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Family control and loan collateral: Evidence from China

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Using a sample of 612 listed Chinese non-SOEs from 2006 to 2009, we show that the use of collateral is higher in family-controlled firms. This effect is more pronounced when family firms have a larger control-ownership wedge, family representation in management, and are led by a descendant chairman/CEO. We further document that having multiple large shareholders, paying higher dividends, having completed the split-share structure reform and being located in provinces with more competitive credit markets can mitigate the incentive of controlling families to engage in expropriation and reduce the level of collateral required. Overall, we contend that in China, the risk of expropriation associated with family control leads to an increased credit risk and, in turn, higher collateral being required by banks.

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1. Introduction

Recent research on the agency conflicts between controlling families and creditors takes two distinct perspectives. The first perspective, labeled reputation concern, argues that family firms are long-term investors who are most concerned with survival, preserving the family's reputation and building a lasting relationship with creditors, in order to mitigate agency conflicts (Anderson et al., 2003; Ellul et al., 2007). The second perspective, known as entrenchment, contends that family control exacerbates the agency conflicts between shareholders and creditors through excessive family control rights and family management, which enables the extraction of private benefits and results in a higher agency cost of debt (Boubakri and Ghouma, 2010; Lin et al., 2011; Yen et al., 2015).

These studies, however, exclude the second largest market, China, where the relative costs and benefits of family control are less straightforward. On the one hand, China has a poor institutional environment and weak legal protection for investors. On the other hand, the Chinese public bond market is underdeveloped and most borrowing comes from banks (Firth et al., 2008). Thus, by focusing on the Chinese lending market, this paper aims to fill this gap by empirically investigating the agency conflicts between controlling families and banks, and how banks react to the behavior of family firms by requiring collateral, an indicator of the agency cost of debt.

China also provides an excellent setting for our study. In a market-oriented loan market, a bank can price credit risks through both the interest rate and the requirement for collateral. However, in an emerging market in which controlling shareholders are more likely to engage in expropriation, using collateral as a measure of the cost of debt is more relevant to banks (Menkhoff et al., 2006; Bae and Goyal, 2009). Furthermore, as the lending rate in China is relatively regulated,[1] banks rely more on collateral to control credit risks. In addition, although family firms have only developed in China quite recently, they have made a considerable contribution to the entire economy. In this sense, an investigation into the agency conflicts between controlling families and banks provides a useful

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[1] During our research period between 2006 and 2009, the People's Bank of China (PBC) relaxed the ceiling of the lending rate but still placed a floor on it, which is 90% of the benchmark interest rate set by the PBC. Though commercial banks have some autonomy to increase the interest rate charged on loan contracts, they were less likely to increase the interest rate due to the severe competition among domestic banks, as well as with foreign banks (Yao et al., 2007). Thus, the interest rate was relatively regulated and less efficient for reflecting the risks of borrowers over the period of our study. Only recently, since 2010, when the period of our data ends, has the shadow banking system become prevalent, in which interest rates have become more market-oriented (Li and Hsu, 2012).

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addition to the literature. Moreover, the unique split-share structure reform represents an exogenous shock with respect to any individual firm, which alleviates any concern about endogeneity in respect of ownership structure.

We follow Anderson and Reeb (2003) and Villalonga and Amit (2006) and define a family firm as one in which the founder or a member of his/her family, by either blood or marriage, is an executive, director or blockholder.[2] We further consider three elements of family control. One is the control-ownership wedge, defined as the divergence between control rights and cash flow rights, following Claessens et al. (2002). The second proxy is family representation in management, defined as when a family member acts as chairman or CEO (Villalonga and Amit, 2006). The last proxy is descendant chairman/CEO, defined as when a descendant acts as chairman or CEO.

Our univariate analysis shows that the use of collateral for family firms is 7.42% higher than for non-family firms. By conducting a multivariate analysis, we further document that this difference becomes larger when family firms have a larger control-ownership wedge, family representation in management, or heirs of the founders in management, and becomes smaller if family firms have multiple large shareholders, pay higher dividends, have completed the split-share structure reform or locate in provinces with more competitive credit markets. Our main findings are robust to alternative estimation methods and the application of the bank loan level dataset. Our further analysis shows that our main findings are not driven by alternative explanations.

Our study contributes to several strands of literature in the following ways. First, existing studies find that investor protection in China is quite weak and the investor protection score is significantly below the average of other countries due to strong bureaucratic influence (Allen et al., 2005; Berkman et al., 2011). We document that, under these conditions, the severe agency problems with other investors, faced by family firms, result in a high agency cost of debt. Therefore, our study adds additional evidence to the literature with regard to the agency problems between family firms and creditors (Boubakri and Ghouma, 2010; Lin et al., 2011).

