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Political connection of financial intermediaries: Evidence from China's IPO market[☆]

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ABSTRACT

Using a sample of Chinese Initial Public Offerings (IPOs) from 2006 to 2011, we document that politically connected (PC) underwriters increase the likelihood of clients' IPO applications being approved by the Chinese Securities Regulatory Commission (CSRC). We further show that PC underwriters charge premium underwriting fees. Consistent with the rent-seeking argument, we find that minority shareholders' interests may be impaired as indicated by post-IPO underperformance. We do not detect significant differences in the underpricing of IPO deals underwritten by PC versus non-PC investment banks.

1. Introduction

Reputation and relationships are two important factors for investment banks to be successful in fulfilling their role of financial intermediaries (Morrison and Wilhelm, 2007). Reputational effects have been extensively researched in the literature (Beatty et al., 1998; Rau, 2000; Fang, 2005; and McKenzie and Takaoka, 2008, among others). Prior studies have documented that reputable underwriters experience faster expansion and enjoy price premium. In contrast, studies examining the effect of relationships on investment banks are scarcer, with few exceptions (Allen and Babus, 2009). Yasuda (2005,2007), for example, show that the underwriter's relationships with commercial banks are effective in attracting new clients and retaining the incumbent clients for corporate bond underwriting businesses.

Political connections, a specific form of relationships, play an important role in economic activities, especially in emerging markets with less developed legal systems, more government interventions, and weaker investor protection (e.g., Faccio, 2006; Fan et al., 2007; Claessens et al., 2008). Previous studies, however, have mainly focused on individual firms' political connections with regard to access to bank loans, borrowing terms, bailout events, long-term performance, and market values, etc. (e.g., Fisman, 2001; Khwaja and Mian, 2005; Faccio et al., 2006; and Ferguson and Voth, 2008). These studies show that firms benefit from such political connections at significant social costs.[3] If financial intermediaries can similarly employ political connections for private benefits, their professionalism may be compromised, resulting in a misallocation of scarce economic resources. However, research on the implications of financial intermediaries' political connections has been very limited. To the best of our knowledge, Butler et al. (2009) is the only study that considers the possible effect of underwriters' political connections in bond markets.

In this study, we extend the analysis to the effect of underwriters' political connections in the initial public offering (IPO) mar-

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3 For example, Khwaja and Mian (2005) estimate that the rent-seeking costs related to political connections in the bank lending process range from 0.2% to 1.95% of GDP each year in Pakistan.

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ket. China's emerging stock market provides an ideal setting for us to delve deeply into these questions. Since its inception, the Chinese stock market has been tightly regulated and controlled by the government. Regulation generates rent-seeking opportunities that can be exclusively appreciated by those with ample political capital (Shleifer and Vishny, 1993).[4] The investment banks in China vary with regard to their political connections. Specifically, the executives of some investment banks once worked as senior bureaucrats in government agencies or even in regulatory agencies for the capital market. The political capital accumulated from such experience is expected to solicit preferential treatment for their clients when the underwriter interacts with government agencies. We define an underwriter as politically connected (PC) if its chairman or CEO has working experience in the government/military at or above the deputy bureau level, or in the China Securities Regulatory Commission (CSRC), or currently sits on the Stock Issuance Examination Committee or M&A Committee of the CSRC. Since the company must obtain CSRC approval to access the stock market via an IPO, we expect such political capital to strengthen the competitive advantage of these investment banks in their underwriting businesses, rendering professional reputation less of a concern.

Given the unique regulatory features of the Chinese IPO market, an exploration of the role of underwriters' political connections and their economic consequences enhances our understanding of how China's capital markets operate. We thus address the following research questions in this study: 1) Do political connections influence dealings with regulators; that is, do underwriters' political connections increase the probability of their clients' IPO application being approved by the regulators? 2) Do political connections generate premium underwriting fees for the investment banks? 3) Are underwriters' political connections beneficial/valuable to minority shareholders; that is, what effect do political connections have on the quality of IPOs measured by post-IPO performance? 4) Do minority shareholders account for the effect of the underwriters' political connections; that is, to what extent do underwriters' political connections influence the underpricing of IPOs?

