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Do strong corporate governance firms still require political connection, and vice versa?

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ABSTRACT

This study investigates whether a firm with strong corporate governance (CG) requires political connections (PCs), that is, we examine whether CG and PC substitute for or complement each other. Using 71,069 individual bank loan contracts from Taiwan, we examine how loan contracts are affected by CG, PC, or both. Our results show that firms with strong CG focus less on building PC. By contrast, politically connected firms are likely to demonstrate poor governance practices. In addition, favorable bank loan prices reduce when both PC and CG are simultaneously considered. All evidence supports the substitution effect.

1. Introduction

The effects of corporate governance (CG) and political connection (PC) on the activities of banks and firms have recently attracted considerable attention. Previous studies investigated separately these two concepts and their respective relationship to business activities. However, their joint influence has been rarely discussed although both concepts play the role of an insurer, as well as share significant commonalities in affecting bank loan contracts and firm value.[2] Considering that both CG and PC could yield favorable loan contracts, an interesting question arises whether a firm with strong CG still requires PC to obtain even better terms, that is, is CG or PC by itself sufficient for a firm as insurance against loan, or do CG and PC substitute or complement each other?

Previous studies reported that firms with positive CG are granted favorable loan contracts, such as lower interest rates or longer maturity, given the presence of financial ratios. For example, Bhojraj and Sengupta (2003) state that lower bond yields and higher credit ratings are associated with higher institutional ownership and a larger fraction of the board composed of non-officers.

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[2] Chaney et al. (2011) demonstrated that firms with PC usually reported lower quality of earning information and financial statements than others. Also, the influence of PC on firm values could be found in Fisman (2001), Faccio et al. (2006), and Goldman et al. (2009); that of CG could be found in Eisenberg, Sundgren, and Wells (1998) and La Porta, Lopez-de-Silanes, and Shleifer (1999).

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Anderson, Mansi, and Reeb (2004) concluded that the cost of debt is inversely related to board independence, and that fully independent audit committees are associated with a lower cost of debt financing. Bae and Goyal (2009) illustrated that banks charge lower spreads and offer longer maturities to firms in countries with better property rights. In addition, creditor rights influence the determination of loan spreads. Lin, Ma, Malatesta, and Xuan (2011) noted that the cost of borrowing is lower in firms with a narrower divergence between their control and cash flow rights.

Results are also typically positive on whether politically connected firms (PC firms) are charged favorable loan contracts. Sapienza (2004) determined that government-owned banks charge lower interest rates in regions where the bank-affiliated party obtained a higher voting rate. Khwaja and Mian (2005) also examined the political influence on preferential treatment using data from Pakistan. They demonstrate that politically connected firms could obtain twice the loan amounts of those of non-connected firms and have 50% higher default rates on their loans. Using campaign contribution data in the 1998 and 2002 elections from Brazil, Claessens, Feijen, and Laeven (2008) discover that contributing firms substantially increase their loan growth in comparison with non-contributing firms after each election.

The current study investigates whether a firm with strong CG still requires PC to obtain even better terms. They could be used as substitutes if firms with both strong CG and PC are charged with the same loan rates as those of firms with only one of the two attributes. Namely, firms with strong CG need not establish PC for loan purposes. The substitution view suggests that engaging in either activity is sufficient in obtaining favorable loans. As substitutes, the benefits offered by one activity are similar or reduced when the other is considered. Hence, well-governed firms do not gain better terms by building PCs, which, in some cases, could even produce a negative effect. By contrast, the two concepts may be complementary if banks charge lower rates to firms with both strong CG and PC than those with only one of the two attributes. In this situation, firms would benefit from pursuing both CG and PC. The complementary view suggests that one activity enhances the effect of the other if they are simultaneously considered. For example, well-governed firms with PCs could obtain better loan terms than those without such connections.

We require detailed individual loan contracts and information of CG and PC to investigate this issue. This high data requirement is one of the reasons for selecting Taiwanese firms as our sample. Taiwan provides unique and reliable loan transaction data because the Financial Supervisory Commission (official authority) requires all listed firms to provide worksheets on loan contracts with annual official financial reports. We collect these worksheets as basis for a comprehensive analysis on bank loan contracts from all listed companies and, therefore, avoid possible sample selection bias encountered in previous studies.[3] Whereas our study is Taiwan-specific, the result could provide a reference for other countries whose corporate finances similarly depend on the banking systems. We further obtained CG data from the Taiwan Economic Journal (TEJ), the economic data bank providing detailed corporate information on ownership and board structures in Taiwan. Following the methods suggested in the literature (Faccio, 2006; Faccio, Masulis, & McConnell, 2006; Fan, Wong, & Zhang, 2007), we collect data on PC from the information provided by corporate websites and news.

The contribution of this study is twofold. First, we add to the increasing literature on CG and PC given that earlier studies focus only on the individual concepts. Our approach is similar to the studies of Qi, Roth, and Wald (2010), Becher and Frye (2011), and Bliss and Gul (2012). However, our discussion focuses more on the interaction of CG and PC when banks provide benefits in making loans. PC and CG are costly, and thus, firms choose only one of the two. Alternatively, this study may relate to the perception of bankers on the "contributions" of CG or PC when processing loans. Second, our results have strong policy implications. Better CG is associated with lower costs of debt, but these benefits are similar to those of the politically connected firms, which explains why firms with strong CG do not require PCs. Therefore, in a country where CG is emphasized, the influence of PC on loan contracts may be insignificant. Accordingly, governments could minimize political influence by strengthening CG.

The remainder of this paper is organized as follows: Section 2 illustrates our hypothesis development; Section 3 discusses the measures of CG versus PC; Section 4 presents empirical models and data statistics; Section 5 provides empirical results and robustness checks; and Section 6 concludes the paper.

2. Hypothesis development

Though no study directly investigates how CG and PC are substitutes or complementary, most investigate the similar concepts between the micro-CG and the macro-regulations. Bruno and Claessens (2010) argue that companies with positive governance practices operating in stringent legal environments gain a valuation discount relative to similar companies operating in flexible legal environments. Thus, the study suggests that CG and regulations are substitutes. Qi et al. (2010) explore the substitution relationship between political rights (from Freedom House) and creditor rights in bond issuing prices. Using data from the initial public offerings of regulated firms, Becher and Frye (2011) suggest that regulation and governance are complementary. They discover that regulators pressure firms to adopt effective monitoring structures. The results vary in that firms in a country with strict regulations may have either strong or weak CG. However, the above studies do not discuss the link between CG and PC.

We first discuss the two concepts of CG and PC as possible substitutes. CG stresses that although laws and regulations attempt to minimize agency problems between shareholders and managers, between shareholders and bondholders, or between large and small shareholders, these regulations have limitations and ambiguity, which could be complemented by focusing on CG. A firm with strong CG does not expropriate and will care for the benefits of small shareholders. Using the bank loan market to illustrate this substitution effect, a firm with strong CG may obtain favorable loan contracts with their positive reputation, and needs no connections with the government. On the other hand, PC is also valuable for firms, as politicians tend to explicitly or implicitly favor their supporters

[3] In prior studies, most bank loan data came from specific banks or bank loan structures during specific periods.