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Bank ownership and executive perquisites: New evidence from an emerging market

Wei Luo [a], Yi Zhang [a], Ning Zhu [b,*]

[a] Guanghua School of Management, Peking University, China
[b] Shanghai Advanced Institute of Finance (SAIF) and University of California, Davis, United States

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ABSTRACT

Direct bank ownership is a common practice in emerging markets. The current paper studies how bank ownership affects firm performance through corporate executive perquisites (perks) in China, a leading emerging economy. In addition to common factors known to influence the level of executive perks, we find a significantly positive link between bank ownership of company shares and executive perquisites. Further analyses suggest that higher level of executive perquisites hurt firm operating efficiency. Specifically, perks are positively associated with interest rate paid by the firms. We find some evidence consistent with the notion that the conflict of interests that banks face as both lenders and shareholders in the emerging markets induces banks to play less effective monitoring if they are concerned with the security of their loans or aim to obtain better arrangement for their loans. Our results reveal a particular mechanism through which bank ownership influences firm decisions and performance.

1. Introduction

Given banks' influences on several aspects of corporate operations, such as credit availability, cost of capital, and capital structure, corporate finance and banking literature has long found the relationship between banks and listed companies an interesting and important topic. In addition to their role of facilitating capital flows, banks also monitor their debtors, thereby providing valuable governance oversight to the entire economy. In many countries, banks extend their control and monitoring of debtors by directly owning company shares and appointing directors (Gorton and Schmid, 2000; Petersen and Rajan, 1994; Santos and Rumble, 2006). Despite the variations across the banking systems in different markets, extant studies on developed markets generally agree that bank ownership is beneficial to companies (Barth et al., 2006). Bank ownership clearly promotes companies' access to bank capital, which can be extremely valuable during market turmoil (Kang and Shivdasani, 1995). In addition, while some theories argue that bank ownership may lead to conflicts of interest (Diamond, 1984; Mahrt-Smith, 2006; Welch, 1997), most studies find support for the notion that banks can effectively monitor and discipline borrowers and improve firm performance, at least in developed markets (Bris et al., 2006; Kang et al., 2000; Kroszner and Strahan, 2001).

Due to the relatively scarce bank capital and loose governance in emerging markets, it seems plausible that banks can play an even more important role in such markets. At the same time, because of the drastic differences in the legal and cultural landscape between the emerging markets and the developed markets, it is naive to assume that banks voluntarily play as effective monitoring roles in emerging markets as they do in developed markets (Barth et al., 2006; Chen et al., 2009; Laeven, 2001). Prior research on emerging markets finds support for the theoretical argument (Diamond, 1984; Mahrt-Smith, 2006) that bank ownership can adversely affect company value due to banks' own conflicts of interest in emerging markets. For instance, the literature on Japanese banks during Japan's development from an emerging market to a developed economy suggests that cross-

* Corresponding author. Room 606, 211 West Huaihai Road, Shanghai, China, 200030. Tel.: +86 10 62932280.
E-mail addresses: luowei@gsm.pku.edu.cn (W. Luo), zhangyi@gsm.pku.edu.cn (Y. Zhang), nzhu@ucdavis.edu (N. Zhu).

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holdings, lack of transparency, and excessive credit liquidity, are all responsible for banks' negative impact on corporate value, especially during the bubble period of Japanese market (Weinstein and Yafeh, 1998). Morck and Nakamura (1999) show that banker directors emphasize policies that favor creditors over shareholders in a dataset on Japanese bank ties. Fok et al. (2004) on Taiwan, and Limpahayom and Polwitoon (2004) on Thailand respectively find negative impact of bank ownership on firm performance. By using data from China, Lin et al. (2009) suggest that bank ownership may lead to irresponsible investments and hurt company performance. However, it remains unclear through which channel bank ownership affects firm value in emerging markets. The current study provides some new evidence regarding the pros and cons of direct bank ownership of companies by investigating how it affects executive perquisites of listed companies in China, a leading emerging economy.

