Why do firms appoint politicians on corporate boards? Evidence from a parliamentary regulation change in the United Kingdom

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Abstract

The active involvement of politicians in the corporate arena is highly contentious. Jurisdictions differ markedly in the restrictions they place on current and prior elected representatives. This reflects a tension between the potential for 'capture' and allowing individuals with business skills and experience to be involved in political decision-making. We examine the effect on firm value of a change in parliamentary regulation in the U.K. that allowed members of parliament (MPs) with corporate board membership to participate in parliamentary debates on issues related to their corporate interests. Using this as a source of exogenous variation in the political value of these MPs, we find that firms with MPs on the board experienced positive abnormal returns around the event. Firms with ex-MPs and other politically connected directors had no change in firm value in the same time-window. Our results suggest that lobbying type concerns, rather than the value of political skills and experience, drive the desire for corporations to hire politicians on boards. Finally, we examine environmental pollution to demonstrate that politically connected firms may generate poorer social outcomes.

***Keywords*:** Political Connections, Board of Directors, Firm value

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1. Introduction

The interaction of the corporate sector and political representatives is controversial. There is a range of concerns regarding the 'co-option' of politicians and large firms, and the potential for elected representatives to not work in the best interests of their electorate. In many jurisdictions, this has led to restrictions aimed at reducing potential conflicts of interest.

The arguments for allowing politicians to hold corporate roles relate to attracting, or at least not excluding, highly productive individuals with business and leadership experience. Including people with relevant skills in corporate decision-making is socially efficient. However, at the same time, this can lower the barrier to corruption and cronyism. Political connections can lead to preferential treatment by government owned enterprise, preferential access to government contracts, and lighter regulatory oversight for the connected firms (Shleifer and Vishny, 1994; Dinç, 2005; Khwaja and Mian, 2005). Therein lies the potential source of endogeneity in econometric analysis of the value of political connections to the corporate sector: are politicians appointed on corporate boards for their expertise or for their influence in regulatory affairs?

Against this backdrop, this paper has two main aims. First, we use an exogenous change in the value of the politicians as corporate directors to estimate the financial benefits to politically connected boards. Second, we seek to disentangle whether these returns, if any, reflect factors such as lobbying and capture of the political decision-making function or the value of politician's knowledge and experience. To that end, we use an exogenous change in parliamentary regulations in the United Kingdom. United Kingdom is an interesting setting for estimating the value of political connections. Whilst it has strong legal protection and low corruption, 46% of the top 50 firms have connections with a minister or an MP, and connected firms form 39% of the market capitalization (Faccio, 2006). In comparison, the respective figures for US are 6% and 4%. In fact, UK has the highest proportion of large firms that are politically connected, and only Russia and Thailand have higher fraction of market capitalization of connected firms.

In the United Kingdom, while sitting Members of Parliament (MPs) are legally entitled to hold outside jobs, there have been a range of specific restrictions related to the parliamentary activities of MPs in the House of Commons who held directorships on corporate boards. For instance, on November 6, 1995, the UK parliament passed a resolution that MPs may, not themselves, or urge other members to, advocate or initiate any matter on behalf of an outside body or individual with whom the MP has a financial relation. This regulation did not prevent a member from being appointed as a director on corporate boards, but it prohibited paid advocacy. Amongst other things, this *de-facto* restricted MPs who were on corporate boards from sitting on parliamentary committees that were concerned with areas of public policy that could reasonably be related to the activities of the corporation for whom they acted on behalf of.

Specifically, we use a change in regulation whereby with effect from 14th of May 2002, members of parliaments with outside interests can initiate parliamentary proceedings on issues that are related to their registered outside interests to estimate the value of political connections.[1] The amendment presents a setting akin to a natural experiment whereby existing MP-directors were in a better position to benefit the firm. If the market values political connections, then the subset of firms with MP-directors will have positive abnormal returns around the announcement of this amendment whilst the subset of firms with no MP-directors shall see no, or even a negative change. The difference (abnormal returns) in difference (between the firms with MP-directors, and those without) around the announcement date provides an estimate of the effect of political connections on firm value. We further investigate the subsequent appointment of members of parliament to corporate boards and the appointment and attendance of the MPs with corporate directorships on parliamentary committees.