Using a sample of Chinese IPO applicants from 2006 to 2011, we document that the probability of obtaining IPO approval from the CSRC is much higher for deals underwritten by PC investment banks. This result is robust after we control for a number of clients' characteristics, such as firm size, leverage, return on assets (ROA), and earning quality. We also control for the characteristics of the underwriter, such as foreign ownership, central government ownership, and ranking status in the market, as well as the success rate of prior underwriting deals, and obtain robust results.

We also find that the PC underwriters recoup economic rents for their political capital by charging premium underwriting fees. Thus, both the underwriters and their clients benefit from the former's political capital. In contrast, we find that the IPO firms underwritten by PC investment banks underperform those underwritten by non-politically connected (non-PC) investment banks in the post-IPO period. The post-IPO (up to two years after the IPO) stock performance is significantly lower, and the change in accounting performance is considerably worse for the client firms of PC underwriters. Overall, these findings indicate that PC underwriters help inferior companies gain access to the equity capital markets by mobilizing their political resources to handle bureaucratic regulation and supervision, which compromises the professionalism and expertise of financial intermediaries. Further analyses show that the IPO underpricing does not exhibit significant differences between the clients of PC and those of non-PC underwriters, implying that minority investors cannot price protect themselves.

This study contributes to the literature in the following ways. First, it expands the limited literature on the value of relationship (political connections in particular) to financial intermediaries with evidence obtained from the Chinese IPO market, which can also be generalized to other relationship-based economies. Second, our study extends the literature on political connections by shedding light on the role that financial intermediaries' political connections play in capital markets. We offer additional evidence to the literature on political rent seeking by documenting how the underwriters and their clients can enjoy the benefits of political capital at the expense of minority shareholders' interests. Third, our findings add to the rich literature on IPO underpricing, effect of underwriters' professionalism and reputation, post-IPO performance, and the role of underwriters in general. Finally, our study generates important insights into the IPO process of Chinese firms and expands our knowledge of the unique features of China's security markets.

The remainder of this paper is organized as follows. Section 2 describes the institutional background of China's IPO market. Section 3 develops our research hypotheses. Section 4 presents the research sample and methodologies. Section 5 discusses our empirical findings, and Section 6 concludes the paper.

2. Institutional background

2.1. China's IPO market

The Chinese stock market has been characterized by heavy government regulation since its inception in the early 1990s. The regulation governing the Chinese IPO market has experienced several stages. The initial "quota" system with tight government control was followed by the relatively more market-based "channel" system with confined competition among underwriters. In 2004, the CSRC switched from the "channel" system to the "sponsorship" system, which is an even more market-based mechanism and allows the underwriter to play a much more important role than ever before. In the IPO process, the sponsor recommends its client firm for IPO application to the CSRC. Only those who pass the CSRC evaluation and gain approval can seek an IPO. Accordingly, underwriters take on more responsibility under the "sponsorship" system. For example, in addition to the services provided during the IPO process, the underwriter would also be held responsible for its clients' information disclosure in the two years following the IPO. This requirement strengthens underwriters' incentive to deliver diligent service in the IPO market and intensively monitor their clients. This system is intended to introduce market mechanisms into the Chinese IPO market and is expected to improve the protection for minority shareholders, mitigate the government intervention in the IPO market, and enhance market institutions.

As a common feature in the above mentioned IPO systems, the regulator plays an essential role in deciding which firms can finally go to the IPO market. Firms pursuing IPOs in China must satisfy with a set of bright line regulations. For example, it requires that the cumulative net profits of the firm in the three years prior to the IPO must exceed 30 million renminbi (RMB); the company cannot report a net loss in any of the three years prior to its listing on the main board. Additionally, the firm needs to meet a number of qualitative and ambiguous criteria, which allows for significant discretions in the IPO approval process. For instance, the firm is required to set up functioning corporate governance before going for the IPO.

[4] Yang (2013) investigates the impact of the political connections of audit firms, defined as having partner serving on the Issuance Examination Committee of the China Securities Regulatory Commission (CSRC), on the decision of IPO application of its clients. Given the specific form of connection as he focuses on, unsurprisingly he finds that the connected auditors increase the likelihood of its clients obtaining IPO approval and they charge a premium in audit fees. We focus on the political connections of underwriters since underwriters play a more crucial role in handling the regulators than auditors in the IPO application process.