We focus on executive perquisites for the following reasons. First, the media such as CBS Marketwatch[1] and forbes.com[2] reports that there has been reportedly a trend of replacing direct executive compensation with non-cash perquisites in US. Such a trend is taking place despite that the stock market generally responds negative to the announcement or revelation of executive perquisites (e.g., Andrews et al., 2009; Grinstein et al., 2008; Yermack, 2006). Second, providing non-cash subsidies and perquisites has been one of traditional compensation treatment under Chinese corporate culture (Chen et al., 2010; Kato and Long, 2006). This comes from the early days when nominal salaries of most employees were very similar and the perquisites really stand the top managers out. Even till nowadays, such a tradition still persists as most top corporate managers enjoy corporate-sponsored apartment, automobile, and country club and elite club membership. Third, managerial excess view, originated from agency costs (Jensen and Meckling, 1976), suggests that consumption of perquisites hurts firm value (Hart, 2001). If banks indeed exercise their control over the companies that they hold stake, their effort on monitoring should influence the perks that executives receive.

Our exploration of the causes behind the under-performance of firms with bank ownership suggests that there exists a significantly positive link between bank ownership of company shares and executive perquisites. Companies with banks as major shareholders report about 10% higher level of executive perks compared to those without bank ownership, when we control for a host of other factors that are known to influence executive perks such as firm size, board size, board composition, management ownership, and so on. Further, we find that a higher level of executive perquisites is associated with a lower level of return on assets in firms with bank ownership, lending some support to that executive perks are 'excessive' and not tied to firm performance. In addition, compensation provision is not sensitive to performance at companies with bank ownership. The fact that companies with bank ownership witness much higher executive perks imply that banks may use less conspicuous perks to motivate executives to carry out actions benefiting banks themselves. Additional analyses suggest that firms with more perks pay higher interest rates for bank loans and incur greater financial expenses.

Such findings are consistent with our conjecture that the underperformance in companies with bank ownership results partly from the conflict of interests that banks face as both lenders and shareholders in the emerging markets. Given that banks' equity stakes are usually much smaller than the notional value of their loans to listed companies (Cull and Xu, 2000), banks may choose to influence corporate executives and play less effective monitoring if they are concerned with the security of their loans or aim to obtain better arrangement for their loans. Based on such considerations, banks are more likely to side with the executives and less likely to carry out their role in monitoring executive (Lin et al., 2009). As a matter of fact, we find that bank ownership becomes insignificant in influencing ROA, once we include executive perks in the regression specification.

Our findings suggest that, similar to the case of developed markets, banks do seem to exercise monitoring over their loans to affiliated companies partly through occupying board seats. However, in emerging markets, banks seem to exercise their monitoring role at the cost of higher executive perks, which in turn hurt the interest of other shareholders of the firm. As it seems, the direct ownership by banks, which often serves as an important monitoring tool in developed markets, can turn into a doubled-edged sword in emerging markets.

The current study makes several contributions to the literature. First and foremost, our paper contributes to the debate on the efficacy of bank ownership on firm performance. Our results suggest that having banks as shareholders may not benefit other shareholders if conflicting interests (e.g., bank profits) are neglected. We complement a growing literature relating commercial banks to firm performance and extend the analysis to specific corporate policies. Güner et al. (2008) and Kroszner and Strahan (2001) study conflicts of interest when commercial bankers sit on corporate boards. Kracaw and Zenner (1996) find a negative stock price reaction to bank loans if an affiliate of the lending bank sits on the board of the borrower. While these studies focus on banks in developed economy, our study provides some fresh insights into the bank ownership in emerging market where bank ownership are more common and banks are indeed more influential.

Unlike the research studying the main bank system in Japan, our paper is more relevant to the literature on banking systems in emerging markets. First, most of the studies on Japan focus on the period when Japan has already become a developed market. In contrast, China remains as one of the leading emerging economy during our period of study. Secondly, the Keiretsu and the Main Bank system and the cross-holdings between banks and companies in Japan are quite unique in the world. Instead, the practice of bank ownership in China, which often does not result in full control but representation on corporate board, is a good representative of many other emerging markets. Finally, our findings on the link between bank ownership and high executive perks are new to the existing literature and have not been documented in previous studies on Japan.

Second, our findings provide a specific mechanism through which banks influence corporate decisions, through their status as a leading shareholder. We show that, banks are more likely to be 'lenient' monitors that grant greater executive perks to corporate management. Our findings that executive perks can be used as a way by bank shareholders to benefit themselves at the cost of

[1] http://www.marketwatch.com/story/aigs-liddy-gets-1-salary-but-much-more-in-perks?tool=1&dist=bigcharts&symb=AIG&sid=511.
[2] http://www.forbes.com/feeds/ap/2009/05/01/ap6365444.html (Vinnee Tong, associated press).