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Chinese commercial banks: Benefits from foreign strategic investors?

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ABSTRACT

Introducing foreign strategic investors (FSIs) has been vital to China's bank ownership reforms. Using relevant data between 1995 and 2014, we employ the propensity score matching and difference in differences approaches to investigate the effects of FSIs on bank risks, including insolvency risk, capital risk, liquidity risk, asset quality, and credit risk. We make several findings. First, FSIs may significantly reduce bank risks, with the exception of insolvency risk. Second, the effects of FSIs on capital risk, liquidity risk, asset quality, and credit risk are weaker in state-owned banks than in non-state-owned banks. In addition, FSIs-assigned directors and managers could further decrease bank capital risk, liquidity risk, and credit risk, and improve bank asset quality. And directors and managers have weaker effects on bank risks in state-owned banks. Finally, bank risks exhibit no significant changes after FSI exits, and the effects of FSIs on bank risks do not differ between banks without and with exited FSIs. This suggests that spillover effects work more than monitoring effects in the context of China's financial background.

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1. Introduction

In this paper, we examine the effects of foreign strategic investors (FSIs) on bank risks, including insolvency risk, capital risk, liquidity risk, asset quality, and credit risk, in the Chinese banking sector for the period between 1995 and 2014. In contrast to the literature (Berger et al., 2009; Lin and Zhang, 2009; Xu, 2011; Jiang et al., 2013; Sun et al., 2013), we not only investigate the effects of FSIs on bank risks but also question whether FSI exits from China's banks affect their partners. Additionally, this paper explores whether the effects of FSIs on bank risks differ between state-owned banks and non-state-owned banks.

In 1996, the Asian Development Bank (ADB) spent US$19 million to purchase 92.222 million shares, a 1.9% stake in China Everbright Bank, which is a national joint-stock bank. This is the first case for introducing FSIs of China's commercial banks. Since then, numerous Chinese banks have introduced FSIs. By the end of 2014, 43 of China's banks had introduced FSIs. However, contrary to the initial expectations of both FSIs and Chinese banks, some FSIs began to sell their shares of Chinese banks in 2007. This setback has also spread to three of the four largest state-owned banks and joint-stock banks. In fact, almost all of these

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foreign investments are profitable. Why do FSIs choose to exit Chinese banks? Policymakers and researchers have focused on the effects of FSIs in China with mixed results (Berger et al., 2009; Lin and Zhang, 2009; Xu, 2011; Jiang et al., 2013; Sun et al., 2013). Some aggressive commentators[1] even argue that introducing foreign banks has been a total failure for Chinese banks. With this background, we attempt to answer four specific questions to provide information for policymakers regarding further reform of the Chinese banking system. How do FSIs affect bank risks? Do the effects of FSIs differ between state-owned and non-state-owned banks? How FSIs-assigned directors and managers influence bank risks? Do FSI exits impact the risks of Chinese banks?

Policy considerations motivate our research. As emphasized by Bernanke (1983), Keeley (1990), Calomiris and Mason (1997, 2003a, 2003b), and Mohsni and Otchere (2014), the risk-taking behavior of banks affects financial and economic fragility. This relation is confirmed by the financial crisis of 2007. Under this background, the government proposes several privatization steps (including introducing FSIs) to shape bank risks in China. However, researchers have not reached a definite conclusion on how introducing FSIs affects their partners. FSI exits from China's banking sector provide further motivation. Why do FSIs choose to exit from Chinese commercial banks, especially state-owned banks, if all foreign investments are profitable? How do FSI exits affect their Chinese partners? The literature has also highlighted the value of examining the effects of FSIs on bank risks. Most authors do not control for selection bias or endogeneity in their studies, which undoubtedly leads to biased results. Therefore, it is urgent and interesting to examine the effects of FSIs on bank risks.

