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Political connections, corporate governance and preferential bank loans

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ABSTRACT

The presidential election in Taiwan during 2000 resulted in the first political changeover in more than fifty years from the ruling party, the Kuomintang (KMT), to the Democratic Progressive Party (DPP). In 2004, the KMT was expected to win, but eventually lost to the DPP. We use these two exogenous events to investigate three issues: how political connections are related to preferential bank loans, how the entrenched position of the ruling party affects the types of preferential bank loans and how corporate governance is related to preferential bank loans. We find that KMT-connected (DPP-connected) firms were associated with higher (lower) abnormal returns before the 2004 election. This pattern of returns was reversed after the unexpected result. Moreover, we find that political connections were positively correlated with preferential bank loans. However, the types of preferential bank loans differed between KMT-connected and DPP-connected firms due to differences in the entrenched power of the ruling party. Finally, we find that corporate governance is negatively correlated with preferential bank loans, probably because firms with good corporate governance have more alternative financial sources.

1. Introduction

Political connections, which are prevalent around the world, allow politically connected firms to benefit from various governmental interventions.[1] Preferential bank loans are characterized by lower

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[1] Such interventions take various forms, including favorable regulatory conditions (Agrawal and Knoeber, 2001), cut-rate credit and import licenses (Mobarak and Purbasari, 2006), capital controls (Johnson and Mitton, 2003), retarding financial development (Rajan and Zingales, 2003), financial bailout (Faccio et al., 2006) and preferential access to debt financing (Khwaja and Mian, 2005; Gomez and Jomo, 1997; Claessens et al., 2008).

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interest rates (Sapienza, 2004; Khwaja and Mian, 2005) and higher leverage ratios (Faccio, 2006; Johnson and Mitton, 2003; Khwaja and Mian, 2005). However, political connections are also associated with costs. For example, political intervention might weaken managerial practices and harm a firm's performance (Fan et al., 2007).[2] Previous studies covering cross-country comparisons indicate that political connections could be a substitute for ineffective external governance.[3]

Nevertheless, the issue of endogeneity might arise when relating political connections to policy outcomes.[4] We use the 2000 and 2004 presidential elections in Taiwan as external shocks to investigate how political connections and corporate governance are related to preferential bank loans. The reason for considering these two presidential elections as external shocks is that the Kuomintang (KMT) had been expected to win, but ultimately lost to the Democratic Progressive Party (DPP).[5]

First, we use the event study to investigate the market response to the 2004 presidential election.[6] The results indicate that KMT-connected (DPP-connected) firms were associated with higher (lower) abnormal returns before the election because the market had anticipated that the KMT would win the election. However, the result of the election surprised the market and led to a reversal in returns, such that the KMT-connected (DPP-connected) firms became associated with higher (lower) abnormal returns after the election. This result is parallel to the finding of Goldman et al. (2009), who note that firms connected to the Republican Party increased in value and firms connected to the Democratic Party decreased in value when a Republican won the 2000 presidential election. Moreover, we find that good-governance firms enjoyed higher abnormal returns after the 2000 and 2004 presidential election, which implies that such firms are able to reduce the negative impact associated with a surprising presidential election result.

We further focus on the relation between political connections and preferential bank loans from government-controlled banks. Referring to Degryse and Cayseele (2000), we use duration and collateral requirement to gauge the extent of preferential treatment. Long-term, non-collateral loans from government-controlled banks are deemed the most preferential treatment resulting from a firm's political connections. Until 2000, the KMT had politically controlled the island for more than fifty years and KMT-connected firms enjoyed the most preferential bank loans due to the KMT's entrenched control during this period. In contrast, DPP-connected firms from 2001 to 2006 are characterized as short and shallow, partially because the DPP was still in its infancy of gaining the ruling legitimacy and partially because its power in congress was evenly shared with the KMT during this period.[7] The difference in power entrenchment implies that KMT-connected firms received significantly more preferential treatment when

[2] The costs of politicians' intervention in business activities are more severe when institutional constraints are weak (Shleifer and Vishny, 1994; Hellman et al., 2003) or legal protections against expropriation by politicians are ineffective (Acemoglu et al., 2005). The net effect of political connections on firm value remains a puzzling issue. For example, Bunkanwanicha and Wiwattanakantang (2009) consider the relationship positive while Bertrand et al. (2007) consider it negative.

[3] For example, Boubakri et al. (2008) indicate that political connections seem to be more prevalent in countries with lower judicial independence. Hu and Leung (2008) find that political executives can serve as disciplinary or monitoring mechanisms for corporate control and the legal protection of investors in political economies that lack external markets. Leuz and Oberholzer-Gee (2006) argue that political connections and global financing are substitutes.

[4] For example, previous studies indicate that it is difficult to disentangle policy outcomes that are the result of politicians' ideologies (e.g. Chappell, 1982) or that are affected by politicians' attempts to forge cozy alliances with political contributors (e.g. Stratmann, 1995; Kroszner and Stratmann, 1998).

[5] The 2000 presidential election was a head-to-head competition among Chen, Lien and Soong, with several of the option polls one month before the election failing to indicate a promising winner. For example, an opinion poll conducted by the United Daily News in March 5, 2000 showed that 27% of the voters surveyed favored Lien, 22% favored Chen and 24% favored Soong. In contrast, another opinion poll conducted by the TVBS Poll Center on the same day indicated that 25% of the voters preferred Lien, 26% favored Chen and 26% favored Soong. These opinion polls suggested a strict tie among the three candidates. The 2004 election represents a competition between Chen and the reunion of Lien and Soong. The TVBS Poll Center revealed the results of an opinion poll conducted on January 5, 2004 that indicated that 48% of voters preferred Lien and 37% favored Chen. On the same day, another opinion poll conducted by Eracom Survey indicated that 39% of the voters preferred Lien and 29% favored Chen.

[6] The 2000 presidential election in Taiwan is subject to the concern of insufficient data because there were only 9 DPP-connected firms before the election.

[7] During the DPP ruling period, the KMT obtained 30.22%, 35.11% and 71.68% of congress membership in the 2001, 2004 and 2007 elections, respectively. The corresponding percentages for the DPP were 38.67%, 39.56% and 23.89%, respectively. Moreover, the KMT, the PFP and the New Party formed the Pan-Blue coalition, which represented the majority membership in the congress. The membership of this coalition was 51.11%, 50.67% and 77.88% in the 2001, 2004 and 2007 elections, respectively. These numbers would be even higher after including the non-party coalition, which typically cooperated with the Pan-Blue coalition during the sampling period.