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Does banks' dual holding affect bank lending and firms' investment decisions? Evidence from China

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ABSTRACT

This study investigates the effect of banks' dual holding on bank lending and firms' investment decisions using a sample of listed firms in China. We find that dual holding leads to easier access to bank loans, a result that is more pronounced for non-state-owned enterprises (non-SOEs) than SOEs. We also find that dual holding distorts banks' lending decisions and harms the investment efficiency for SOEs, while resulting in optimal lending decisions and enhanced investment efficiency for non-SOEs. For non-SOEs, further analysis suggests that optimal lending decisions and efficient investment can be achieved for firms with higher ownership concentration, and firms in which the family and foreign investors are the controlling shareholders. We argue that, in emerging markets, whether a bank plays a monitoring role by directly holding the debt and equity claims of companies relies heavily on whether the potential collusion between firm executives and bank managers can be averted, which in turn is determined by the firms' governance framework and ownership structure.

1. Introduction

A large body of literature argues that banks are able to provide more efficient debt-related external monitoring for the corporate governance of firms because they have a comparative cost advantage in accessing superior inside information (Fama, 1985; Datta et al., 1999). But what happens if banks as creditors also hold equity in the same firm (dual holding)?

Recent investigations have focused on this phenomenon and its financial implications for the corporate governance system, albeit with mixed results. Some studies from developed markets agree that dual holding can help to internalise the conflicts of interest between shareholders and creditors and to obtain proprietary information about the firm due to dual holders' involvement on both the debt and equity sides. Thus, these studies find that dual holding can benefit firms by promoting their access to bank capital and improving their performance (Kang et al., 2000; Mahrt-Smith, 2006; Jiang et al., 2010). Meanwhile, another strand of studies focuses on the harmful effects of dual holding, arguing that it leads to potentially more serious conflicts of interest (Diamond, 1984; Welch, 1997). Empirical evidence suggests that, although dual holdings allow firms in emerging markets to have better access to debt financing, banks do not monitor these firms quite so extensively, which may result in poorer firm performance (Lin et al., 2009; Luo et al., 2011).

The literature also documents that in emerging markets, where the banks are the main providers of capital and bank credit is scarce and highly regulated by the government (Cull and Xu, 2000), bank lending may increase the probability that borrowers will collude with bank managers. This in turn encourages borrowers to seek rents through bribing bank managers. However, the existing empirical results concerning the effect of corruption are mixed. Cai et al. (2011) find that bribing officials reduces firm performance, while Chen et al. (2013) argue that corruption can improve banks' lending decisions and aid private firms in China. These studies provide no evidence for whether corruption prevents dual holders from playing a monitoring role, and thus from contributing to improved firm performance.

In addition to the ambiguous findings from studies of the financial and economic implications of dual holding, there is no comprehensive analysis showing the mechanism through which dual holding works, especially in emerging markets. In this paper we attempt to address the interesting and unresolved question of

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the role that banks' dual holding has played, what are its related costs and benefits, and how it influences firm performance, given that corruption in the banking industry is prevalent in emerging markets.

To achieve a better understanding of the role of banks' dual holding in corporate performance in emerging markets, we first examine the effect of dual holding on firms' access to bank loans, and then explore the channel(s) through which dual holding affects firm performance by investigating its effect on banks' lending decisions and firms' investment efficiency. The existing literature finds that optimal bank lending reinforces firms' investment efficiency, while politically based soft lending may bias firms' behaviour with regard to investment decisions (Lang et al., 1996; Chen et al., 2011). Firms' investment decisions thus significantly influence firm performance, because firm performance responds positively to better investment, and gains from investments enhance firm profitability (Fama and French, 1998; Chen et al., 2009). Since dual holding facilitates the flow of capital and promotes companies' access to bank capital (Kang and Shivdasani, 1995; Lin et al., 2009), we expect dual holding will affect firm performance through its influence on banks' lending decisions and firms' investment policy.

In developed countries, permitting banks to hold equity in non-financial companies can mitigate the conflicts of interest between shareholders and creditors that create incentives to deviate from optimal investment[1] (Kang et al., 2000; Kroszner and Strahan, 2001). Nevertheless, in emerging markets, where there is often strong government intervention and prevalent corruption in the banking sector, existing evidence suggests that banks are reluctant to be effective monitors (Barth et al., 2006), and state-owned banks are obliged to lend largely to SOEs to maintain normal economic growth and achieve social goals (Cull and Xu, 2005; Allen et al., 2005). On the other hand, banks' dual holding may also lead to potential collusion between banks' and borrowers' managers, who often pursue empire-building and other private benefits. This collusion leads to connection-based soft lending decisions, which results in inefficient investment by borrowers and further destroys firm value. Therefore, it is the net effect of banks' dual holding, between the benefits of accessing bank loans and the costs of collusion, that will determine banks' lending and firms' investment decisions.

