Journal of Financial Stability 9 (2013) 475–486

Contents lists available at ScienceDirect

Journal of Financial Stability

journal homepage: www.elsevier.com/locate/jfstabil

Connected lending and concentrated control☆

Siwapong Dheera-aumpon*

Department of Economics, Kasetsart University, Thailand

ARTICLE INFO

Article history:
Received 17 October 2012
Received in revised form 2 April 2013
Accepted 23 July 2013
Available online 2 August 2013

JEL classification:
G21

Keywords:
Firm financing
Financial institutions
Bank governance

ABSTRACT

Banks' controlling owners may exploit business relationships with other firms so as to tangibly or intangibly benefit themselves. This paper uses data from more than 2600 firms across 25 countries to study whether the control rights of the banks' controlling owners are associated with whether firms need special connections with banks in order to obtain loans. I find that the control rights of the controlling owners increase the need for special connections. I also find that supervisory power raises the need for special connections and intensifies the adverse effect induced by concentrated control. No evidence is found that shareholder rights protection reduces the need for special connections, nor that bank officials become less corrupted as the control rights of the controlling owners increase. The results thus indicate that an increase in the control rights of the banks' controlling owners only reduces the integrity of bank lending.
© 2013 Elsevier B.V. All rights reserved.

1. Introduction

Ideally, financial intermediaries such as commercial banks allow better resource allocations as they can provide better loan contracts. According to Diamond (1984), with delegated monitoring, well-diversified financial intermediaries should allocate resources properly. In reality, we frequently observe departures from this ideal world. One departure occurs in the form of connected loans. Banks may extend loans to some borrowers based on the fact that they are related, and disregard borrower characteristics. Leightner (2007) argues that some politicians considered loans from the Bangkok Bank of Commerce, which collapsed in 1996, as bribes and had no intention to repay. In 1996, many Thai financial institutions also faced serious cash flow problems due to non-performing loans which were granted to the real estate sector. Also, Bualek (2000) argues that the founders of most Thai commercial banks set up banks in order to channel funds to their own non-bank businesses.

Most large Thai firms and banks are controlled by prominent families and are explicitly related to each other by share holding or implicitly in some way. Charumilind et al. (2006) found that Thai firms which are related to such families have better access to long-term loans, while firms without connections have to rely on short-term loans. Since an investment in physical capital is better facilitated by long-term loans, firms with better access to long-term loans should be more able to acquire capital. Thus, firms with exactly the same characteristics except their special connections may end up with different amounts of capital. Their result also shows that related firms have more total assets and sales than unrelated ones. Also, Beck et al. (2005) show that firms which reported being constrained by the need for special connections with banks have significantly lower growth rates.

Special connections and related loans are prevalent in many countries including Russia and Mexico. Laeven (2001) found that many Russian firms hold shares of the banks that grant their loans and some firms are even the major shareholders of such banks. He also found that firms that are related to banks get preferential loan sizes. La Porta et al. (2003) found that loans to insiders have interest rates 4.15–5.15 percentage points lower than those of outsiders' loans, and they have longer maturities and grace periods, higher default rates, and lower recovery rates than loans to outsiders.

This paper is also motivated by Levine's (2004) argument that banks' controlling owners may exploit business relationships with other firms so as to benefit themselves. Particularly, banks' controlling owners may channel funds to businesses of their own or those connected with them. Laeven and Levine (2009) also show that major owners with substantial cash-flow rights induce banks to increase risk taking. In addition, Haw et al. (2010) show that banks with more concentrated control have poorer performance, lower cost efficiency, and higher insolvency risk. Yet, to my knowledge, there exists no study which investigates the relationship between

☆ I am grateful to Paul Evans for his guidance and support. I thank Hu McCulloch, Pok-sang Lam, Nan Li, and Pornkamol Traiwittayanggoon for their helpful comments and suggestions. I also would like to thank the Editor, Iftekhar Hasan, and two anonymous reviewers for their helpful and constructive comments.

* Corresponding author at: Department of Economics, Faculty of Economics, Kasetsart University, Bangkok 10900, Thailand. Tel.: +66 81 742 9514.
E-mail addresses: dheera-aumpon.1@osu.edu, siwapongt@gmail.com

1572-3089/$ – see front matter © 2013 Elsevier B.V. All rights reserved.
http://dx.doi.org/10.1016/j.jfs.2013.07.005

the control rights of the banks' controlling owners and the issue of connected lending. Beck et al. (2006) study the effects of bank supervisory policies on the corruption of bank officials. Beck et al. (2004) study how firm size affects the need for special connections with banks faced by firms. This paper looks at the issue of connected lending in a different way. Particularly, this study examines whether the control rights of the banks' controlling owners increase the need for special connections with banks, and examines how legal and supervisory systems affect this relationship.