In addition, unlike Amit et al. (2014), who compare the performance between family firms and state-owned enterprises (SOEs), we examine the impact of different types of ownership on the use of collateral by focusing on non-SOEs, which are free of the implicit guarantee that government provides to SOEs. Moreover, the comparison between family firms and other types of non-SOEs is more justifiable, as they all face the same dominant agency problem, which is between the controlling shareholder and minority shareholders, while the dominant agency problem in SOEs is between managers and shareholders (Villalonga and Amit, 2006; Fan et al., 2013).[3] Therefore, we present a complementary perspective to that of Amit et al. (2014).

Furthermore, this study confirms the importance of a proper privatization process, such as the split-share structure reform, in an emerging market. We provide evidence that the reform may reduce the inherent risks that concern banks, leading them to lower the amount of collateral they require, which supports the findings of Li et al. (2011) that the reform removes market frictions. Finally, extending the studies of Lin et al. (2011) and Hainz et al. (2013), who argue that credit market competition reduces the cost of borrowing, we provide com plementary evidence that credit market competition lowers the amount of collateral required by banks.

The rest of the paper proceeds as follows: Section 2 discusses the institutional background and develops the hypotheses; Section 3 describes the data and methodology; Section 4 discusses the empirical results and additional tests; and Section 5 concludes.

2. Institutional background and hypothesis development

In this section, we describe the evolution of listed family firms in China, as well as the collateral required by creditors and the means of recourse available to creditors, to provide institutional background for our study. Then, we develop our main hypotheses based on existing theories and China's institutional system.

2.1. Institutional background

2.1.1. Listed family firms

Family firms in China evolved for a short period along with the Chinese economic reform. Even after the establishment of two stock exchanges in China in the early 1990 s, the government issued 'Provisional Regulations for the administration of the issuance and trading of stock' in 1993, which still stipulated that individuals were not allowed to directly hold more than 0.5% of the total shares issued by a listed company. Later on, in 1998, this stipulation was abolished and the first family firm was listed in 2001. Although listed family firms only accounted for a small proportion of all family firms, these listed family firms contributed over 90% of the GDP made by all family firms, while the latter accounted for more than 50% of total national GDP, according to the survey conducted by the State Administration for Industry & Commerce of the People's Republic of China (SAIC).[4] Therefore, these listed family firms are quite representative of all family firms.

2.1.2. Collateral requirements on bank lending

Originally, bank loans mainly took the form of credit loans granted at low interest rates and without any guarantees or collateral; this, among other factors, resulted in a higher ratio of non-performing loans (NPL). As the market-oriented economy developed, banks became aware of lending risks, and from the 1990 s they increasingly demanded collateral (Chen et al., 2013). Indeed, according to a survey of 13 domestic banks between 2000 and 2005, the average proportion of collateral loans increased from 22% to 32% of all loans granted (Yang and Qian, 2008).

The bankruptcy law (enacted in August 2006 and taking effect in June 2007) also affected creditors' propensity to require collateral. This law resembles the bankruptcy laws in many other countries, and creates an effective threat of bankruptcy for all listed firms. The current law facilitates bankruptcy proceedings, as it clarifies creditor rights, bankruptcy expenses and other procedural matters (Lee and Ho, 2010; Mo et al., 2015). In particular, it specifies that the bankruptcy process starts with the formal application for bankruptcy, and that liquidation and reorganization are two alternative forms of recourse for creditors, who can apply directly to the People's Court. By requiring collateral, creditors enjoy the right to make a pre-emptive claim prior to the debtor company's

[2] Consistent with Amit et al. (2014), family firms are those in which the largest stake in ownership can be traced back to the founder, if the firm was founded within the private sector, or to the entrepreneur, if he/she took over a previous SOE when it was privatized.

[3] As argued by Fan et al. (2013), SOEs do not have a 'true' owner to take care of their interests, so the main conflict of interest exists between the shareholders and managers. Moreover, the pyramid ownership structure of SOEs in China is formed by the governments' incentives to reduce their interference to the business operation of the firms under their control. Thus, the divergence between control and cash-flow rights reflects the delegation of formal authority rather than the level of expropriation. As a result, the agency problem between shareholders and managers dominates the agency problem between the largest shareholders and minority shareholders in those SOEs.

[4] Source: http://business.sohu.com/20150427/n412042902.shtml.

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