



Bank financing and corporate governance [☆]



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ABSTRACT

Extant literature suggests that bank monitoring improves corporate governance. This paper demonstrates that inefficiency in banking can also significantly reduce the equity capital markets' disciplinary power. Specifically, we show that in an environment in which the banking system is dominated by inefficient state-owned banks, controlling shareholders' tunneling activity is positively associated with firms' bank loan access. This relation is particularly strong in firms with high borrowing capacity, as measured by tangibility, and in regions where the banking industry is severely inefficient. As firms with high tunneling can continue to receive new loans with interest cost compatible to others, equity capital market disciplinary forces do not apply to them. Indeed, we further show that through tunneling, bank financing is negatively associated with future firm performance. These results suggest that, for an economy to develop mature capital markets, it is imperative to improve banking efficiency because its inefficiency dilutes the monitoring role of the market.

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1. Introduction

Corporate governance is a central issue in modern financial economics. Extant literature studies the relation between the efficiency of equity market, bank financing and corporate governance, respectively. Equity capital markets potentially efficiently price capital and provide a mechanism for active corporate control (Gompers et al., 2003). At the same time, banks play an important role in examining firm quality and disciplining them through creditor rights enforcement. We reckon that the disciplinary roles of equity capital markets and banks are interconnected. In this paper, we examine this interconnected relation.

Our premise is that inefficiency in banking hurts corporate governance not only through its own failure in monitoring firms but also by diluting the market's monitoring role. Specifically, capital markets' punishment of poor corporate governance through increasing financing costs becomes irrelevant when banks fail to take into account firms' governance in allocating loans. Intuitively, firms with secured bank financing through non-economic factors are less concerned about the cost of capital on equity markets, hence are less likely to respect returns to minority shareholders. As Ivashina et al. (2009) shows that bank's informational role improves value creation in merge and acquisition activities, we propose further that the failure of this information role actually dilutes the monitoring role of markets.

China's economic and financial structure provides an important and advantageous setting to verify this proposition. In China, firms' reliance on bank financing is arguably exogenous to corporate governance. On the one hand, firms traditionally rely on only bank financing due to government decree. Equity financing is a relative new development and remains trivial (Alan and Shen, 2012). On the

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other hand, private firms are still being discriminated against in formal financing (Allen et al., 2005; Cull and Xu, 2003; Cull et al., 2009, etc). Given limited financing channels and the dominant role of banks, firms are constrained to bank financing even though they may be willing to commit to respecting equity investors' rights. This setting mitigates the impact of potential equity market financing on corporate governance and allows us to focus on the relationship between bank financing and corporate governance. The interesting aspect is that secured bank financing appears to aggravate tunneling and thus highlights how inefficient banking renders equity market monitoring ineffective.

We measure firms' corporate governance by tunneling—the transfer of assets or profits out of the firm for the benefits of controlling shareholders. Although tunneling occurs mostly within the legal boundary, it is nevertheless loss to minority shareholders (Johnson et al. (2000)). The loss could be economically significant and the conduct of tunneling may occur in many forms, through acquisition, security offering, or non-operational transactions (Bae et al., 2002; Baek et al., 2006; Bertrand et al., 2002).

Compared to the US where groups of diverse investors own listed firms, corporate ownership in China is much more concentrated, which is similar to many countries in Europe and Asia (Claessens et al., 2000; Faccio and Lang, 2002). This institutional feature, together with weak legal or regulatory protections for minority shareholders, makes the Chinese stock market highly conducive for tunneling activities (e.g., Jiang et al., 2010; Peng et al., 2011). As a result, the conflict of interest between controlling and minority shareholders, rather than the one between the delegated manager and diverse investors, becomes the central theme of agency problems in Chinese firms.² A common form for controlling shareholders to tunnel is to borrow on company assets or cash, which in the Chinese case, is largely captured by an accounting item “other receivables.”³

Our argument for inefficient bank financing as a culprit for governance failure is as follows. When firms can secure banking financing through non-economic factor such as political status, they become less concerned with the cost of capital on equity markets and thus less likely to respect returns to minority shareholders. Further, market takeover is almost impossible in China prior to 2008 due to the highly concentrated ownership and the non-tradable share scheme. Both mechanisms make market punishment on tunneling unimportant. Our analysis focuses on the first mechanism: there is a positive relation between bank loans and tunneling; this relation is severer for firms have easier access to bank loans; and finally, bank loan is associated with poor firm performance.

Our empirical work is based on Chinese non-financial listed firms sampled in 1995–2009. We first show that tunneling has a strong predictive power on future performance deterioration, which validates our measurement of corporate governance. We further demonstrate that tunneling, although punished by market financing sources, is largely overlooked by bank loan financing. That is, new loan allocation does not “price” tunneling, which verifies the assumption that banks and markets respond differently toward poor corporate governance. Moreover, we document a positive relation between bank loans and tunneling activities. To differentiate our hypothesis from other alternatives and to address the potential issue arising from omitted variables, we examine the cross-sectional implications of our argument. We show that the relation between bank loan and tunneling is stronger in firms with higher tangibility which are favored in bank loan allocations, but weaker in regions where the banking industry is more efficient. Finally, we show that bank loans are negatively associated with firm performance primarily because of tunneling activities.

Our findings—that banks do not punish tunneling and that firms with a higher bank borrowing capacity have a more severe tunneling problem—confirm that inefficient bank financing compounds poor corporate governance. As secured bank financing negates the relevance of capital market punishment, control shareholders tunnel more aggressively when the reputation on the financing market is less valuable. The implication is that to nurture more effective equity market disciplinary forces, China has to improve its banking market efficiency.

Although the empirical evidence is based on Chinese data, the theory proposed and the implications of results for corporate governance are general. In particular, our findings suggest that improving the banking efficiency or changing its dominant status is crucial for adequate corporate governance, development of financial system, and the maturing of a functionally efficient capital market.

The rest of the paper proceeds as follows. Section 2 elaborates our proposition on controlling shareholders' decision and outlines our hypotheses and methodology. Section 3 introduces the data. Section 4 reports the empirical results. Finally, Section 5 concludes the paper.

2. Hypotheses and identification

2.1. Controlling shareholders' decision

In deciding whether or not to steal, controlling shareholders face a tradeoff between short run benefits and long run reputation loss which may result in higher future cost of capital. Controlling shareholders with future external financing needs are less likely to expropriate minority shareholders if such behavior raises the future costs of capital.

There is, however, a difference between capital market financing and bank financing. Residual claimants aware of controlling shareholders' past expropriation will demand a discount in providing finance, which raises the cost of the controlling shareholders'

² Jiang and Kim (2014) comprehensively review the corporate governance features in China, covering a broad range of conflicts of interests and monitoring mechanisms. The feature of concentrated ownership stands out in discussions of all aspects compared to the conventional understanding based on US firms.

³ Chinese Security Regulatory Committee (CSRC) made it mandatory for firms to disclose details of the borrowing after 2006. The disclosed amount matches well with this accounting item within the sub-period when both numbers are observable.

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