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Thorny roses: The motivations and economic consequences of holding equity stakes in financial institutions for China's listed nonfinancial firms

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ABSTRACT

The reforms of China's financial system have significantly changed the country's financial sector. One noteworthy phenomenon is that many nonfinancial firms have obtained equity stakes in financial institutions. This study investigates the motivations behind and economic consequences of this recent proliferation of investments in financial institutions by nonfinancial listed firms. We find that the motivations for holding equity stakes in financial institutions include alleviating the pressure of industry competition, reducing transaction costs, and diversification to reduce risk. These investments, however, have double-edged effects on the performance of the investing firms. While their investment income increases, their operating income and overall return on assets decrease, as the investment income cannot compensate for the decrease in other operating income. The investing firms' cost of debt also increases, their cash-holding decreases, and stock price performance does not improve after investing in financial institutions. These effects contrast with the enthusiasm nonfinancial listed firms have for investing in financial institutions. The empirical findings in this study can inform financial industry regulators and decision-makers in listed firms. We advise nonfinancial firms to be cautious when considering investing in financial institutions.

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1. Introduction

The debate over mixing/separating banking and commerce has carried on for centuries. The activities of banks have been restricted since they first emerged in the Mediterranean city states, and government limitations on the trade investment of banks first appeared in Venice in 1374 (Salley, 1976), before spreading throughout continental Europe. The powers of England's banks were restricted in the late 17th century, and the practice was then exported to colonial America. The market collapse of 1929 in the U.S. and the subsequent great depression reinforced restrictive powers of banks with the enactment of the Glass-Steagall Act in 1933 (Halpert, 1988). Today, financial systems worldwide are generally regulated (Barth et al., 2001). The fear of bank failure and monopoly were previously the main reasons to restrict bank powers, but today the most common concerns include conflicts of interest, excessive bank powers, and threats to the safety net (Krainer, 2000). There are, however, obvious benefits from the mixing of banking and commerce (Wall et al., 2008), such as economies of scale and scope, the fostering of internal capital markets, and diversification. The boundary between banking and commerce has never been clear-cut. Merchant banking was very common among banks in the Italian States of the Middle Ages (Craig, 2001), and universal banks in Germany and Japan have long been encouraged. In the U.S. today, there are various ways banking and commerce mix (Haubrich and Santos, 2003); commercial firms can own banks, for example. In fact, commercial firms throughout the world are commonly found to possess equity stakes in banks.

Traditionally, the activities of banks are restricted from two dimensions; first, from carrying out fee-based activities such as securities, insurance, and real estate, and second, from owning commercial firms, and/or from restricting commercial firms from owning banks. Globally, the divisions between bank and non-bank finance have been dismantled since the late 20th century, and increasingly more countries allow commercial firms to own banks. Bank ownership of commercial firms is permitted in Germany and other countries, but with certain limitations. The effect of bank ownership of firms, though restricted throughout the world, has been examined in the literature. But commercial firms' ownership in banks, though permitted in many countries, has been largely ignored. In this study, we attempt to fill this gap by investigating the motivations and economic consequences of commercial firms' equity stakes in banks. We also expand the concept of combining banking and commerce to include the equity stakes in various types of financial firms held by commercial businesses. We define this as the integration of finance and commerce, where finance represents the broad financial sector including banks, securities, insurance, various funds, trusts, etc., and commerce represents the nonfinancial sector as a whole.[1]

During China's financial system reforms, many commercial firms obtained equity stakes in financial institutions.[2] According to the Chinese Entrepreneurs Survey System (2011), 20.4% of firms surveyed had equity investments in financial institutions, and 27.8% had their own finance firms. The 2009 report of the International Finance Research Institute of the Bank of China (2010) revealed that nonfinancial business groups actually controlled 24 out of 52 trust firms, 19 out of the top 50 investment banks, 12 out of 25 property insurance firms, and 20 out of 39 life insurance firms. These represent 46%, 38%, 48%, and 51%, respectively. Even financial institutions controlled by the government or financial groups were found to be partially held by nonfinancial firms. An increasing number of commercial firms are interested in investing in the financial sector. For example, in 2010 China Mobile obtained 20% of the equity in Shanghai Pudong Development Bank for RMB39.8 billion. In 2013, Vanke invested RMB2.7 billion in Huishang Bank in exchange for 8.28% ownership, and the Evergrande Group obtained 5% of Huaxia Bank in 2014. Alibaba and Tencent, the two Chinese Internet giants, are currently expanding their financial empire though Alipay and WeChat Wallet.

[1] Political economists view the integration of finance and commerce as creating finance capital. The concept of finance capital was first proposed by Hilferding (1910), and then taken up by Lenin in his wartime analysis of the imperialist relations of the great world powers. Hilferding (1910) summarized the development of capitalism and concluded that "the most characteristic features of 'modern' capitalism are those processes of concentration which, on the one hand, 'eliminate free competition' through the formation of cartels and trusts, and on the other, bring bank and industrial capital into an ever more intimate relationship. Through this relationship capital assumes the form of finance capital, its supreme and most abstract expression."

[2] In this study, commercial firms refer to all nonfinancial firms. Financial institutions include banks, and firms dealing in securities, venture capital and private equity, insurance, finance, loans, trusts, guarantees, futures, asset management, investment funds, leasing, and pawnshops, etc.

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