Ownership structure and collateral requirements: Evidence from China’s listed firms

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A B S T R A C T

This paper examines the effect of ownership structure on collateral requirements using a sample of China’s listed firms from 2007 to 2009. We find that compared to privately controlled companies, state-controlled companies are less likely to be required to pledge collateral, and such a difference is more pronounced for firms in troubled industries. The empirical results also show that the effect of state control on collateral requirements is weaker in companies with more foreign ownership. Moreover, the effect of state control on collateral requirements is weaker in companies with more third party guarantees. Finally, we find that the effect of state control on collateral requirements is more pronounced for firms operating in regions with more government intervention.

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1. Introduction

The use of collateral has been a common feature of loan contracts between borrowers and lenders. Since the 2007 financial crisis, the use of collateral has again come back into focus of academics and practitioners. Based on theories of asymmetric information, research into the credit market reveals that the requirement for collateral is the consequence of adverse selection (Besanko & Thakor, 1987; Bester, 1985; Chan & Kanatas, 1985), and/or moral hazard (Thakor & Udell, 1991). These researchers argue that collateral can limit potential losses for lenders, and screen potential borrowers. Because safer borrowers are less likely to default (and therefore lose control of the collateral), they are more likely to pledge collateral in exchange for a lower interest rate on the secured loans. Another strand of literature has well documented that the government often puts pressure on the banking system to lend primarily to state-owned enterprises (SOEs), and the expected government bailouts of troubled SOEs further increase the supply of bank loans to these enterprises (Cull, Xu, & Zhu, 2009; Li, Yue, & Zhao, 2009). However, there is little evidence to show how state ownership impacts on collateral requirements.

This paper extends the existing literature and examines the relationship between ownership structure and collateral requirements using a sample of China’s listed firms from 2007 to 2009. China’s listed firms provide an excellent environment in which to examine the effect that ownership structure has on the use of collateral. Government ownership of Chinese firms remains widespread, even in firms quoted on Western-style stock markets; indeed, one of the important features of China’s listed firms is that the ownership of the dominant shareholder, which in many cases is the state, far exceeds that of the second largest shareholder. On this basis, we are able to assess the implications of the type of controlling shareholder for the setting of collateral requirements. Meanwhile, as the stock market opened up to foreign investors, listed firms were allowed to issue foreign shares, while the empirical evidence suggests that firms with foreign ownership were able to improve their information environment (Baker, Nofsinger, & Weaver, 2002; Lang, Lins, & Miller, 2003). A natural question to ask would be how foreign ownership and its interaction with state ownership affect collateral requirements. Furthermore, recent literature emphasizes the importance of third party guarantees as a substitute for collateral, which also reduces the risk of the lender not recovering their loans (Menkhoff, Neuberger, & Rungruxrisrivorn, 2012; Voordeckers & Steijvers, 2006). However, little is known about whether ownership structure and guarantees could substitute for each other. China also combines greater heterogeneity in institutional development across provinces with homogeneity in cultural norms and laws (Hasan, Wachtel, & Zhou, 2009). These differences in government intervention therefore enable this study to determine how the link between collateral requirements and state ownership is affected by the evolution of the country’s market institutions.

Our empirical evidence strongly supports the fact that the requirement for collateral is lower in SOEs than in non-SOEs, and by investigating industry performance further, we find that the benefit of state ownership in gaining access to unsecured loans is further magnified for firms in troubled industries. Moreover, there is a negative

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1 Recently, individuals in China have been allowed to buy foreign shares if they have access to foreign currency. However, firms with foreign shares are still different from their counterparts without foreign ownership because they issue financial statements that are compliant with international standards.
relationship between the use of collateral and foreign ownership and the negative relationship between state control and collateral requirements is weaker in firms with more foreign ownership. Firms with more third party guarantees are also more likely to enjoy unsecured loans, and the benefit of state control in reducing the proportion of collateralized loans is weaker for firms which borrow from banks with more third party guarantees. Finally, this study shows that disparities in regional institutional development matter for the role of state control in reducing collateral requirements, because more intervention by regional government is related to a stronger role for state control in reducing collateral requirements.

The paper contributes to the literature in three significant ways. First, it provides a useful test of whether the theories that have been established and applied to explain the determinants of collateral in developed markets are applicable to emerging markets. Menkhoff, Neuberger, and Suwanaporn (2006, 2012) sought to determine whether there were systematic differences in collateral-based lending between mature and emerging markets. They analyzed a data set of credit files from Thai financial institutions, and discovered that the need for collateral was higher in less developed markets and borrowers could overcome the threatening lack of collateral by substitutes, such as third party guarantees and relationship lending. This paper complements their studies, and finds that firms with a close relationship with the government are more likely to receive unsecured loans than their counterparts without such a relationship, and its role in reducing collateral requirements could be substituted by the third party guarantees. Firms can also reduce the use of collateral by issuing foreign shares, which also weakens the effect that state ownership has in gaining access to unsecured loans.