[1] Initiating parliamentary proceedings include presenting a bill, presenting a petition, tabling and asking parliamentary questions, seeking to initiate an adjournment (or other) debates, tabling or moving any motion and amendment to a bill, proposing a draft report, or moving an amendement to a draft report, in a select committee, etc.

Our main result is that firms with Members of Parliaments as directors experienced 5% positive abnormal returns in the 3 day [-1, +1] and 7 day [-3, +3] time windows around 14^{th} of May 2002.[2] We account for the fact that firms in some industries are disproportionately likely to benefit from political connections, and our results are robust to the addition of industry controls. This result is consistent with the argument that firms benefit from appointing politicians on corporate boards who are directly involved with political decision-making.

While the relationship between political connections and firm valuation is interesting, it does not provide any information per se, on whether this is socially beneficial. Most notably, these returns could reflect returns to influence or the additional expertise brought to the board by individuals who are also valuable in political decision making. Hence, the second main thrust of our paper is to provide evidence aimed at distinguishing between these two channels.

To do that, we examine the price reaction firms with other forms of politically connected boards that should not be affected directly by the amendment show no price-reaction.[3] This subset of firms have ex-MPs, Members of European Parliament (MEP) and members of the House of Lords on their board. These firms show no price-reaction to the announcement of the amendment in parliamentary regulations. The value-effect seems to be localized for firms with an MP on the board at the time of the regulation change.

Finally, we examine the likelihood of new corporate directorships of MPs ex-post the regulation. On average MPs were more likely to be appointed on corporate boards for the first time following the regulation change. Among the MPs who had their first corporate appointments following the regulation change, members of parliamentary committees related to environmental affairs, and science and technology had a higher likelihood of being appointed on corporate boards. The effect on firm value in response to the regulatory change supports the view that politically connected firms benefit from the influence of the politician-directors in regulatory affairs.

[2] It can be argued that such regulations are not entirely exogenous and there are some expectations leading to the day of the event. If that is the case, then the regulation change will be priced in the securities of the affected firms and will lead to a conservative bias in our estimates.

There is a growing body of literature examining the corporate wealth effects of political connections. Using unexpected deaths of politicians, Faccio and Parsley (2009) document a fall in value for firms headquartered in the politicians' hometown. Fisman, 2001 find that Indonesian firms connected to the Suharto family decreased in firm value following bad news about the health of President Suharto.

Whilst these results indicate the value-effect of politically connected firms, it may be difficult to generalize because they are usually based on small samples or depend on an isolated event, often related to one politician. Moreover, these papers does not distinguish between the channels through which this value-effect might operate. In contrast, our setting is advantageous to examine the value effects for connected and unconnected firms at the time of an exogenous regulation change, and provide evidence on the channel through which political connections can affect firm value.

The rest of the paper unfolds as follows: sections 2 and 3 provides brief summaries of related literature and the data, section 4 discusses the preliminary results, and section 5 concludes.

2. Background

The political connections of firms may take a range of forms, from passive connections such as those based on the voting districts of politicians to more active connections from campaign donations, lobbying, and appointment of politicians on corporate boards or as advisers to firms. Firms may benefit from such connections in various ways. Such benefits the form of preferential access to credit (Khwaja and Mian, 2005), increased likelihood of receiving government contracts and lower probability of being detected for fraud (Goldman, Rocholl and So, 2009; Yu and Yu, 2011; Duchin, and Sosyura, 2012), and better access to government bailouts (Faccio, Masulis and McConnell, 2006).

These studies focus on two forms of political connections: political donations by firms, and explicit connection of firms to a politician. Roberts (1990) find decline in value of firms following the death of Senator Henry Jackson that contributed to his presidential campaigns. Similar positive (negative)

[3] These includes having ex-members of parliament, MEPs, and members of House of Lords on the board.

value effects are reported for firms connected to Democratic (Republican) candidates following Senator James Jeffords' decision to leave the Republican party (Jayachandran, 2006). A Republican win in the US presidential elections of 2000 led to an increase in the value of firms connected to the Republican party through political donations (Goldman, Rocholl and So, 2009). The value of political donations are particularly strong for firms based in the same state of the serving politicians (Cooper, Gulen and Ovtchinnikov, 2010).