Due to spillover and monitoring effects, FSIs are expected to reduce bank risks. According to the spillover effect view, FSIs provide not only external financing but also advanced management knowledge, which are presumably beneficial to investment recipients (Wei and Liu, 2006; Buckley et al., 2007; Spencer, 2008; Zhang and Li, 2010; Aggarwal et al., 2011; Zhu and Yang, 2016). Generally, FSIs are well-known, mature foreign financial institutions with financial management experience and technology. This advanced knowledge can be broadly spread to China's banks in the fields of corporate governance and risk management. The China Banking Regulatory Commission (CBRC) also recognizes that FSIs help Chinese banking institutions bolster their operational management, risk control, and corporate governance (CBRC 2010 Annual Report[2]). Aggarwal et al. (2011) suggest that foreign investors may export good corporate governance to host countries if they are from countries with strong shareholder protection measures. Hasan and Xie (2013) suggest that active involvement of FSIs in bank management has improved the corporate governance model of Chinese banks. Jia (2009) suggests that commercial banks with better corporate governance exhibit more prudent risk-taking behavior. Thus, we predict that FSIs may decrease bank risks. The monitoring effect view argues that FSIs can serve as outside monitors of target banks and improve banks' risk-taking behavior and risk management. For instance, monitors may prevent high-risk behavior and reduce moral hazards by preventing the most egregious forms of misbehavior (Tirole, 2001; Zhu and Yang, 2016). Additionally, the introduction of FSIs may attract attention from overseas regulatory institutions or media, which may also reduce banks' risk-taking behavior. Although FSIs have the ability to reduce bank risks according to the spillover and monitoring effects, why are FSIs willing to help China's banks to reduce bank risks? This is mainly due to the fact that the CBRC announced the rules for FSIs in five criteria[3] at the end of 2005. These rules ensure that FSIs are long-term strategic investors (more than 3 years), not short-term financial investors, and transfer risk control experience and skills to their Chinese partners. Furthermore, FSIs hope that their investments would help them get long-term strategic returns, rather than short-term financial returns. For instance, they hope to tap into an economy with a seemingly limitless growth potential and deliver greater access to the broader Chinese economy (Chang, 2013). Thus, FSIs would like to help China's partners, and access to Chinese economy. Therefore, based on spillover and monitoring effects, we predict that FSIs reduce bank risks.

Using data from China's banks between 1995 and 2014, we combine the propensity score matching (PSM) and difference in differences (DID) approaches (we call this combination the “PSM-DID” approach) to investigate the effects of FSIs on bank risks and make several findings. First, introducing FSIs reduces bank risks, with the exception of insolvency risk. Second, the effects of FSIs are weaker in state-owned banks than in non-state-owned banks. Third, FSI-assigned directors and managers can further reduce bank capital risk, liquidity risk, and credit risk, and improve bank asset quality. And directors and managers have weaker effects in state-owned banks. Finally, our empirical results support the view that spillover effects work more than monitoring effects in the context of China's financial background.

This article makes several contributions to the literature. First, we not only examine the effects of FSIs on bank risks but also question whether FSI exits from China's banks affect their partners. The existing studies mainly explored the effects of FSIs or foreign ownership on bank performance in China (Berger et al., 2005; Lensink et al., 2008; Berger et al., 2009; Lin and Zhang, 2009; Xu, 2011; Jiang et al., 2013; Sun et al., 2013). Some FSIs began to sell their stakes in Chinese banks in 2007. This setback has also spread to three of the big four state-owned and joint-stock banks. However, to the best of our knowledge, no study has explored the effects of FSI exits on their partners. Given this background, we question whether FSI exits affect Chinese banks. Second, due to the particularities of state ownership, we posit that state ownership may moderate the effects of FSIs. When we analyze the background of FSIs in Chinese banks, we notice a puzzling phenomenon. Some well-

[1] For example, Zuo Dapei, a famous researcher in the Chinese Academy of Sciences even argues that foreign banks actually consider Chinese banks to be automated teller machines.

[2] http://www.cbrc.gov.cn/EngdocView.do?docID=20110419222D1DDDE39BE80AFFEB3FF789309200.

[3] The five criteria are as follows: an FSI should take stakes between 5% and 20%; the lock-up period for FSIs should be more than 3 years; FSIs are encouraged to assign directors to the board of directors of the banks in which they invest; FSIs should not invest in more than two banks with similar types; and FSIs should transfer their knowledge and network technology skills.

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