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Does the cutoff of "red capital" raise a red flag? Political connections and stock price crash risk

Min Zhang [a,b], Yaosong Liu [a,*], Lu Xie [a], Tingting Ye [c,*]

[a] School of Business, Renmin University of China, Beijing, PR China
[b] The Collaborative Innovation Centre for State-owned Assets Administration, Beijing, PR China
[c] School of Accounting, Shanghai Lixin University of Accounting and Finance, Shanghai, PR China

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ABSTRACT

Using a Chinese exogenous regulatory setting that forbids political officials from sitting on boards, we investigate whether disruption to political connections induced by independent director's forced resignation increases the firm's stock price crash risk. The results show that firms announcing resignations of politically-connected independent directors after the regulation experience a significant increase in crash risk, suggesting that disruption to political connections intensifies managers' bad-news hoarding behavior and makes firms more crash-prone. We further find that the negative impact of disrupted political connections on crash risk is less pronounced in state-owned enterprises (SOEs) than that in non-state-owned enterprises (non-SOEs). Moreover, the association is more salient when the resigned director has a geographic and industrial working background overlapping with the firm's operation. Our findings are consistent with the notion that heightened resource acquisition pressure caused by disruption to political networks increases stock price crash risk.

1. Introduction

The rising frequency and enlarging scales of stock market crash have aroused increasing attention, particularly with respect to identifying their causes. Prior studies have generally recognized that managerial bad-news hoarding behavior is a primary cause of stock price crashes (e.g., Jin & Myers, 2006). These studies have concentrated on the factors that facilitate or constrain managers' incentives for withholding negative news from outside investors, such as financial reporting opacity (e.g., Hutton, Marcus, & Tehranian, 2009), compensation contracts (e.g., Benmelech, Kandel, & Veronesi, 2010; Kim, Li, & Zhang, 2011a), institutional ownership (e.g., An & Zhang, 2013), tax avoidance (Kim, Li, & Zhang, 2011b) and other corporate governance mechanisms (Andreou, Antoniou, Horton, & Louca, 2015; Robin & Zhang, 2015). However, the role of resource acquisition pressure in motivating managers to conceal bad news and forecasting stock price crash risk remains unexplored.

Under environmental dynamics, firms dedicate themselves to acquiring vital resources that will viably increase their range of responses to potential opportunities and threats (McGrath & Nerkar, 2004). To guarantee resources from market

* Corresponding authors.
E-mail addresses: minzhang@ruc.edu.cn (M. Zhang), liu_yaosong@163.com (Y. Liu), rbsxielu@163.com (L. Xie), yetingting_lisa@163.com (T. Ye).

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participants such as equity investors and creditors, firms are expected to maintain satisfactory performance and superior reputations, which motivates managers to withhold negative information when managing and structuring the portfolio of firm resources (Simon, Hitt, Ireland, & Gilbert, 2011). For example, when firms conduct either initial public offering or seasoned equity offerings, managers may temporarily deceive investors by manipulating earnings upwards to raise more capital (Rangan, 1998; Teoh, Welch, & Wong, 1998a; DuCharme, Malatesta, & Sefcik, 2004; Shivakumar, 2000; Teoh, Welch, & Wong, 1998b), and such bad-news withholding behavior could then increase the stock price crash risk (e.g., Hutton et al., 2009; Jin & Myers, 2006).

Taking advantage of a Chinese institutional scenario, we investigate the impact of regulation-induced resource acquisition pressure on managerial bad-news hoarding and then the stock price crash risk. Specifically, the regulation stipulates that political officials are not allowed to serve as independent directors on firm boards, giving rise to an unprecedented wave of independent director resignations and massive disruptions to political connections in listed firms. It is extensively documented that political connections enhance firms' potential to acquire resources by lowering capital costs (Claessens, Feijen, & Laeven, 2008; Houston, Jiang, Lin, & Ma, 2014; Sapienza, 2004), offering government subsidies and bailouts (Faccio, 2006), providing tax privileges (Adhikari, Derashid, & Zhang, 2006; Wu, Wu, Zhou, & Wu, 2012) and other scarce resources (Bai, Lu, & Tao, 2006; Tahoun, 2014). However, when bureaucrat directors are forced to resign, political connections maintained by them get disrupted and can no longer relieve firms from competing fiercely in market-driven resource allocations. In such circumstances, managers revert to pleasing the market for essential resources, which remotivates them to conceal negative information and thus increases the firms' crash risk.

By employing a sample of firms that disclosed independent director resignations after the regulation took effect, our results suggest that stock price crash risk increases significantly when a politically-connected independent director resigns from a firm. Moreover, the association between disrupted political connections and crash risk is less pronounced in state-owned enterprises (SOEs) than that in non-state-owned enterprises (non-SOEs). As in the former case, the resignation causes a greater degree of disruption to a firm's network of political connections. Furthermore, the resignation-induced crash risk increase is more salient when the resigned independent director has an overlapping geographic and industrial working background with the firm's operation. The above findings are consistent with the notion that resource acquisition constraints brought about by the cutoff or reduction of political connections heighten managers' bad-news hoarding incentives and increase the firms' stock price crash risk.

This paper contributes to the literature from two perspectives. First, prior studies have documented managers' private interests (such as stock-based compensation, career concerns, litigation risk, and empire building) as motivations for withholding negative information from investors, which thereby triggers crash risk (e.g., Hutton et al., 2009; Kim et al., 2011a; Xu, Li, Yuan, & Chan, 2014). We highlight resource acquisition constraint as another incentive for managers' bad-news hoarding behavior. By providing evidence that a firm's crash risk increases when its resource acquisition networks are impaired by disrupted political connections, our paper extends the extant literature by identifying political connection as a new determinant of stock price crash risk.

Second, we enrich the studies on the economic consequences of political connections by introducing the perspective of crash risk. Much work in this area to date has focused on whether the political connections affect stock return performance (first moment of stock return distribution) and firm value (second moment of stock return distribution) (e.g., Fan, Wong, & Zhang, 2007; Fisman, 2001; Goldman, Rocholl, & So, 2009; Luechinger & Moser, 2014). We depart from these studies by investigating the unique role of political connections in forecasting crash risk, which captures asymmetry in firm risk and the third moment of stock return distribution. Moreover, by taking advantage of the exogenous shock to the presence of political connections maintained by independent directors, we successfully address the prevalent endogenous concerns in examining the implication of political connections.

Our study is closely related to, but differs from, the work of Piotroski, Wong, and Zhang (2015), which examines how the political pressure impacts on the connected firms' suppression of negative information around the time of national political events in China. Specifically, they argue that politically-affiliated firms suffer a significant increase in stock price crash risk after high-profile political events take place, because firms withhold bad news for the sake of their connected politicians' careers. While Piotroski et al. (2015) investigate how political pressure shapes the information flow and triggers the crash risk of Chinese listed firms, our research focuses on whether the mandatory disruption to political connections leads to the resource acquisition constraints and later crash risk induced by the managerial bad-news withholding intention.

As to the remainder of this paper, in the next section, we introduce the institutional background and then develop hypotheses. We describe the sample and variable measurements in Section 3. The empirical results and conclusion are presented in Section 4 and Section 5, respectively.

2. Institutional background and hypothesis development

2.1. Institutional background

The quotation "Marrying Washington and Wall Street adds value for shareholders" particularly rings true for firms in highly politicized environment such as China. With overarching government interference and control over resource allocations, it is especially critical for firms to cultivate political connections to gain access to scarce resources (Li, Meng, Wang, &