Direct connections to politicians are arguably more durable than one-off contributions to political campaigns (Faccio, 2006). For a cross-section of firms drawn from 47 countries, she shows that direct political connections through corporate directors or large shareholders is valuable, particularly in institutional settings with poor legal protection and high corruption. Using sudden death of legislators as exogenous shock to political connections, Faccio and Parsley (2009) show a decline in the value of the politically connected firms following the unexpected deaths.

The theoretical underpinning of the relationship of political connection and firm value is that firms benefit from reducing the uncertainties in their information and operating environment, of which the government is a major source. One way for a firm to reduce these uncertainties is to appoint a politician on the board of directors. From a resource dependence perspective, the board of directors are the conduits of information and linkages to the firm's external environment. Therefore, political appointments on the corporate boards are likely to be of benefit to the firm in mitigating uncertainties. These benefits can stem from the advice and counsel of the politicians on regulations and compliance, or from the influence and preferential treatment for the connected firms. The social welfare implications will be opposite, depending on whether the former or the later channel dominates.

There are few challenges to causal interpretation of the value effect of political connection. First, politicians are likely to be more inclined to accept directorships of better performing and/or large firms. In a similar vein, while politicians who are better placed to influence public policy are more likely to be appointed as directors the opportunity cost of their time is higher and hence may be less likely to accept outside jobs (Besley, 2004). Therefore, it is econometrically challenging to identify the mechanisms through which political connections can affect firm outcomes.

Our approach to disentangling these effects is to examine an exogenous change in the British parliamentary regulations. The amendment of 14th May 2002 removed the prohibition on MPs with outside business interests to participate in parliamentary affairs that are directly related to their business interests. This change in regulation enhanced the influence of the MPs in regulatory affairs whilst not changing his expertise in the short run. If the change in parliamentary regulation increased the influence of the MPs, in the post-regulation period, we will expect to see previously unaffiliated MPs to be more likely to find corporate affiliation compared to other politicians. This part of the research will map the composition of parliamentary committees to that of members' *ex-post* appointment as directors on corporate boards.

3. Data

The sample used for this study is the set of firms featured in the FTSE 350 listings as of 2002. BoardEx coverage of the sample firms are more comprehensive post-2002, hence we restrict our sample accordingly.[4] For these firms, we collected information on board composition from *BoardEx*. Information on experience and backgrounds of directors are also obtained from BoardEx, which is updated annually to reflect the changes at both firm and director levels. Financial information is obtained from DataStream. We use stock price information for the period 10/05/2002-18/05/2002.
We exclude from our sample observations where firms do not feature in the FTSE 350 for at least two years after our event of interest, and do not have the full set of board characteristics, and financial data available. This constraint restricts our sample to 338 firms.

To identify a politician on the board of FTSE 350 firms, we undertake a series of matching exercises. BoardEx reports the main occupation for every non-executive director. For a politician or an MP, a typical entry in that field is… We encode our indicator for a MP-director using the following keywords. Similarly, we encode directors with other form of political expertise using the following keywords.

Next, we use the listings of outside interests listed on XX in the UK parliament's website to enhance the quality of the classification. Finally, we use publicly available news to augment the information on politically connected directors. In the final sample, we have 390 politically connected directors, 203 of whom are current MPs, 73 are members of house of lords, 66 are ex-MPs, and 48 are MEPs. 53% of our sample firms have at least one politician on the board, with the median firm having 1 MP on the board. We present this in figure 1.

The summary statistics is tabulated in Table 1. We begin our analysis with univariate comparisons of firms with and without an MP on their board in the year 2002. Firms with MPs as directors are on average larger and have more profitable. Politically connected firms also seem to have marginally higher proportion of independent directors. These differences indicate possible endogeneity in firm performance and political connections. We discuss in details below our approach to circumvent this endogeneity problem.

