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Bank shareholding and corporate cash management: Evidence from China

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ABSTRACT

We study the effect of bank shareholding on corporate cash management in China. We document that for state-owned enterprises (SOEs) with some of their shares owned by banks, the market value of cash holdings is less, and the overinvestment of free cash flow is more than those SOEs without bank shareholding. For non-SOEs, we do not find such an adverse impact. We also find that the adverse impact of bank shareholding is confined to state-owned banks owning SOE shares and stronger for pyramidal structure than those of non-pyramidal structure SOEs. The Chinese environment offers lessons that can help other emerging markets to review their bank shareholding regulations.

1. Introduction

Bank shareholding refers to a bank that owns a significant number of shares of an industrial firm. The firm typically engages in a banking (lending) relationship with its shareholding bank. Bank shareholding is a global phenomenon with a long history[1]. In the context of bank shareholding, a bank has dual roles of a shareholder and a loan provider, making a bank different from other shareholders (Luo, Zhang, & Zhu, 2011; Mahrt-Smith, 2006).

The literature primarily focuses on the effect of bank shareholding on firm value with mixed conclusions. Hoshi, Kashyap, and Scharfstein (1990), Hoshi, Kashyap, and Scharfstein (1991) and Gorton and Schmid (2000) suggest that bank shareholding increases firm value. Barth, Caprio, and Levine (2006) suggest that, despite the variations across banking systems in different markets, bank shareholding is beneficial to firms in developed markets. A bank, as a shareholder and a creditor, can lower the information asymmetry so that the bank has less uncertainty about its credit evaluation of the bank shareholding firm; hence, bank shareholding enhances the flow of capital from banks to firms and makes the firm's banking relationship effective. In addition, banks can play a role in the corporate governance of their shareholding firms (e.g., Kang, Kenneth, Kitsabunnarat-Chatjuthamard, & Nishikawa, 2011). In contrast, banks do not play as effective of monitoring roles in emerging markets as they do in developed markets due to weak institutions and governance (Laeven, 2011). Prior research on emerging markets supports this argument; for instance, Limpahayom and Polwitoon (2004), Lin, Zhang, and Zhu (2009), and Luo et al. (2011) suggest that banks, as shareholders, are rent-seekers and they destroy value. A typical scenario is that a bank leverages its shareholder position to get above-market rates and better terms for its loans to the firm; however, it remains unclear through which channel bank shareholding adversely affects firm value in emerging markets.

While there may be several channels that relate bank shareholding with firm value, we contend that corporate cash management

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[1] Cull, Haber, and Imai (2011) summarize the popularity of bank shareholding in emerging markets.

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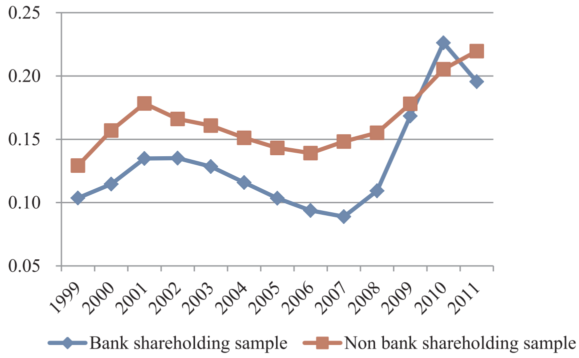

Fig. 1. Yearly mean value of cash holdings to total asset for firms with at least 1% of shares owned by banks and firms with no bank shareholding (includes firms with less than 1% shares owned by banks).