Secondly, our paper presents fresh evidence on the interaction between state ownership and institutions to affect collateral requirements. Existing studies have examined the role of developed institutional environments and nascent financial compensation to performance and relinquishing its shareholding. During our sample period we discovered that on average, the largest shareholder owns 36.6% (the median is 35.3%) of a firm while the second largest owns 8.5% (the median is 5.6%), which indicates that the largest shareholder has substantial control over the firm. Chen, Firth, and Xu (2005) pointed out that China's firms should be categorized according to the type of controlling shareholder instead of the type of share that followed the legal classification of shares, because early studies treated state shares and legal person shares as two distinct groups, and do not adequately acknowledge the different objectives and incentives of these shareholders. In line with the recent literature, we investigated the shares of China's listed companies based on the ultimate identification of the controlling shareholders and took into account how they faced a different comparative advantage of access to direct bank credit.

2. Background and Development of Hypotheses

2.1. Background

China began its transition from a centrally planned economy to a market-based economy in 1978. Under its communist system, China's government collected revenues from SOEs and provided financing to those firms according to the state budget, so there was no need for risk management by banks with the use of collateral. Since SOE reform began, the state has tried to give autonomy to enterprises by linking financial compensation to performance and relinquishing its shareholding. That was followed by the adoption of the “loan for (fiscal) grant” (bo gai da) scheme, which aimed at increasing financial incentives and hardening the budget constraints faced by SOEs in the early 1980s. A new phase of reform began in 1984, when the separation between management and ownership was further emphasized. In the Third Plenary Session of the Fourteenth Chinese Communist Party (CCP) Congress, held in 1993, a new goal of establishing a modern enterprise system was set for SOE reform. This reform of shareholding was then extended throughout the nation, which resulted in many SOEs being restructured into joint stock companies and being listed on the stock exchanges in Shanghai and Shenzhen, with shares sold to the public. However, both central and local governments often retained enough shares to maintain control. Some of the equity carved out of SOEs is now majority owned by private investors, and there is a growing number of private firms that are now listed.

According to the Guidelines on Shareholding Experiments and Regulatory Opinions on Joint Stock Companies issued in 1992, shares in China's listed firms are classified into six types: state, legal person, foreign, management, employee, and individual shares. On average, about one third of these shares are owned by the state, one third are owned by legal entities, and one third are owned by individuals and private institutions. Foreign, management, and employee shares represent less than 10% of the outstanding shares, so they do not constitute major voting blocks.

A distinct characteristic of Chinese firms is that they often have one dominant shareholder whose ownership is much higher than the second largest shareholder. During our sample period we discovered that on average, the largest shareholder owns 36.6% (the median is 35.3%) of a firm while the second largest owns 8.5% (the median is 5.6%), which indicates that the largest shareholder has substantial control over the firm. Chen, Firth, and Xu (2005) pointed out that China's firms should be categorized according to the type of controlling shareholder instead of the type of share that followed the legal classification of shares, because early studies treated state shares and legal person shares as two distinct groups, and do not adequately acknowledge the different objectives and incentives of these shareholders. In line with the recent literature, we investigated the shares of China's listed companies based on the ultimate identification of the controlling shareholders and took into account how they faced a different comparative advantage of access to direct bank credit.

2.2. Development of Hypotheses

In China's capital market, the bank loan is the main external finance available for firms (Cull et al., 2009). As the Chinese banking system, like SOEs is still under the control of the government, the Chinese government has historically mandated the banking relationship with SOEs, and the banks have more interaction with SOEs than non-SOEs. Because of the repeated lending relationship and the homogeneity of government ownership, state-owned banks have developed good channels for obtaining credit information about SOEs and are inclined to charge lower borrowing costs in terms of collateral requirements, while non-SOEs may find themselves disadvantaged in this regard (Firth, Lin, Liu, & Wong, 2009; Lin, 2011).

In addition, banks will be especially concerned about the safety of their loans to firms in financial distress because these firms are more likely to be abandoned by customers and other stakeholders, which may reduce these firms' ability to repay the loans (Opier & Titman, 1994). If the financially distressed firm is a SOE, state-owned banks are more likely to extend credit at a lower cost to maintain these SOEs in order to satisfy political and social objectives. In particular, Cull & Xu (2003) find that loss-making SOEs receive a disproportionate share of bank finance. However, if the financially distressed firm is a non-SOE, state-owned banks may not have the incentive to inject capital due to information asymmetry (Firth et al., 2009). Therefore, we expect that the effect of state ownership on reducing collateral

Legal person shares are owned by the state and by private firms.
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