4. Methodology

Our initial starting point is to estimate the value-effect of corporate political connections by making use of a regulatory change. To do that, we run an event study around the announcement of the regulation change. At the time of the announcement, a subset of our sample firms had an MP on the board of directors. If the value of political connection is through the expertise of the MP-directors, it will be priced in and there will be no effect in the cumulative abnormal return (CAR). However, if influence drives the value of political connection, the announcement should be associated with a positive CAR. The abnormal returns are calculated based on a market model using the equal-weighted market portfolio. We use daily data from days -280 to -61 prior to the event to estimate the parameters of the market model. We calculate the returns over 3-day, 7-day and 10-day windows, with 14th May 2002 as day zero:

$$\mathbf{R_{i;t} = E\left[R_{i;t} \middle| X_t\right] + \xi_{i,t}} \qquad (1)$$

[4] For example, discuss the issue of director profile backfilling here.

where we decompose stock-returns $\mathbf{R_{i;t}}$ around the announcement of the regulatory change allowing MPs with board memberships to participate in parliamentary discussions around issues closely aligned to their corporate interests. $\mathbf{X_t}$ is the conditioning vector of firm characteristics at time t and $\boldsymbol{\xi_{i,t}}$ is the abnormal returns within the event windows. In that sense, this represents a quasi-natural experiment where we compare the effect of an exogenous change in regulation on stock returns of affected firms to other unaffected firms.

To further disentangle the influence and expertise motives of political connection, we examine the announcement effects for firms with directors on their board with other forms of political connections (ex-MPs, member of House of Lords, local councilors, etc.) The parliamentary regulatory change does not affect the influence-value of these directors. Therefore, if the value of political connection is driven by the influence motive, we should not see any statistically significant effect on CAR.

Finally, in our cross sectional regressions we examine the likelihood of MPs being appointed as corporate directors after the regulation change, with particular focus on the MPs serving on the parliamentary committees.

5. Results

Table 3 presents our initial estimates of the value of political connections by calculating abnormal returns around the event days using the market model[5]. All specifications control for firm size, profitability, board characteristics, and industry classification. Consistent with the univariate results presented in table 1, politically connected firms on average have better returns than non-connected firms in the month prior to the event (column 1). Around the event date, we see a further increase in value to the tune of 5% for the firms with an MP on the board at the time of the regulation change. To quantify, this translates to 90.845 points of the FTSE 350 index as of 2002 (mean of 3789.21 and a standard deviation of 49.21). In terms of firm value, this represents a gain of £M1.3 million for the average firm.

[5] We also test the robustness of our results using the Fama and French (1993) model.

[Table 3 around here]

There may be a concern that political connections are more important for firms in certain industries. Therefore, we control for the industry classification of the firms and find a larger effect of about a 10% increase in value in the 3-day and 7-day windows.

[Table 2 around here]

To investigate the expertise and influence hypotheses as discussed in the previous sections, we re-estimate our main models where we replace our right-hand side variable of interest with indicators for directors with other forms of political connections, such as Members of the European Parliament (MEP), ex-MPs and members of the House of Lords on the board. The intuition here is that if our main results reflect a general rising return to political expertise these should be apparent for this group of ex and current politicians. These models, reported as Table 4, demonstrate that the change in legislation led to no change in financial returns for these firms. Insofar as these individuals cannot sit on the parliamentary committees that form the focus of the change in legislation this suggests our prior results reflect change in firm value due to the ability of either sitting MPs to influence or gain information from sitting on parliamentary committees.

[Table 4 around here]

Finally, we examine the likelihood of MPs being appointed as a director on a corporate board ex-post the regulation change. We find that MPs who had a corporate affiliation prior to the regulation change are not more likely to be appointed as director in another firm within the next 2-years. However, the likelihood of MPs who did not have a corporate affiliation prior to the event are more likely to be appointed as a director after the event. The likelihood is strongest for the MPs who serve on parliamentary committees. The results are presented in table 5.

[Table 5 near here]

6. Robustness

First to examine that we are not capturing an idiosyncratic trend in stock prices, we simulate the experiment for the 'treated' and the 'control' group for 100 randomly defined dates in the 24-months prior to the event and calculate the CAR for 3-day, 5-day and 10-day windows. We find no statistically significant value-effects in any of these time windows for the politically connected firms. Next, we examine if the value of the effects vary by the party affiliation of the MPs. Specifically, we examine if the MPs of the ruling party drive our results compared to MPs in the opposition. We find no statistically significant results in favour of party-wise variation in the value of political connections.

