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Margin trading, short selling, and bond yield spread

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ABSTRACT

Using a quasi-natural experiment, this study examines the effects of margin trading and short selling on bond yield spread in China. It finds that both margin trading and short selling can reduce bond yield spread. Additionally, it finds that margin trading lowers firms' debt ratios and increases their credit ratings, which explains the reduced spread. In other words, margin trading can impact investors' decisions by revealing positive information about a firm. Another finding is that short selling lowers the bond yield spread by decreasing earnings management, suggesting that short selling has an impact on investors' decisions through its effect on corporate governance. Our results suggest that margin trading transmits positive information and short selling impacts firms' policies. These results provide support for future regulations of margin trading and short selling.

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1. Introduction

Compared to the abundant information about the equity market provided by analysts, there is little information about the bond market. Furthermore, the lag in the credit rating of bonds creates a poor information environment. Therefore, information that spills over from the equity market to the bond market may be important. Specifically, margin trading activities on a stock may reveal good news about the firm, whereas short sellers may transmit bad news to the bond market. Thus, margin trading or short selling may affect bond yield spread.

Short selling activities could transmit bad news about a stock price and help to avoid a stock crash (Hong et al., 2008). In addition, short sellers try to acquire private information to increase their profit, which intensifies the absorption of information into stock price (Xiao and Kong, 2014). Accordingly, as short sellers seek

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negative information, managers could make timely disclosures of bad news (Li and Zhang, 2015) to facilitate accounting conservatism (Chen and Liu, 2014b), decrease earnings management (Fang et al., 2016; Massa et al., 2015; Chen and Liu, 2014a), and reduce overinvestment (Jin et al., 2015). Margin trading helps to transmit positive information, which leads to higher stock prices (Chu and Fang, 2016). Additionally, insiders may purchase stocks through margin trading to earn arbitrage profits (Zhang et al., 2016). Therefore, optimistic investors use leverage to buy securities and pessimistic investors sell borrowed securities. These transactions reveal positive and negative private information, which results in stock price return with intrinsic values. By causing information to spill over into the bond market, margin trading and short selling may affect the bond yield spread.

Developed capital markets have permitted margin trading and short selling of securities for many years. As an emerging market, China's capital market is relatively young, suggesting a concomitant need to enhance regulations and guide investors' rationality. However, after 20 years of development, the capital market in China has made great progress. To incorporate more information into stock price (Miller, 1977), the China Securities Regulatory Commission (CSRC) launched a trial period of margin trading and short selling in March of 2010. This offers researchers an opportunity to explore the effects of margin trading and short selling on bond yield spread. Kecskés et al. (2013) have verified that in an American setting short selling leads to lower credit ratings and higher spreads. However, margin trading and short selling in China possess some special characteristics. First, margin trading and short selling are very popular in America, but they are only pilot schemes in China. The 900 firms that allow the short selling of stocks also allow leverage buyouts. Short selling delivers bad news, and thus leads to increased bond yield spreads, whereas margin trading may release good news into the bond market. Second, after the introduction of margin trading and short selling in America, regulators realized the potential risks of these transactions and developed appropriate regulations. However, these transactions are still new in China. The current regulatory system needs to be improved, as insufficient regulations may provide opportunities for speculators. Third, due to the absence of short selling, Chinese investors are more used to margin trading. Although both short selling and margin trading are approved, short selling transactions account for a smaller proportion of the total transactions. Securities refinancing has been allowed since February 2013, which has increased the number of short selling transactions. However, lenders of securities for refinancing face liquidity and market risks. Given the lower interest rates of securities refinancing, lenders have no desire to engage in refinancing transactions. Fourth, the interest rates of financing and refinancing are not always adjusted. The current interest rate is not consistent with brokers' capital costs. Short selling fees and securities refinancing fees for these securities are the same for all stocks, and as a result borrowing fees do not reveal the lending value, which discourages stock owners from lending out their securities. Lastly, brokers' self-management of their business and social securities fund have limited the opportunities for margin trading and short selling, leading to weaker trade size and effects. Therefore, margin trading and short selling effects may be different in the Chinese stock market than in America, and it is necessary to examine the effects of margin trading and short selling on bond yield spread in China.

We examine the relationship between bond yield spread, margin trading, and short selling based on monthly bond data for the 2008 to 2015 period. We find that margin trading and short selling both decrease bond yield spread, even after the application of the propensity score matching method, which eliminates the selection biases in our data. Additional tests show that margin trading leads to lower leverage and higher credit rating, which results in lower bond yield spread, whereas short selling reduces bond yield spread by lowering earnings management.

This study makes several contributions. First, it examines the information spillover effects between the stock market and bond market. Previous studies have come to different conclusions about spillover (Fleming et al. 1998; Shi et al. 2013). Fleming et al. (1998) concluded that there are links between the stock market and the bond market. However, Shi et al. (2013) found no significant interaction between the stock market and bond market using Chinese data. This study finds that positive information in the stock market can be transmitted to the bond market. Therefore, this study contributes to the literature on the spillover effects. In addition, the effects of margin trading and short selling on bond yield spread are explored in this study. Merton (1974) and Jiang (2008) studied the relationship between firm characteristics and bond yield spread. Longstaff and Schwartz (1995) and Wang et al. (2015) examined the effect of the bond yield spread on macro perspective. This study contributes to the understanding of bond yield spread by finding that margin

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