While banks' dual holding of non-financial companies is not unique to China, the Chinese corporate and financial environment is particularly interesting for this research because China is the largest transition economy, and is characterised as having an absence of mature public bond markets. Indeed, corporate external finance relies mostly on bank borrowing, so banks play a very important role in determining the availability of credit. In addition, the Chinese financial system is dominated by the government through direct and indirect state ownership and control of most banks, while these banks' lending decisions often reflect government-dictated policies (Firth et al., 2009; Chen et al., 2013). In other words, state-owned banks dominate the Chinese financial system, and tend to allocate and price loans according to government preferences.

Second, the co-existence of state-owned enterprises (SOEs) and non-SOEs in China provides another unique institutional environment in which to examine the effects of dual holding on banks' lending decisions and borrowers' investment efficiencies and, in turn, on the performance of firms with different ownership. From the banks' perspective, because state-owned banks wish to achieve multiple objectives, including their political and economic goals, they tend to lend largely to SOEs and bail out poorly performing SOEs; thus they can largely ignore SOEs' non-performing loans, a typical soft lending decision (Cull and Xu, 2003; Firth et al., 2008). Moreover, SOEs have a multilayered principal-agent framework and inadequate ultimate property-rights protection, which may further increase the chance of collusion between managers of borrowers and banks when banks have dual holdings in SOEs, due to lack of sufficient monitoring by the state controlling shareholder. In contrast, banks are required to extend their discipline and monitoring to the non-SOEs they lend to (Santos and Rumble, 2006), and are eager to maximise their proceeds by advocating effective monitoring on firms' investments. From the borrowers' perspective, non-SOEs are similar to their counterparts in developed markets in that they have a simpler objective of value maximisation (Chen et al., 2011), and thus the potential collusion between managers of firms and banks can be averted by the controlling shareholders. Therefore, the homogeneity of state ownership in both banks and SOEs and the heterogeneity of ownership structure between SOEs and non-SOEs make China an excellent context in which to examine the effect of banks' dual holding on their lending decisions and firms' investment policy across SOEs and non-SOEs.

Furthermore, the unique Chinese institutional setting for banks' dual holding also allows us to further reduce concerns about an endogeneity issue. Although the Commercial Bank Law implemented in 1995 did not force banks to relinquish their existing ownership in listed non-financial firms, banks have not been allowed to invest any new equity in non-financial firms since then. Therefore, banks' dual holding during our sample period (2003–2010) was largely exogenously determined and less likely to be affected by firm characteristics and corporate governance variables. This is perhaps the most significant advantage of using Chinese data: it allows us to infer the nature of banks' dual holding when its formation predates, by several years, the lending decisions and firm investment policies we wish to analyse. We argue that such a lag between the formation of banks' dual holding, their lending decisions and firms' investment policies removes concerns about reverse causality. Nevertheless, we will also apply alternative approaches to dealing with the potential endogeneity issue, including event-study methodology, natural experiment, and two-stage least square and fixed-effect regressions.

From the empirical analysis we find that the change in the ratio of bank loan to total assets is higher when a borrower's lender (a bank) is among the borrower's top ten largest shareholders (dual holding). This effect is more pronounced in non-SOEs than SOEs. We also find that dual holding reinforces the exercise of using commercial judgments in allocating capital to non-SOEs, which is consistent with previous studies (Firth et al., 2009; Chen et al., 2013), while dual holding is more likely to distort banks' lending decisions and lead to capital misallocation to SOEs. We further find that dual holding is likely to enhance investment efficiency only in non-SOEs, whereas dual holding in SOEs relates to a less efficient investment. Our results also suggest that for non-SOEs, shareholders with more highly concentrated ownership, or family and foreign controlling shareholders are more able to exert effective monitoring on the collusion between the managers of firms and banks, which leads to optimal lending decisions and more efficient investment than for other non-SOEs.

Our findings also confirm that dual holding is less likely to add value for SOEs, which is consistent with the evidence from other emerging markets (Fok et al., 2004; Lin et al., 2009), while dual holding is more likely to increase value for non-SOEs, which is similar to what occurs in developed markets. Our investigation complements the notion that dual holding can be a double-edged sword in emerging markets. We argue that whether a bank plays a monitoring role by directly holding the debt and equity claims of companies relies heavily on whether the potential collusion

[1] The asset-substitution problem (Jensen and Meckling, 1976), the underinvestment problem (Myers, 1977), and the overinvestment problem (Stulz, 1990) are well-known examples of such distortions of investment policy.