7. Conclusion

The ethics of politicians on corporate boards is currently a matter of public debate. On the one hand, politicians as directors can bring in valuable human capital and bridge the information gap between firm management and regulatory authorities. On the other hand, firms can benefit from the social network in lobbying for government contracts, and support in weaker economic conditions, etc. However, it is difficult to disentangle the human capital effect from the social network effect due to endogenous selection in corporate board formation.

In this paper, we make use of a change in parliamentary regulations as an exogenous variation in the value of politician directors to examine how firms benefit from these connections. Whereas the human capital of individual politicians would not have changed over the small window of change in regulation, the value of the MPs political capital increased through their ability to participate in parliamentary proceedings. We find that firms with existing MP Directors experienced positive abnormal returns around the regulatory change. We also examine the effect of political connection on environmental performance. In further work, we will investigate the subsequent appointment of MPs to corporate boards and parliamentary committees to investigate the channels of benefits from having politicians on corporate boards.

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Figure 1: Distribution of different categories of directors in FTSE 350 firms in 2002.

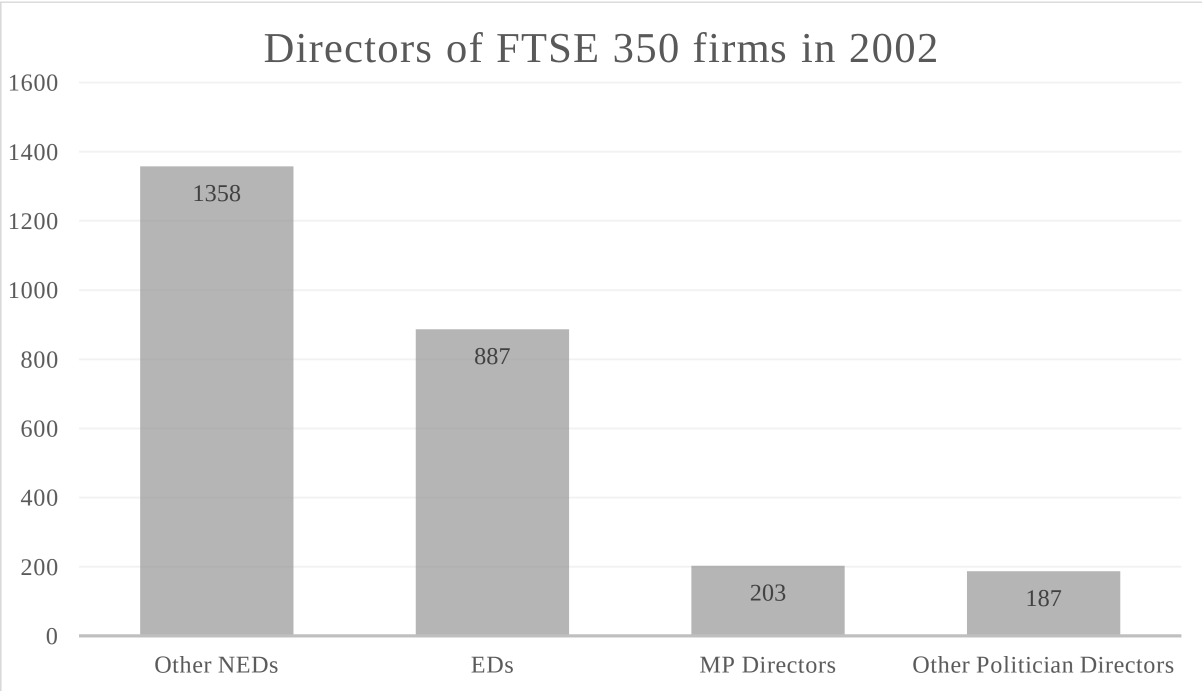

Table 1

The Value of MPs as directors: Price Reaction to 14th May 2002

In this table, we present the results for the market reaction to the change in regulation on Members of Parliaments outside interest. Column (1) presents the price trend for previous 28-trading days. Firms with MPs on the board have higher market value, and experiences an increase in market returns around the announcement date. All specifications control for firm size, profitability, board characteristics, and industry classification. t statistics in parentheses. * p<0.1, ** p<0.05, *** p<0.01

