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Ownership structure and risk-taking: Comparative evidence from private and state-controlled banks in China

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ABSTRACT

This study examines the impact of ownership structure on Chinese banks' risk-taking behaviours. We classify the Chinese commercial banks into three categories based on the types of controlling shareholder, and find that banks controlled by the government (GCBs) tend to take more risks than those controlled by state-owned enterprises (SOECBs) or private investors (PCBs). This is attributed to the severe political intervention and weak incentives to follow prudent bank management practices for GCBs. We also find that the results are more pronounced among banks with concentrated ownership presumably because the large controlling power helps to enhance the monitoring of the management and promotes prudent operating procedures. Our findings have important implications for the ongoing reform in the Chinese banking sector.

1. Introduction

The Basel Committee on Banking Supervision (BCBS) recently issued a set of "Principles for enhancing sound corporate governance" (BCBS, 2010) in the banking sector to discuss the link between governance quality and bank failure as well as economic development. Poor corporate governance has been found to motivate excessive risk-taking and therefore been blamed as a contributory factor of the recent financial crisis (Laeven & Levine, 2009). The report highlighted some corporate governance challenges including bank ownership structures that are unduly complex, lack transparency, or impede appropriate checks and balances, and pointed out that "*Challenges can also arise when insiders or controlling shareholders exercise inappropriate influences on the bank's activities*" (2010, p.6). Corporate governance in the banking sector differs from that in the non-financial sectors in terms of transparency, business complexity and regulation (Mehran, Morrison, & Shapiro, 2011), and banks have the ability to take on risk very quickly and in ways that are not readily visible to directors or investors, thus posing a broader risk to the economy than non-financial firms. To date, however, corporate governance studies in the literature have largely focused on non-financial firms. Therefore, the issue of corporate governance and risk-taking in the banking sector is of particular interest. To shed light on this issue in the under-researched emerging markets, we study the role played by the controlling shareholders of Chinese banks by exploring the impact of their nature and the ownership concentration on banks' risk-taking behaviours.

Since 1979, the Chinese authorities have undertaken gradual banking reforms to address the institutional, political and organizational problems faced by its banking industry. The speed of the reforms has accelerated since 2003, and the Chinese banking sector has been dramatically reshaped. The latest round of banking reform measures include financial capital injections, shareholding restructures, the introduction of foreign strategic investors, the listing of banks' share capital on foreign and Chinese exchanges, and the establishment of a system for the boards of directors. These reforms have changed the ownership structure of Chinese banks, and are expected to improve the governance quality and have important implications on their behaviours.

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In China and some other emerging market countries the banking sector operates under a two-tier ownership structure including state-owned banks and privately owned (domestic or foreign) banks. Both theoretical and empirical studies in the literature suggest that the performance and risk-taking behaviour of organizations depend on the identity of the controlling shareholders (i.e., the ultimate owners) (e.g., Barry, Lepetit, & Tarazi, 2011; John, Litov, & Yeung, 2008). In terms of state ownership, political interference usually comes at the expense of corporate profitability because of politicians' deliberate policy of transferring resources to their supporters (Shleifer, 1998; Shleifer & Vishny, 1986). This suggests that state-owned banks might be seen as vehicles for raising capital to finance projects with high social returns, but possibly high-risk and low-profit returns, or to provide finance to favoured groups such as state-owned enterprises (SOEs) (Clarke, Cull, & Shirley, 2005).[1] State-owned banks find it difficult to resist such harmful government interference, whereas private banks are more able to oppose it, and typically employ more sensible prudential lending policies and/or profit-maximizing strategies as a consequence (Shirley & Nellis, 1991; Shleifer & Vishny, 1994). Moreover, lower performance incentives (Shleifer & Vishny, 1997) and "soft" budget constraints (Sheshinski & Lopez-Calva, 2003) in state-owned banks also result in excessive risk-taking and the misallocation of resources.

These theoretical inferences have been supported by some empirical evidence. For example, government-owned banks and large state ownerships are associated with lower efficiency (Bonin, Hasan, & Wachtel, 2005; Fries & Taci, 2005), inferior long-term performance (Berger, Clarke, Cull, Klapper, & Udell, 2005), greater risk-taking (Angkinand & Wihlborg, 2010; Iannotta, Nocera, & Sironi, 2007, 2013), and less prudent lending behaviours (Jia, 2009). However, there are also some contradictory results. State-controlled banks have also been found to be associated with less risk in Russia (Fungáčová & Solanko, 2009) and higher efficiency in India (Bhattacharyya, Lovell, & Sahay, 1997) and Turkey (Isik & Hassan, 2002). Altunbas, Gardener, Molyneux, and Moore (2001) find little evidence that private banks are more efficient than state-owned ones in Germany. Overall, the results are not conclusive and little is known about the role of state controlling shareholders in Chinese banks' risk-taking behaviours.[2]