is an important channel. We use a sample of Chinese listed companies to show how bank shareholding affects firm value via adverse corporate cash management. We focus on corporate cash management for the following reasons. First, corporate cash management decisions are critical decisions for a firm. The average cash holdings to total asset ratio in China is high. While the average cash holdings to asset ratio is 16.8% for all years, the mean ratios increase to about 20% in recent years (Fig. 1)[2]. A poor cash management can mean liquidity risk for a firm and/or not maximizing firm value. Bates et al. (2009) suggest that good corporate cash management can help a firm to manage risky cash flows that result from holding fewer inventories and receivables, and having higher R&D expenditures. Thus, the exceptionally high cash holdings among Chinese firms make the corporate cash management important in China. Second, although Chinese companies, especially state-owned enterprises (SOEs), obtain considerable capital from the public through either the banking system or the capital market, they remain extremely inefficient (Bai, Liu, Lu, Song, & Zhang, 2004). We examine corporate cash management as an important source of efficiency loss in capital. Third, the Chinese environment is characterized by the dominance of bank financing, and by the presence of SOEs and state-owned banks. Chen, Chen, Lobo, and Wang (2010) report that, between 2001 and 2006, firms in China obtained a total of 12.5 trillion yuan bank loans which was 20 times that of the capital raised in the stock market. Chen, Li, and Zhang (2016) document that Chinese banks help SOEs but hurt non-SOEs in the firm performance. The role of banks and bank shareholding, hence, is critically important for firms raising capital for liquidity and investment. In addition, due to the Chinese government's directives, state-owned firms and state-owned banks carry out policies along these directives. Thus, the nature of state-ownership offers potential different perspectives than those of western studies in bank shareholdings. Overall, we examine corporate cash management among SOEs and non-SOEs and study the impact of state-owned and non-state-owned bank shareholding. The findings will help us to understand if corporate cash management is a channel in the relation between bank shareholding and firm value.

Specifically, we study two aspects of the corporate cash management: the market value of cash holdings, and the overinvestment of free cash flow. The findings extend the literature of bank shareholding beyond firm value. We contend that if bank shareholding is beneficial (harmful) to a firm, we should see an increase (decrease) in the market value of cash holdings, and a decrease (increase) in free cash flow overinvestment. Our findings suggest that the market value of cash holdings is lower in SOEs with bank shareholding relative to SOEs without bank shareholding. In addition, SOEs with bank shareholding, on average, overinvest more than SOEs without bank shareholding; thus, our results indicate that bank shareholding adversely affects corporate cash management in SOEs. The overinvestment of free cash flow in bank shareholding SOEs reflect the inferior corporate cash management that leads to a lower market value of cash holdings. Our results have two possible explanations. First, contrary to the case of developed markets, banks in China do not exercise their monitoring role in SOEs. Therefore, the adverse effect of bank shareholders out-weighs their positive effect. Second, due to the fact that bank shareholders help their firms better to resolve their financial distress than those without bank shareholding. Bank shareholders can provide an implicit guarantee (worsen the soft budget constraint) to a firm in case of a financial distress. Then, firms with bank shareholders are able and willing to take excessive risk when making investment decisions. Therefore, bank shareholding firms overinvest and the market value of cash is lowered

In addition, among SOEs, we find state-owned banks are more likely than non-state owned banks in increasing the overinvestment of cash flow and thus reducing the market value of cash holdings. Pyramidal structure SOEs also shows a lower market value of cash holdings and higher overinvestment of cash flow relative to those of non-pyramidal structure SOEs.

The paper contributes to the literature in two ways. First, we provide new insights into bank shareholding in emerging markets where banks dominate the financial markets. Our research setting, however, is different from other emerging countries because the Chinese banking regulator has prohibited bank shareholding since 1995 and the nature of state-owned firms and banks. In fact, according to the Institute of International Bankers Survey, China is the only reporting country not allowing bank shareholding as of 2013. Nonetheless, there are exceptions (to be discussed in Section 2.1) to the regulation in China that results in some cases of banks holding shares of industrial firms. Our findings provide information to bank regulators in China and other countries to review the

[2] Bates, Kahle, and Stulz (2009) show that the cash-to-asset ratio in the US increased to about 20% in recent years. The mean cash holdings-to-total asset ratio is 12.2% in a sample of US firms, reported in Bao, Chan, and Zhang (2012).