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Do politically connected independent directors create or destroy value?☆

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ABSTRACT

We investigate whether politically connected independent directors (PCIDs), compared with other independent directors, create or destroy firm value and the channels through which they create or destroy firm value. Based on an exogenous regulatory change, we find that PCIDs—especially high level PCIDs—destroy firm value compared with non-PCIDs. The value-destroying effect is a net effect of: (i) PCIDs are less effective than non-PCIDs in monitoring managers, (ii) PCIDs do not differ from non-PCIDs in monitoring controlling shareholders, and (iii) PCIDs can divert political resources to a firm. However, PCIDs' value-destroying effect can be attenuated by effective external governance mechanisms (i.e., high levels of marketization and analyst coverage). Our results make a significant contribution to the literature and have important policy implications.

About three hundred independent directors with political connections voluntarily resigned since October, 2013. Up to July 22nd, 2014, all the politically connected independent directors of the largest ten listed firms on the A share market have resigned.

—People's Daily, July 24, 2014

1. Introduction

The independent director system has captured considerable attention from both academics and practitioners in the past two decades. However, the prevalent research has not yet reached an agreement on the firm value that can be brought in by independent directors (Core, Holthausen, & Larcker, 1999; Hermalin & Weisbach, 1991; Nguyen & Nielsen, 2010; Rosenstein & Wyatt, 1990). There are at least two possible reasons for this mixed evidence (Zona, Gomez-Mejia, & Withers, 2015). First, the net effect of an independent director is a combination of his or her effectiveness as an independent director in both mitigating agency conflicts (Fama & Jensen, 1983; Ye, 2014) and providing resources (Pfeffer & Salancik, 2003; Wang, 2015). Second, and more importantly, independent directors with different backgrounds can behave differently in their monitoring and resource-providing roles. To that end, it is crucial to explore the value effect of specific types of independent directors and the channels through which they create or destroy firm value.

China issued a new regulation titled "Opinion Regarding Further Regulating Party and Government Officials' Part-Time (and Full-Time) Careers in Enterprises" (hereafter the Opinion) on October 19, 2013. Employing the Opinion as an exogenous shock, we investigate the value of a particular type of independent director, that is, the politically connected independent director (PCID). The idea of having (usually former) politicians serving as independent directors on corporate boards is not new in the West. Politicians account for approximately 10% of all independent directors in the United States (Do, Nguyen, & Rau, 2015).[2] However, no market has ever witnessed such a pervasive presence of PCIDs as the Chinese market has. Statistics show that political figures accounted for approximately 45% of all independent directors in the Chinese A-share market before the regulatory reform.[3]

In this study, we aim to answer the questions of (i) whether PCIDs create or destroy value compared with non-PCIDs[4] and (ii) how they do so. China provides a unique and rich setting in which to investigate the

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[2] Politicians who serve as independent directors are also common in emerging markets. A 2014 *Times of India* article, for example, reported that many politicians serve as independent directors in the banking sector of Indian public firms (August 6, 2014).

[3] The figure was obtained from the iFind database, a Chinese stock market data provider and news agency that is similar to Bloomberg, as of September 30, 2013.

[4] We draw our conclusion using non-PCIDs as the benchmark. The focus of this study is the value effect of PCIDs, as compared with non-PCIDs, rather than the value effect of independent directors in general. Therefore, when we refer to PCIDs' value-creating (value-destroying) effect, it should be interpreted as PCIDs being more (less) valuable than non-PCIDs. To be concise, we use the terms *create* (*destroy*) *value* and *more* (*less*) *valuable* interchangeably throughout the paper.

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above questions. First, the Opinion serves as an exogenous regulatory shock to investigate how the market values a specific group of independent directors, that is, PCIDs, and how their monitoring and resource-providing roles differ from those of other types of independent directors (non-PCIDs). The Opinion offers a unique opportunity to examine the value of PCIDs largely free from endogeneity concerns. Specifically, the Opinion largely prohibits incumbent and former politicians from accepting appointments as independent directors in any enterprise, including listed firms.[5] This exogenous regulatory shock serves as a natural experiment and enables us to investigate the overall value effect of PCIDs compared with that of non-PCIDs. In contrast, the literature on the value of independent directors likely suffers from endogeneity issues (Hermalin & Weisbach, 1998; Shivdasani & Yermack, 1999), which could lead to biased conclusions.

Second, the literature typically focuses on one specific type of agency conflict and treats all firms homogeneously. However, Chinese listed firms face the traditional principal–agent (P-A) conflicts between shareholders and management, as well as severe principal–principal (P-P) conflicts between controlling and minority shareholders (Sun, Hu, & Hillman, 2016; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). On one hand, managers may not act in the best interests of outside shareholders. On the other hand, different types of shareholders have different interests and incentives. When firms are domiciled in countries with weak legal protection of property rights, controlling shareholders are able to exploit minority shareholders (Young et al., 2008). In this sense, China provides a rich setting that enables us to study PCIDs' roles in different scenarios.