	(1)	(2)	(3)	(4)	(5)	(6)
	(-30, -2) CAR	(-1, +1) CAR	(-2, +2) CAR	(0,0) CAR	(-1, +1) CAR	(-3, +3) CAR
MPs on Board	0.255***	0.0563***	0.0464***	0.00542***	0.0119***	0.0555***
	(33.29)	(22.96)	(14.92)	(3.96)	(8.07)	(14.77)
Constant	-0.268***	0.0527***	0.0396	0.00552***	0.0882	0.0473
	(-3338881)	(2122734)	(.)	(541485)	(.)	(.)
R^2	0.0125	0.00296	0.00414	0.000706	0.00298	0.00261
N	234	234	234	234	234	234

Table 2

The Value of Politician Directors: Controlling for Industry

In this table, we present the results for the market reaction to the change in regulation on Members of Parliaments outside interest, controlling for industry classification of the firms. Column (1) presents the price trend for previous 28-trading days. Firms with MPs on the board have higher market value, and experiences an increase in market returns around the announcement date. All specifications control for firm size, profitability, board characteristics, and industry classification. t statistics in parentheses. * p<0.1, ** p<0.05, *** p<0.01

	(1) (-30, -2) CAR	(2) (-1, +1) CAR	(3) (-2, +2) CAR	(4) (0,0) CAR	(5) (-1, +1) CAR	(6) (-3, +3) CAR
MPs on Board	0.205**	0.0905***	0.104***	0.0106	0.0471	0.134***
	(2.88)	(3.24)	(2.89)	(1.65)	(1.17)	(2.69)
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes
Constant-	-0.269***	0.0822***	0.0861	0.0166	0.0479	0.102*
	(-3.76)	(2.80)	(2.15)	(1.35)	(1.19)	(1.80)
R^2	0.112	0.184	0.111	0.134	0.0633	0.0840
N	234	234	234	234	234	234

Table 3

The Price Effect for Firms with other political connections

In this table, we present the results for the market reaction to the change in regulation on Members of Parliaments outside interest. Column (1) presents the price trend for previous 28-trading days. Firms with other politicians on the board, i.e. ex-MPs, MEPs, local councillors, etc. have higher market value, and experiences no increase in market returns around the announcement date. All specifications control for firm size, profitability, board characteristics, and industry classification. t statistics in parentheses. * p<0.1, ** p<0.05, *** p<0.01

	(1) (-30, -2) CAR	(2) (-1, +1) CAR	(3) (-2, +2) CAR	(4) (0,0) CAR	(5) (-1, +1) CAR	(6) (-3, +3) CAR
Other Politicians on Board	0.207***	0.0903	0.0003	0.00967	0.0078	0.133
	(2.90)	(1.18)	(1.31)	(1.05)	(1.21)	(1.56)
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes
Constant-	-0.296***	0.0824***	0.0638	0.0193	0.0390	0.783
	(-3.75)	(2.57)	(1.37)	(1.15)	(1.02)	(1.24)
R^2	0.112	0.161	0.0990	0.160	0.0870	0.0934
N	234	234	234	234	234	234

Table 4

Political Connections and Environmental Performance

In this table, we present the results for the environmental performance of firms with MPs on the board. Column (1) presents the probability of disclosure a column (2) presents the actual GHG emissions. Firms with MPs on board are less likely to disclose quantitative GHG data, but when they do disclose they have lower GHG emissions. All specifications control for firm size, profitability, board characteristics, and industry classification. t statistics in parentheses, standard errors are clustered at firm level. * p<0.1, ** p<0.05, *** p<0.01

	(1) Pr(Disclosure)	(2) GHG Emissions
MPs on Board	-0.3197***	-0.082**
	(-2.49)	(2.01)
Constant	0.189***	0.017***
	(2.71)	(3.09)
R^2	0.188	0.161
N	3523	3523