Besides the nature of the controlling shareholder, another important dimension of banks' ownership structure is ownership concentration (Iannotta et al., 2007). Opposite effects of ownership concentration on firm performance are predicted from theories from the literature. On the one hand, Shleifer and Vishny (1986) and Admati, Pfleiderer, and Zechner (1994) argue that concentrated ownership can overcome the free-rider problem and enhance firm performance by improving the monitoring of management. An agency problem is created when ownership is dispersed because atomistic shareholders bear the full cost of monitoring while reaping only a fraction of the benefits and therefore have less incentive to monitor the firms. On the other hand, other theoretical studies argue that large shareholders may exercise control rights to pursue private benefits at the cost to the minority shareholders (La Porta, Lopez de Silanes, & Shleifer, 1999; Shleifer & Vishny, 1997). Mixed empirical evidence is also documented in this literature. Concentrated ownership has been found to be associated with higher risks (Laeven & Levine, 2009), higher insolvency risk and greater return volatility (Haw, Ho, Hu, & Wu, 2010). In contrast, ownership concentration has been found to be associated with a lower level of risk-taking in Spanish commercial banks (Garcia-Marco & Robles-Fernández, 2008), better loan quality, lower asset risk and a lower insolvency risk (Iannotta et al., 2007) and a lower non-performing loans ratio and better capital adequacy ratio (Shehzad, de Haan, & Scholtens, 2010). These differences may partially be attributed to the different settings which embed different institutional features from the various countries and regulatory regimes.

To perform our analysis, we hand collect the ownership information of 108 Chinese commercial banks over the period from 2003 to 2011. We regress the ownership structure characteristics, including the identity of the controlling shareholder and the ownership concentration and their interaction terms, on the bank's risk-taking proxies. We also incorporate other corporate governance characteristics as control variables including the independence of the risk committee chair and the proportion of female directors on the boards. We use three categories of ownership identity to reflect the nature of their largest shareholder: government-controlled banks (GCBs), SOE-controlled banks (SOECBs), and privately controlled banks (PCBs). For the ownership concentration, we use the Herfindahl index based on the ownership shares of the top ten shareholders and the percentage of shares held by the three largest shareholders. Our findings show that SOECBs tend to take less risk than GCBs. Unlike GCBs, SOECBs have greater incentives to pursue profit-maximizing strategies and exercise prudential lending practices. We also find that the effect of controlling shareholders on bank risk-taking depends on the ownership concentration. More specifically, concentrated ownership can reduce risk-taking in SOECBs and PCBs, but increase risk-taking in GCBs presumably because of their different objectives. Finally, consistent with Aebi, Sabato, and Markus (2012), we also find that the presence of the Chief Risk Officer (CRO) on the executive team and a greater number of female directors significantly reduce risk-taking.

We believe that our study makes an important contribution to the literature in several ways. First, it adds to the literature of banking governance by providing original evidence on the impact of two dimensions of ownership structure (i.e., controlling shareholder type and ownership concentration) on banks' risk-taking. Some related studies either focus on the nature of the bank (Barry et al., 2011; Forssbæck, 2011; Nichols, Wahlen, & Wieland, 2009) or on the degree of ownership concentration (Iannotta et al., 2013; Laeven & Levine, 2009; Sullivan & Spong, 2007). To the best of our knowledge, this is the first study to address how the ownership concentration affects the role of controlling shareholders. Second, this study contributes to the growing literature on emerging markets by exploring the rapidly developing Chinese banking sector from the largest emerging market in the world. The existing Chinese banking literature mainly examines the determinants of banks' (accounting) performance or efficiency (Berger, Hasan & Zhou, 2009; Fu & Heffernan, 2007, 2010; Kumbhakar & Wang, 2007; Lin & Zhang, 2009; Zhang, Jiang, Qu, & Wang, 2013), while our study focuses on the risk-taking behaviour of Chinese banks using three risk measure proxies, i.e., Z-score, non-performing loans, and the capital adequacy ratio. Finally, our findings have important implications for regulators and investors. Our findings suggest that the transfer of bank ownership from the government to marketized SOEs helps to improve the stability of the banking system.

The remainder of the paper is structured as follows. Section 2 introduces the institutional background of the Chinese banking sector. Section 3 develops our predictions on the impact of the controlling shareholders. Section 4 presents the research design. Section 5 provides the empirical results and Section 6 concludes.

2. Institutional background

Over the last thirty years, the Chinese authorities have implemented a series of significant reforms aimed at transforming the country's banking sector from policy-driven, wholly state-owned and monopolistic to market-oriented and competitive. One important aspect of the reform is the ownership restructuring of the Chinese banks through the introduction of foreign strategic investors, getting listed on stock exchanges, and sales of shares to domestic firms. These gradual reforms

[1] Firth, Lin, Liu, and Wong (2009) find evidence that political connections play a role in gaining access to bank finance in China.

[2] There are a number of studies assessing the efficiency or other performance of the Chinese banking sector (e.g., Fu & Heffernan, 2007; Shin, Zhang, & Liu, 2007; Berger et al., 2009), but they do not explore either banks' risk-taking behaviour or the role of controlling shareholders in banks.