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Choice of corporate debt in China: The role of state ownership

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ABSTRACT

We analyze the factors affecting the decisions of Chinese firms to take on debt in the form of either bonds or syndicated loans over the period of 2006–2010. The study reveals the extent to which corporate debt choices are politically or economically driven. We test if central government ownership, flotation costs, asymmetries of information, and renegotiation and liquidation costs influence the choice of debt. We find evidence in favor of the influence of central government ownership on the financing choices of firms because Central State owned firms are more likely to issue bonds and to borrow uniquely on the bond market, rather than tapping both debt markets. Overall, our findings show that financial factors play a much more minor role in corporate debt choices compared to other countries, whereas central government ownership is a key determinant of preference for the bond market.

1. Introduction

The Chinese financial system is characterized by a weak, albeit fast-growing, corporate bond market and an over-dominant banking industry.[1] As Chinese banks have proven to be poorly efficient (Berger, Hasan, & Zhou, 2009) – mainly because of a lack of experience in risk management and severe political influence in lending decisions (Yeung, 2009) – capital allocation remains biased towards inefficient state-owned companies in China. In the long run, this misallocation of capital threatens the development of the country.

A competitive corporate bond market should alleviate such concerns by providing benchmarks in risk pricing and putting pressure on banks to attract other types of borrowers, such as small and medium enterprises, which are currently rationed on the credit market (Herring & Chatusripitak, 2006).

To determine whether this capital allocation problem can be solved through the corporate bond market development, one needs to understand whether the banking system and the corporate bond market truly compete in China. This paper provides evidence on this issue by analyzing the determinants affecting firms' choice of debt market. Thus, our aim is to investigate the determinants of the choice for a Chinese firm to issue a bond, rather than borrowing from banks.

The Chinese Communist Party has recognized the usefulness of capital markets and the importance of developing the corporate bond market in its *Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets* in 2004. The

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[1] In 2006, the corporate bond market provided only 1.4% of the financing needs of Chinese firms (Hale, 2007). Its growth reached 24.13% on average during the period 1990–2006 (People's Bank of China and China Statistical Yearbooks, cited by Allen, Qian, Qian, & Zhao, 2009). In 2010, bank loans accounted for 75% of non-financial sector's external funding sources (People's Bank of China, China Monetary Policy Report, 2010).

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Governor of the People's Bank of China (PBOC) stated that "China's underdeveloped corporate bond market has distorted the financing structure in the economy which poses a threat to financial stability, as well as to social and economic development" (Zhou, 2005).

However, since the market turmoil in the early 1990s, during which an important proportion of issued bonds ended up in default, China's corporate bond market development has been impeded by tight regulation on bond issuance approval. The regulator notoriously favored large state-owned enterprises to avoid financial instability in the corporate bond market. The situation evolved in 2007 when the China Securities Regulatory Commission (CSRC) published new issuance rules.

It is, however, not clear whether corporate bond issuance is free from political intervention in China. On the one hand, Central State owned enterprises have historically been favored in their access to the corporate bond market. On the other hand, there has been an official move since 2004 to recognize the usefulness of the corporate bond market development. We employ a set of hypotheses to analyze whether the choice of corporate debt is politically or economically driven in China.

Firstly, we consider a central government ownership hypothesis that can influence the approval required to issue a corporate bond. We investigate whether state ownership at the central level plays a role on the choice of debt financing with recent data on listed firms' debt choices. Moreover, as favoritism towards Central State enterprises has been driven by the will to avoid corporate bond defaults in the market, we expect that Central State owned enterprises that present less asymmetries of information for the regulators are to be particularly favored in the approval process.

Secondly, three financial theories have been provided to explain the choice between public and private debt issuances in the literature: flotation costs (Blackwell & Kidwell, 1988), asymmetries of information (Diamond, 1991; Rajan, 1992), and costs of debt liquidation and renegotiation (Berlin & Loeys, 1988). We analyze the relevance of these theories in China.

We test these four theories of corporate financing choices on a dataset of 220 Chinese listed firms during the period of 2006–2010. In line with the method of Esho, Lam, and Sharpe (2001), we employ an incremental approach, rather than focusing on balance sheet ratios. This method allows us to identify factors related to a particular issuance type. Therefore, we study which factors increase the probability for a firm to issue a bond, rather than a syndicated loan.[2] We also examine which factors explain a firm's choice to select only one of these markets, rather than borrow on both markets during the sample period.

We find that ownership influences the choice of corporate debt in China because Central State owned firms are more likely to issue a bond, rather than a syndicated loan. We also observe limited support for the premise that this influence is stronger for Central State owned firms located closer to the regulator. Moreover, we find that these companies tend to borrow uniquely on the bond market, rather than tapping both debt markets. We provide evidence in favor of the flotation cost hypothesis but provide weak evidence for the renegotiation and liquidation hypotheses and reject the information asymmetry hypothesis. These results show that financial factors do not play a strong role in debt choices, whereas ownership matters. Consequently, the corporate bond market and the banking industry do not appear to truly compete on a financial basis to attract borrowers.

This paper's contribution to the literature of debt choice is twofold. Firstly, we take into account a key characteristic of China: the influence of the State on the economy. Secondly, we analyze the relevance of the three financial theories that explain choices of debt in the literature for China. The study provides evidence on the lack of perspective for the future development of the corporate bond market in China. To the best of our knowledge, this study is the first to examine the choice of debt in China.[3]

Next, we extend two empirical works, which have similarly investigated the choice of large debt financing between bonds and syndicated loans based on these three theories. Esho et al. (2001) perform this analysis on a sample of debt financings in Asian countries, which are widely dominated by financings of Japanese companies. China is included in the sample, but only for 6 syndicated loans, whereas no Chinese bonds are considered. Esho et al. (2001) test the influence of several financial variables to investigate the relevance of the three theories. These researchers find empirical support for the three theories, notably with bond issuances related positively to firm size and negatively to the probability of financial distress of the issuer. Altunbas, Kara, and Marques-Ibanez (2010) focus on determinants of financing choices between corporate bond and syndicated loan markets in European countries. These authors also find support for the three theories of corporate financing choices. In particular, larger firms with more financial leverage, higher fixed assets to total assets, but fewer growth opportunities are more likely to borrow from the syndicated loan market, rather than the corporate bond market.

The rest of the paper is organized as follows. Section 2 presents an overview of the large debt markets in China. Section 3 reviews the determinants of financing choices. Section 4 describes the data and methodology. Section 5 develops the results. Section 6 concludes.

2. Overview of large debt financing markets in China

2.1. The corporate bond market

The bond market still remains notably small, although its annual growth was sustained at 26.9%, on average, during the period of 1995–2005 (OECD, 2010). The total outstanding bonds reaches 45% of GDP by mid-2009, a comparable figure to that

[2] The main alternative financial instrument to a bond is indeed a syndicated loan, as a bond issuance is associated with a large amount more commonly provided by a syndicate of banks than by one single bank (see Section 2.3).

[3] Some studies have explored the determinants of capital structure, i.e., the choice between debt and equity in China (see e.g., Huang & Song, 2006; Qian, Tian, & Wirjanto, 2009; Tse & Rodgers, 2011; Li, Yue, & Zhao, 2009).