J. of Multi. Fin. Manag. 22 (2012) 39–53

Contents lists available at SciVerse ScienceDirect

Journal of Multinational Financial Management

journal homepage: www.elsevier.com/locate/econbase

Political connections, ownership structure, and financial institution failure

Piruna Polsiri [a], Pornsit Jiraporn [b,c,*]

[a] Dhurakij Pundit University, Bangkok, Thailand
[b] School of Graduate Professional Studies, Pennsylvania State University, United States
[c] Thammasat University, Mahidol University, National Institute of Development Administration (NIDA), Bangkok, Thailand

A R T I C L E I N F O

Article history:
Received 10 May 2011
Accepted 16 January 2012
Available online 25 January 2012

JEL classification:
G32
G33
G34
G38

Keywords:
Concentrated ownership structure
Political connections
Failure prediction model
Financial sector fragility
Early warning systems
East Asian financial crisis

A B S T R A C T

Thailand was at the origin of the Asian financial crisis of 1997. Our research seeks to understand what economic and political factors contributed to the collapses of Thailand's financial institutions during the crisis. The distinctive feature of our model is that it incorporates variables for ownership structure as well as political connections in addition to the traditional financial variables. Foreign-owned financial institutions were less likely to fail. The probability of failure is also inversely related to the control rights of the largest shareholder. Finally, there is evidence of the too-big-to-fail (TBTF) policy. Our results are important because they demonstrate that traditional models, especially when applied to emerging economies, can be enhanced by incorporating variables related to ownership structure as well as political connections.

1. Introduction

The 1997 East Asian financial crisis, generally considered to have originated in Thailand, had negative impacts across the entire region. During the crisis, a large number of banks and other financial institutions in Thailand experienced extreme distress and eventually failed. The objective of this paper, using Thailand as an example, is to develop a model of predictive failure which explicitly accounts

* Corresponding author.
E-mail address: pxj11@psu.edu (P. Jiraporn).

1042-444X/$ – see front matter
doi:10.1016/j.mulfin.2012.01.001

for the peculiar characteristics of financial firms in several emerging economies. Although the crisis took place over a decade ago, its remaining impacts can still be felt in Thailand. Its implications also continue to be widely debated in the literature.

A distinctive feature of firms in developing economies is the extensive network of political connections which may exist between a firm and the government. The literature has found that the existence of such connections may bring a number of benefits to a firm (Fisman, 2001; Johnson and Mitton, 2003; Cheung et al., 2005; Leuz and Oberholzer-Gee, 2006; Ferguson and Voth, 2008; Bunkanwanicha and Wiwattanakantang, 2009). Politically connected firms tend to have a superior access to debt financing (Sapienza, 2004; Cull and Xu, 2005; Dinc, 2005; Khwaja and Mian, 2005; Faccio, 2006; Charumilind et al., 2006). Political connections have also been shown to play a role in determining the likelihood with which firms will be rescued by the government through the IMF or World Bank financial assistance during an economic crisis (Faccio et al., 2007). Based upon this literature, it would also be expected that the existence of political connections should also affect the probability that firms will go bankrupt or be closed.

Another crucial characteristic of firms in many developing economies is the highly concentrated ownership structure. When investigating the impacts of concentrated ownership structure on firms, the literature has typically concentrated on linking ownership and performance (Wiwattanakantang, 2001; Claessens et al., 2002; Mitton, 2002; Anderson and Reeb, 2003; Joh, 2003; Lemmon and Lins, 2003; Lins, 2003; Baek et al., 2004). This paper deviates from this norm by instead investigating the effects of ownership concentration on the likelihood of business failure.[1] It is advantageous to examine eventual failure rather than performance because the impacts of ownership should be more pronounced when firms are in serious trouble and at risk of collapsing.

Using the data of all financial institutions that operated in the period 1991–1997, this paper develops a model to predict financial institution failure during the 1997 East Asian economic crisis. Overall, the failure prediction model developed in this study shows high accuracy rates. The ownership concentration variables prove to play an important role in determining the probability with which a financial institution is closed. Specifically, financial institutions of which a foreign investor is the largest shareholder are less likely to fail. Furthermore, a higher fraction of voting rights held by the largest shareholder reduces the probability of business failure.

As for the political connection factors, only the connection with Thailand's Crown Property Bureau (CPB) appears to be significant in determining the likelihood of financial institution failures in Thailand.[2] In particular, the financial institutions that belong to the Crown Property Bureau (The Palace's business office) are less likely to fail during the crisis. Connections to CPB improve the probability of survival by as much as 47%, relative to firms with no such connections.[3] On the other hand, political connections via controlling families and the state play an insignificant role.

Regarding financial variables, the model suggests that financial variables based on a CAMEL analysis also appear to perform relatively well in predicting financial institution failure.[4] More precisely, higher loan growth increases the likelihood that a financial institution fails; the operating expenses to revenue ratio, return on assets and interest income to total income ratio have negative effects on the probability of failure. Finally, evidence of "too-big-to-fail" policies in the closure process of Thai financial institutions is documented.

As far as the prediction accuracy, the logistic regression model incorporating ownership concentration, political connection, as well as financial variable displays good predictive power when predicting firm failure. More precisely, 86.25%, 87.27%, 84.87%, 80.36%, and 79.82% of financial institutions are correctly classified in the models that use the explanatory variables of one, two, three, four, and five years prior to the failure, respectively.

---

[1] Not until recently have studies documented significant effects of ownership variables on the probability of failure/bankruptcy (Bongini et al., 2001; Dewaelheyns and Van Hull, 2004) or financial distress (Claessens et al., 2003; Lee and Yeh, 2004).

[2] The Crown Property Bureau is a Thai government agency responsible for managing the personal wealth of the King of Thailand and his immediate family. Section 2.2 provides further discussion.

[3] Calculated as the marginal probability when the other independent variables are held at their means.

[4] CAMEL stands for Capital adequacy, Asset and Management quality, Earnings, Liquidity.