Third, PCIDs were common throughout Chinese listed firms before the regulatory reform. China provides the largest market for studying the consequences of PCIDs. At the same time, China is the fastest growing emerging market. As such, it is important to obtain an insightful understanding of PCIDs in China.

Based on a sample of non–state-owned enterprises (non-SOEs) in the Chinese A-share market, we find significantly positive price jumps for firms with PCIDs in various event windows around the issuance of the Opinion, which indicates that the market perceives the potential departure of PCIDs as good news for these firms. The positive market reaction thus implies an overall value-destroying effect of PCIDs. We then investigate the channels through which PCIDs destroy value. We find that PCIDs, compared with non-PCIDs, are not significantly different in their monitoring role when they face P-P conflicts. However, PCIDs are less valuable than non-PCIDs in mitigating P-A conflicts. We find some weak evidence for PCIDs' resourcing role. Taken together, our results suggest that PCIDs' overall value-destroying effect is a net effect that is driven by their loose scrutiny and weak political resource provision. Our results are robust to different measures of PCID presence, different proxies for P-P and P-A conflicts and resource demands, and different event windows. We also show that PCIDs' value-destroying effect is mainly driven by central-level PCIDs, PCIDs of high political rank, and PCIDs who serve (or have served) in the government, the Communist Party (the Party), the National People's Congress (NPC), or the Chinese People's Political Consultative Conference (CPPCC). However, PCIDs' value-destroying effect can be attenuated by the strength of external monitoring mechanisms.

The current study contributes to the literature in the following three ways. First, while most of the previous studies investigate the value effect of independent directors in a general sense (Basuil & Datta, 2017; Core et al., 1999; Kim & Lim, 2010; Rosenstein & Wyatt, 1990), we investigate the channels through which independent directors, in particular PCIDs, can affect firm value. Specifically, we separately examine PCIDs' monitoring role when P-A or P-P conflicts prevail in a firm. We also investigate PCIDs' resourcing role when the firm demands various resources. A deep understanding of the channels through which PCIDs affect firm value provides important implications for corporate governance systems, especially for firms with politicians serving on the board.

Second, we provide new empirical results that are arguably free from endogeneity concerns. As has been noted by previous studies, board independence and firm performance are interdependent (Hermalin & Weisbach, 1998), and the selection of independent directors is hardly exogenous (Shivdasani & Yermack, 1999). Without controlling for endogeneity, the conclusions on the value of independent directors that have been drawn by the previous research (Wang, 2015) could be biased. Although Nguyen and Nielsen (2010) use the event of the sudden death of independent directors as a natural experiment, and Dewally and Peck (2010) study the event of director resignation, their conclusions on the value of independent directors depend on the value of the successors as well as the departing directors. In this study, we take advantage of the Opinion as an exogenous event and focus on the cumulative abnormal returns over short windows. Unlike the studies of Nguyen and Nielsen and Dewally and Peck, in the current study the change in stock prices upon the regulation reflects investors' perceptions of the future departure of PCIDs, rather than their actual departure. In addition, the succeeding directors will be non-PCIDs. We are thus confident to conclude that our evidence is relatively free from endogenous concerns or other confounding events.

Third, we contribute to the literature on political connections. The literature typically investigates the consequences of politically connected managers (e.g., Fan, Wong, & Zhang, 2007; Guo, Xu, & Jacobs, 2014) and politically connected board members (e.g., Goldman, Rocholl, & So, 2009; Sun et al., 2016). Alternatively, a political tie is defined when the government (partially) owns a firm (e.g., Wu, 2011). We instead focus on PCIDs, whose incentives and capabilities in monitoring and/or providing resources may differ substantially from those of politically connected managers and board members. Therefore, while the majority of the research views political connections as valuable resources for firms, recent studies (Sun et al., 2016) realize the potential dark side of board political connection in enabling large shareholders' appropriation. In response to this line of research, we illustrate scenarios in which political connections do not necessarily deliver value to firms. More interestingly, we deepen the understanding of PCIDs' value effect by showing that their value-destroying effect is mainly driven by particular types among them. To the extent that the costs for firms, especially non-SOEs, of being politically connected are likely to be nontrivial (Lin, Morck, Yeung, & Zhao, 2016), our study reminds managers, controlling shareholders, and outside investors of the potential negative, rather than positive, value effects of political connections. Overall, our results provide a new perspective with regard to the value of PCIDs and have significant implications for investors and policymakers.

The rest of the paper is organized as follows. The next section presents the institutional background of PCIDs in China, reviews the relevant literature, and develops hypotheses. We present our sample, variable construction, and methodology before describing our empirical results. Then, we conduct several additional tests and robustness checks. In the last section, we discuss our results and conclude the paper.

2. Institutional background, literature review, and hypothesis development

2.1. PCIDs in China and the opinion

Typically, there are two types of agency problems. The first is the conflict of interest between managers (the agent) and shareholders (the principal), that is, the P-A conflict. The second is the conflict between controlling and non-controlling shareholders, that is, the P-P conflict. Both types of agency problems prevail in China. On one hand, the

[5] The regulation for incumbent and retired politicians is slightly different though, which is discussed in Appendix A.