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Bank lending incentives and firm investment decisions in China☆

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ABSTRACT

This study investigates whether and how banks' lending incentives influence firms' investment behaviors in China. First, empirical results show that loans granted to politically connected firms are less influenced by those firms' profitability and tangibility. Second, political connection is a violation factor in debt markets, and our study finds that firms with political ties invest less efficiently than firms without political ties when they can access abnormal debt. Finally, we find that regional development with regard to market development and government quality improvement reduces the negative impact of politically connected lending on firms' investment efficiency.

1. Introduction

Based on the data from the national bureau of statistics of China (NBS), fixed-asset investment accounts for nearly 50% of China's GDP growth. Nevertheless, many scholars and practitioners are becoming increasingly concerned with whether such investment-driven economic growth can be sustained going forward. A parallel question we would like to raise is how much of such investment

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is actually excessive and how much of such excessive investment could be reduced. By "excessive investment" we mean the investments that are of low efficiency; although they contribute to the GDP, they barely create value rather than generate excessive supplies here and there. In the corporate finance literature, the seminal work by Modigliani and Miller (1958) suggests that, in perfect capital and credit markets, the investment behavior of a firm is irrelevant to its financing decisions. However, in the presence of market imperfections, any financing frictions should reflect on firms' investment decisions. For example, information asymmetry between insiders and outsiders could affect firms' cost of capital and cause investment distortion. In addition to information asymmetry and agency problems, improper incentives or agency problems in the credit market (hereafter, soft lending[1]) are financing friction of consequence, which undermines their primary function of allocating scare capital efficiency. This is a particularly serious problem in emerging markets, like China, with a lack of efficient law enforcement and property rights protection. For instance, 461 cases of bank fraud involving more than one million Yuan (US$125,000) each were uncovered in China in 2005 (Barth et al., 2009). Therefore, this study will identify a pronounced type of soft lending – lending based on political ties – in China and then investigates whether political-connection-based soft lending influences firms' behaviors with regard to investment decisions, the key determinant of firms' productivity.

Relationship-based transactions are popular in the business world in emerging markets, and one important example of such a relationship is political ties. For example, empirical evidence indicates that, in some countries, politically connected firms have preferential access to debt financing (e.g., Cull and Xu, 2005; Faccio, 2006). In addition, a large amount of literature documents that politically connected firms outperform companies without relationships when institutional constraints are weak (e.g., Dinc, 2005; Fisman, 2001; Johnson and Mitton, 2003). However, prior research keeps silent about the related cost of political connection to firms and to the whole economy. Our paper will shed light on this issue by addressing two fundamental questions: do politically connected firms have better access to bank loans? And what is the economic consequence of such political-connection-based lending? Many companies in China are led by politically connected CEOs who have served as bureaucrats in central or in local government (Fan et al., 2007a,b). Almost 27% of listed companies are led by politically connected CEOs[2] in China, which provide a semi-experimental setting to investigate this interesting issue. We argue that politically based lending could cause misallocation of resources by banks and reduce investment efficiency in China. China has a big, fast-growing economy but a weak legal institution and a less-developed financial market. The "Big Four" banks dominate Chinese banking system,[3] which are ultimately controlled by central or local government, and consequently, the government has huge influences on banks' operations, including lending decisions. Thus, it is easier for government officers to help politically connected firms to receive bank loans regardless of the firms' performance and creditworthiness.[4] Prior research indicates that political connection is a rent-seeking tool to extract private benefits. In the context of China, managers could use their political connection to get bank loans as much as they can. However, after political connection brings more funds to firms, firms will invest more whether they have promising investment opportunities or not. For example, managers can pursue "empire-building" and expand firms fast, which increases the likelihood of promotion and compensation of CEOs. Furthermore, banks as major fund providers could play an important role in governing firms in corporate governance literature (Shleifer and Vishny, 1997). However, politically connected lending is accompanied by less monitoring posted by banks, which can reduce managers' incentives to invest efficiently but provide convenience for managers to pursue personal benefits.

In our study, we use a sample of 8148 Chinese firm-year observations over the period from 1999 to 2009 to investigate the issue. Our study finds that loans granted to politically connected firms are

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[1] Soft lending is defined as the making of lending decisions based on non-market terms to privileged clients; for example, political connection and regulation.

[2] In our paper, we refer to both "chairman" and "general manager" as the CEO of a firm.

[3] Berger et al. (2009) analyze the efficiency of Chinese banks from 1994 to 2003, and their findings suggest that the Big Four banks are by far the least efficient, foreign banks are the most efficient, and minority foreign ownership is associated with significantly improved efficiency. Lin and Zhang (2009) also find that the Big Four state-owned commercial banks are less profitable, are less efficient, and have worse asset quality than other types of banks, except for the "policy" banks.

[4] Chaney et al. (2007) find that, for politically connected firms, lower quality reported earnings are not associated with higher cost of debt.