's capital-intensive projects, and promoters seek to maintain and enhance the market value of their shares.

3. Emphasis on number of connections over quality of connections

While the impact of the size of a director's network is well explored, attention must also be paid to the quality of the directors and his network. Owing to a limited director pool, director appointment in India is an uphill task. Very often, the same few directors find a place on multiple boards. This is a more substantial concern for women directors as their number is even lesser[11].

Although the strength of connections is understandably higher in such cases (serving together at multiple places is likely to lead to less friction and quick decision-making), the overall quality of strategic insights declines. Multiple appointments of the same directors across boards leads to a lack of diversity in the overall board composition, making it difficult to generate new ideas that would benefit firms. It is also unlikely that firms will possess information that can be used for strategic advantage as similar information will flow between similar director groups.

In compliance with the Companies Act of 2013, one third of the board of Indian firms must be independent and at least one woman director must sit on the board of Indian firms. To work around these mandates, many firms used regulatory loopholes and bring female family members such as wives, daughters and relatives of the current management on their boards. Under such circumstances, their connectedness might not bring any additional benefits and lose relevance.

Business groups also often appoint the same directors across their multiple affiliates. This is done to adhere to the broader vision of the conglomerate and to help enhance the speed of implementing policies across firms. On occasion, this is known to reduce the role of directors as they face pressure to conform to the requirements

[10] https://www.ey.com/en_in/india-at-100/how-india-can-fill-the-credit-gap-to-fuel-economic-growth (accessed on 20.03.2023)
[11] https://www.livemint.com/Companies/9tIeuFcZJUAPPfjxcTHpvJ/Indian-companies-struggle-to-place-women-on-boards.html (accessed on 20.03.2023)

and policies of firms[12]. Sitting on multiple firms of the same group may also hinder a director's ability to monitor accurately. In the past, such connected directors have misused their connections to display unethical behaviour, with practices such as tunnelling and informed trades coming to light[13].

4. Uncertainty levels in the business environment

An upcoming study (Kalia et al., 2023), which explores the perception of director networks in India also finds that investors do not attach any incremental value to firms with better-connected directors in general. This relationship is moderated by the level of uncertainty in the environment; for example, during the COVID-19 pandemic, information breakdowns were rampant, and information asymmetry escalated. Under such circumstances, investors perceived director networks as an uncertainty mitigation mechanism and investors valued firms with better-connected directors positively. This positive perception is correlated to the level of uncertainty in the business environment. For example, even within the time frame of the pandemic, higher levels of uncertainty were documented during the lockdown as there was ambiguity regarding markets reopening, availability of vaccines, availability of essential products and job opportunities in general. The investor perception of firms with better-connected directors was much stronger and higher during this period.

A more efficient way to overcome the problem of voids includes a better understanding of the country's markets and institutions and focusing on the quality of connection over the mere existence of the connections. The market context should be considered when strategizing ways to overcome these voids.

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