This paper uses firm-level data on more than 2600 firms across 25 countries to study the relationship between the control rights of the banks' controlling owners and the problem of the need for special connections with banks faced by firms, while controlling for various firm characteristics and country-level factors. The firm-level data is obtained from the World Business Environment Survey (WBES) which was conducted between late 1999 and early 2000. This data set includes information on the degree to which the need for special connections with banks is an obstacle to firms' operation and growth. These data are based on a survey question which asks firms to rank the issue on a scale from one to four, with higher values indicating that the need for special connections is a greater obstacle. The higher values also indicate the more prevalence of connected lending and thus the more resource misallocation. The data on the control rights of the banks' controlling owners are taken from Caprio et al. (2007).

Beck et al. (2006) discuss the advantages of using the WBES data. First, it provides direct information on the degree to which the issue is an obstacle for firms. Second, it covers firms of all sizes and ownership types. Third, it provides firm-level characteristics so that I can control for them and draw appropriate inferences about the relationship between the control rights of the banks' controlling owners and the extent of connected lending. In addition, another advantage of using the WBES data is that it does not restrict the scope of connected parties to insiders and shareholders as in La Porta et al. (2003) and Laeven (2001). Also, as pointed out by Beck et al. (2006), there are good reasons to believe these self-reported data do not bias the results in favor of this paper's findings. First, if a firm facing the same obstacle responds to the survey question differently to the extent that it is a pure measurement error, it would only bias the results against finding the relationship. Second, the results are robust when I control for many firm-level and country-level characteristics.

Due to the discrete nature of the dependent variable, I use the ordered probit procedure. The dependent variable is the measure of the degree to which the need for special connections with banks is an obstacle for firms seeking external finance, and the key explanatory variable is the country average of the control rights of the banks' controlling owners. I use the country-level variable because the survey question of interest is about the whole banking system rather than an individual bank, and firms can apply for loans from any banks.

The results are consistent with the argument that bank control concentration is susceptible to severe agency problems which raise the need for special connections with banks faced by firms seeking external finance. Specifically, I find that the control rights of the banks' controlling owners always increase the need for special connections. The results also indicate that bank supervisory power raises the need for special connections. Furthermore, I find that the relationship between the control rights of the controlling owners and the need for special connections is stronger as bank supervisory power increases. However, it is unclear whether private monitoring can reduce the need for special connections and the adverse effect induced concentrated control. Moreover, I do not find that shareholder rights protection reduces the need for special connections. In addition, I find that the control rights of the banks' controlling owners have no significant relationship with the corruption of bank officials, indicating that bank control concentration does not improve the internal governance of banks.

This paper contributes to the literature on bank corruption as it points out the important role played by the control rights of the banks' controlling owners on the integrity of bank lending. Particularly, this paper documents the relationship between bank control concentration and the degree to which it obstructs the ability of firms to raise external finance. This paper indicates that the cash-flow rights might not induce banks' controlling owners enough to improve the integrity of bank lending. This paper also points out the distinction between the need for special connections with banks and the corruption of bank officials, suggesting that they reflect different issues in bank governance.

The remaining of the paper is organized as follows. Section 2 describes the data, the variables, and the model. Section 3 presents and discusses the results. Section 4 tests the robustness of the results, and Section 5 concludes.

2. Data, variables, and model specification

2.1. Presentation of the variables

2.1.1. Need for special connections as a financing obstacle to firms

The data at the firm level are obtained from the World Business Environment Survey (WBES) which was conducted between late 1999 and early 2000 in 80 countries, both developing and developed. The WBES data comprise the survey responses of over 10,000 firms of all sizes- small, medium, and large. The survey question of interest asks the management of a firm to indicate how problematic the need for special connections with banks or financial institutions is for the operation and growth of its business. The answer to this survey question is assigned a value of 1 for no obstacle, 2 for minor obstacle, 3 for moderate obstacle, and 4 for major obstacle.

2.1.2. Bank ownership

The data on ownership structure of banks are taken from Caprio et al. (2007). Their data set is based on the information of the 10 largest publicly listed banks of each country ranked by their total assets at the end of 2001. The ownership data are from either 2000 or 2001. Since ownership structures are relatively constant over time, this difference in timing should not pose any problems. After combining the above data sets, the sample consists of about 3000 firms across 28 countries. A bank is defined to have a controlling owner if there is a shareholder directly or indirectly holding at least 10% of the voting rights. If there is no such shareholder, the voting rights data is assigned a value of zero. If there are multiple shareholders each having more than 10% of the voting rights, the largest shareholder is picked as the controlling owner. The control rights variable is constructed as the country average of the fractions of the voting rights of the banks' controlling owners. I use the country-level variable because the survey question of interest asks firms about the whole banking system rather than an individual bank, and firms can apply for loans from any banks. This data set also identifies whether the controlling owners are individuals/families, states, widely held financial corporations, widely held non-financial corporations, or others. The widely, family, state, financial, and corporation variables are the fractions of banks which have no controlling owner, an individual/family, the state, financial corporation, and non-financial corporation as their controlling owners, respectively.

2.1.3. Bank supervision

The integrity of bank lending can be influenced by bank supervisory practices as studied by Beck et al. (2006). They found that

Download English Version:

https://daneshyari.com/en/article/10487990

Download Persian Version:

https://daneshyari.com/article/10487990

Daneshyari.com