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# Taking the lord's name in vain: The impact of connected directors on 19th century British banks☆

Richard S. Grossman[a,b], Masami Imai[c]

[a] Department of Economics, Wesleyan University, Middletown, CT 06459, USA
[b] Institute for Quantitative Social Science, Harvard University, Cambridge, MA 02138, USA
[c] Department of Economics and East Asian Studies Program, Wesleyan University, Middletown, CT 06459, USA

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**Abstract**

This paper utilizes data on the presence of prominent individuals – that is, those with political (e.g., Members of Parliament) and aristocratic titles (e.g., lords) – on the boards of directors of English and Welsh banks from 1879 to 1909 to investigate whether the appointment of well-connected directors enhanced equity value for bank shareholders. Our analysis of panel data shows that the appointment of connected directors did not increase equity returns (as measured by the capital gain plus dividend yield on bank shares). In fact, we find that the appointment of MPs to directorships had *negative* effects on bank equity returns. Our event-study analysis corroborates this finding, showing that a bank's shares exhibited *negative* abnormal returns when their directors were elected to Parliament. Taken together, our results indicate that connected directors yielded little – or even negative – economic payoff to bank shareholders in pre-war Britain.


*Keywords:* Banks; Corporate governance; Britain; 19th century; 20th century

## 1. Introduction

The prevalence of politically influential firms in emerging market economies is extensively documented, as companies frequently appoint well-connected individuals to chief officer positions and/or directorships (Faccio, 2006; Gomez and Jomo, 1997). The economic rationale behind such appointments is a subject of controversy. A positive interpretation is that these directors are selected because they bring some knowledge or experience that is relevant to the firm's operation—either specific know-how about the business or more general expertise in organization, management, or logistics. Additionally, their presence on the board might reassure the firm's customers, who would otherwise be less willing to purchase the products made by the firm, or financiers, who would otherwise be less willing to provide the firm with debt or equity finance. A less charitable view is that these individuals are selected for political reasons: because they can influence politicians, regulators, or other government

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*E-mail addresses:* rgrossman@wesleyan.edu (R.S. Grossman), mimai@wesleyan.edu (M. Imai).

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officials in ways that may materially affect the company's performance. These opposing views have important implications for the allocation of resources across and within firms, financial and economic development, and prescriptions about what type of regulations ought to govern potential conflicts of interest.

The empirical literature in development economics suggests that political connections can be pernicious and are likely to constitute a form of rent-seeking.[1] Firms seek connections with politicians who can protect their economic interests, while politicians seek close connections with firms in order to extract resources, both for private gain and to protect their political interests (Faccio, 2006; Faccio et al., 2006; Ferguson and Voth, 2008; Fisman, 2001; Johnson and Mitton, 2003; Khwaja and Mian, 2005; Imai, 2006; Sukhtankar, 2012). A welfare implication of this negative view of politically connected firms is that if left unchecked, they will stifle market competition and distort the allocation of resources toward connected firms and away from their more efficient competitors, imposing substantial economic costs. Moreover, another strand of the related literature shows that politically connected firms suffer from deficient internal governance since managers and directors, who are appointed based on political consideration, are less likely to represent shareholders' interests (e.g., Bertrand et al., 2006; Fan et al., 2007; Horiuchi and Shimizu, 2001).

A more historically inclined literature recognizes that political connections can have a positive role for economic development in the face of market and institutional failure. For example, in a weak institutional environment where the government finds it difficult to make a credible commitment to protect property rights, firms with viable investment projects might seek political connections as an informal way to secure property rights (Haber, 2002; Razo, 2008). Similarly, when firms face difficulty raising finance from outside investors due to asymmetric information problems, they might seek political connections as a way of signaling their high quality assets and management. Ghita et al. (2009) show that firms with better social and political connections had higher levels of growth and probability of survival in Belgium during 1858–1909. Okazaki and Sawada (2014) also show that firms benefitted from political connections in Japan in the late 1920s and early 1930s during the long periods of recession and financial difficulty.

Hannah (2007: p. 667) notes that the presence of titled individuals on the board provided a positive signal to British investors during the 19th century. Similarly, Braggion and Moore (2013) show that the presence of Members of Parliament (MPs) on boards of directors was associated with greater access to external capital for firms in "new tech" industries in Britain during 1895–1906. During a time in which British securities markets stand accused of starving new tech firms for capital and having accelerated Britain's relative economic decline, this effect is not trivial (Kennedy, 1987).[2]

A related extensive literature explores many different aspects of boards of directors and their role in corporate governance. This literature includes studies of board size (Coles et al., 2008), structure (Linck et al., 2008), composition (Hermalin and Weisbach, 1988, 1998; Menozzi et al., 2012), and the impact of outside directors (Duchin et al., 2010), women (Adams and Ferreira, 2009), and celebrities (Ferris et al., 2011) on corporate governance and firm performance.

This paper contributes to the literature by measuring the extent to which well-connected individuals served on the boards of English and Welsh banks during 1879–1909.[3] We do this by focusing on an easily identifiable quality of directors: their titles. Specifically, we focus on two types of titles: political and noble. By political titles, we mean individuals who were simultaneously Members of Parliament (MPs) and on the board of directors. By noble titles, we mean directors who possessed aristocratic titles, who were likely to have had a well-connected network even though their direct political influence may have been less than the members of the House of Commons.[4] By using these two types of titles, we hope to distinguish between the political influence of directors and other aspects (for example, social standing or notoriety), although we are mindful of the fact that this is an imperfect distinction and that our measures of

[1] See Goldman et al. (2009), Lee et al. (2013), and Fisman et al. (2006) for the literature on politically connected firms in the US.

[2] One substantial strand of related research shows that well-connected directors and, in particular, those connected with reputable financial institutions, help firms raise external funds to undertake large investment projects in an underdeveloped financial system (De Long, 1991; Ramirez, 1995). However, the economic benefits of bank–firm relationship seem to depend on institutional context (see Fohlin, 1998; Rajan and Zingales, 1998; Cull et al., 2011).

[3] We use the term "British" throughout the paper; however, our sample consists of English and Welsh banks only.

[4] Nobles were members of the House of Lords, which was theoretically co-equal with the House of Commons. Its concurrence was required on all legislation prior to 1911 and, in fact, several governments during 1875–1900 were headed by prime ministers serving in the House of Lords. There is reason to believe that the power of the House of Lords to influence legislation decreased during the 19th century. A turning point in this decline occurred when King William IV was advised to create enough new peers to pass the Reform Act of 1832 over the objection of the majority of the sitting members of the House of Lords. Under this threat, the House of Lords allowed the law to pass (Parliament of the United Kingdom, 2006).