Officials on boards and the prudential behavior of banks:
Evidence from China's city commercial banks☆

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1. Introduction

Given their important role in financial and economic stability, the authorities generally impose stringent controls over commercial banks, and one common way of doing this is to own them, completely or partially. In fact, government ownership of banks is pervasive around the world (La Porta, Lopez-de-Silanes, & Shleifer, 2002). Previous research has documented that this form of ownership, as the main method of government participation in the financial markets, is harmful to their prudential behavior that is an operating principle to which commercial banks should adhere. Jia (2009), for example, finds that China's state-owned banks are less prudent than the country's joint-equity banks. Berger, Clarke, Cull, Klapper, and Udell (2005) show similar findings for Argentina.

However, the above research mainly focuses on the relationship between government ownership and lending behavior, which does not address how the government ownership affects the banks' behavior. The gap is surprising, because government ownership is pervasive and matters greatly to banks' behavior. Uncovering the black box of how state ownership functions would contribute to the related research, as well as to bank practice and policy making. One important method by which shareholders participate in bank operations is voicing on the boards – the apex of the bank control and monitoring mechanism – through their designated directors.

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Thus, government owners often select their own officials to act as directors, making the banks politically connected. This paper focuses on the special political connections of officials-and-directors (hereafter OADs) and their consequences for banks’ prudential behavior.

Another strand of the literature deals with firms’ political connections. Numerous works of research have found that political connections not only affect corporate value, but also firms’ financial decisions (Faccio, 2006; Fisman, 2001). Evidence from Pakistan provided by Khwaja and Mian (2005), from Indonesia by Leuz and Oberholzer-Gee (2006) and from Brazil by Claessens, Feijen, and Laeven (2008) document that politically connected firms have more access to bank loans. In countries with weak legal institutions and poorly protected property rights, such as China, informal institutions such as political connections play a dominant role in firms’ decisions. Li, Meng, Wang, and Zhou (2008) find that, in China’s private sector, politically connected firms can obtain more loans or loans with longer maturities, which is also supported by Firth, Lin, Liu, and Wong (2009). While these works discuss how political connection influences corporations in terms of the demand side of loans, there is a lack of studies concerned with how the political connections of banks affect loans on the supply side. In fact, there are studies that have considered this issue. For example, Liang, Xu, and Jiraporn (2013) explore the impact of current or former officials on boards on banks’ performance and asset quality. However, their definition actually conceals the effects of current officials and they only examine the relationship between the director and the bank’s results, while we still do not know what the channel is for this relationship. The current paper tries to fill this gap.

China’s city commercial banks (hereafter CCBs) provide an ideal setting in which we can test how the practice of appointing OADs affects banks’ behavior. First, CCBs, whose predecessors were urban credit cooperatives, are a special group in China coming under the jurisdiction of the local government. In fact, the local authority is generally not only the controlling shareholder of the CCB but can also appoint and dismiss its senior executives, facilitating the practice of dispatching of officials designated to act as directors. As the OADs of CCBs share some organizational as well as individual features, we need to analyze their behavior from these two perspectives.

As the OADs of CCBs share some organizational as well as individual features, we need to analyze their behavior from these two standpoints. From an organizational viewpoint, the OAD is appointed by local government as a shareholder of the bank, which represents government control because the choosing of the official in itself means that the government wants to control the bank directly, and the presence of an OAD on the board will facilitate the government’s intervention in bank operations. So, the OAD’s behavior actually reflects the interests of the local government. During the gradual transition in China, local governments have been loaded with many policy burdens, including employment, social stability and security, which have increased their fiscal expenditure (Lin, Cai, & Li, 1998). China’s tax-sharing reform in 1994 exerted more pressure on them. Consequently, mobilizing financial resources from banks serves as an important way for local authorities to finance their projects. The introduction of a new Budget Law in 1995, prohibiting local governments from issuing bonds, further limited their financial options. Under these circumstances, the CCBs that had just been
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