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

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ABSTRACT

From the perspective of officials-and-directors (OADs), who are commonly appointed by the Chinese government to the banks it owns, this paper takes studies of government ownership and banks' behavior to the micro level of boards. We analyze the relationship between the special political connection of the OADs and banks' prudential behavior, using a sample of China's City Commercial Banks during 2006–2010. We further explore the impact of OADs' characteristics and the role of independent directors and female directors. The results indicate that banks with OADs exhibit lower prudential behavior, and the higher is the administrative rank of the OADs, the larger is the effect. And the older is the OADs, the larger is the effect. More importantly, the government ownership of banks does not have a significant and robust influence on their prudential behavior. Meanwhile, independent directors can significantly weaken the effect of the OADs, while female directors can enhance the prudential behavior of banks in the absence of OADs. Finally, our results persist even after controlling for sample selection bias and alternative variable measures. Our research contributes to the practice of improving bank governance and regulating systematic risk.

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 officials to serve on the CCB's board (OADs). Second, although Chapter 53 of China's *Civil Servant Law* regulates that officials should not generally have part-time jobs outside of their official unit, Chapter 42 stipulates that if an official needs to do a part-time job to assist them with their official work, he should be approved by the higher authorities. Thus, officials can serve as bank directors when approved. More importantly, previous studies have always defined political connection as a "former official acting as director", while this paper refers to it as an OAD, or an "incumbent official acting as the member of a board". These two kinds of officials (former and incumbent) differ significantly in terms of their influence, their ability to allocate public resources and their political motivation. Though former officials have some power, their influence will be much less than that of incumbent officials in a society that emphasizes '*guanxi*' as China does. Thus, addressing the role of incumbent officials designated to act as directors will provide more persuasive results.

We frame our empirical analysis around the abovementioned literatures. By hand-collecting personnel information on OADs, we focus on how they and their characteristics affect banks' prudential behavior. Moreover, we examine the impact of independent and female directors on the OAD's role. Our paper contributes to research about government ownership, political connections and bank behavior. This paper innovates in comparison to previous research in three aspects. Firstly, compared to other research linking government ownership and banks' behavior directly, this paper explores more fully the channel from the perspective of the OAD. Our results indicate that the OAD matters more than the type of ownership, which should help to motivate future research about the relationship between government ownership and banks' behavior. Secondly, this is a pioneering research in the Chinese context, discussing how political connections affect financing from the perspective of the supplier instead of the requestor and extending the evidence concerning the relationship between political factors and bank behavior. Thirdly, our results suggest that independent directors can diminish the negative effect of the OAD, while female directors can enhance a bank's prudential behavior when there is no OAD, which provides empirical guidance as to the optimization of board structure.

The remainder of the paper is organized as follows. Section 2 reviews relevant researches and formulates our hypothesis. Section 3 describes our data and the empirical methodology. Our initial empirical analysis is presented in Section 4. Section 5 discusses the functions of independent and female directors, and the robust check is presented in Section 6. We conclude in Section 7.

2. Hypothesis development

A growing body of researches, motivated by La Porta et al. (2002) who suggests that government ownership of banks is pervasive around the world, concentrates on the economic consequences of government ownership. Dinc (2005), who focuses on bank loans, finds that state-owned banks increase their lending in election years compared with private banks. Micco, Panizza, and Yanez (2007) share this view, using a sample of banks from developing countries to test it. Saunders, Strock, and Travlos (1990), from the perspective of risk-taking behavior, indicate that banks controlled by stockholders have incentives to take higher risks than those controlled by management. The Argentinian evidence presented by Berger et al. (2005) shows that banks' prudential behavior improves after privatization, while Haber (2005) comes to the opposite conclusion for the Mexican context. The inconsistency of the results demonstrates the value of discussing the relationship between government ownership and bank behavior from a new perspective and the OAD provides an appropriate channel, linking these two aspects.

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