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Social trust and foreign ownership: Evidence from qualified foreign institutional investors in China

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ABSTRACT

We investigate the effects of social trust on foreign institutional investors' equity holdings in listed Chinese firms from 2005 to 2011. We find that social trust embedded in the regional environment is an important factor for the investment decisions of foreign institutional investors. We also find that the proportion and likelihood of foreign ownership increases with the level of social trust. The results support the notion that social trust and trust-related information help mitigate informational barriers in international equity investments. Our results are robust to alternative measures of social trust and a range of model specifications, including instrumental variable estimation. We document that the effects of social trust on foreign ownership diminishes in the presence of organizational learning, better formal institutional development, conservative financial reporting, and asset transparency. We also show that foreign institutional investors from countries with a common law origin are more likely to incorporate trust-related information in their investment decisions.

1. Introduction

Recent literature emphasizes cross-border financial linkages facilitating international capital flow (Bartram et al., 2016; Ferreira and Matos, 2008). Particularly, the asset management industry has an increasingly important role in the spread of the competition and integration of global financial markets. According to the International Monetary Fund (IMF) "Global Financial Stability Report" (2015), the top 500 asset managers in the world manage more than U.S. $70 trillion, a significant portion of which are allocated internationally. These investors are sophisticated, with advanced skills and in-depth investment knowledge (Grinblatt and Keloharju, 2000), and they are able to identify superior investment opportunities (Barber et al., 2009). Nonetheless, investing at a distance imposes significant information costs for foreign institutional investors (FIIs), which further retards the international flow of funds and results in a home bias in portfolio investment (Ahearne et al., 2004; Cooper and Kaplanis, 1994; Dahlquist and Robertsson, 2001; Kang and Stulz, 1997; Krimminger, 2008).

In this study, we posit that social trust functions as an information-processing mechanism for FIIs to cope with informational barriers and improve their asset allocation in the global capital markets. An emerging line of research has shown that social trust, a component of social capital, plays an important role in economic development and related transactions (Algan and Cahuc, 2010; Ang et al., 2015; Butler et al., 2012; Gennaioli et al., 2015; Guiso, 2012; Guiso et al., 2008, 2009; Jia et al., 2015; Wu et al., 2014). In addition, in June 2011, Muddy Waters Research (MWR) claimed that that several Chinese companies listed in the U.S. equity markets engaged in "aggressively committing fraud" by providing misleading information in their financial statement. Lacking of trust in the financial information disclosure by Chinese firms results in a significant and immediate adverse impact on the stock prices of almost all listed Chinese firms following the release of the analyst reports by MWR. Therefore, anecdotal evidence also corroborates

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the academic research and highlights the importance of trust in foreign equity investment.

Although the meaning of social trust is elusive, it is generally a crucial determining factor when individuals choose to act or react (Hardin, 2002). For example, people in an environment with high social trust tend to cooperate to produce socially efficient outcomes (Wu et al., 2014). Moreover, trust is inherently rooted in uncertainty (Cook, 2001) and is likely to produce trust-related information (Yamagashi, 2001). Therefore, we investigate whether and to what extents FIIs use trust-related information in their international investments.

China is ideal for our investigation. In China, the history of the impact of social trust on economic development may go back as far as the Ming Dynasty (Hasan et al., 2009). Although legal institutions are generally uniform across different regions in China, there is significant variation in terms of social trust at the provincial level. Accordingly, several recent studies show that social trust promotes the use of trade credit and encourages foreign direct investment in research and development (Ang et al., 2015; Wu et al., 2014). Moreover, qualified foreign institutional investors (QFIIs) have a relatively short history. Thus, we perform a clean test of the impact of social trust on foreign ownership, avoiding many confounding effects because of other mechanisms designed to address informational problems.

Using a sample of firms listed on the Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) in China from 2005 to 2011, we show that listed firms in provinces with higher social trust scores are associated with higher equity holdings by FIIs. The positive relationship is both statistically and economically significant. Our main results are robust to several alternative measures of social trust, a range of different model specifications, and instrumental variable (IV) estimation for possible endogeneity concern. The evidence in this paper strongly indicates that FIIs incorporate trust-related information in their investment decisions.

We further test the limitation of social trust in mitigating informational barriers by interacting social-trust measures with other mechanisms dealing with informational problems. We find that FIIs tend to follow domestic institutional investors, and reply less on trust-related information in the presence of higher ownership holdings by domestic institutions (i.e., learning by observing). Over time, the positive effect of social trust on foreign ownership diminishes, which suggests that FIIs learn from their own investment activities (i.e., learning by trading). We also document that with better formal institutional development, FIIs rely less on trust to build their investment portfolios. We partition our sample according to the conservatism of firm financial reporting and asset opaqueness. The empirical analysis reveals that social trust works best for the subsample with conservative accounting practice and transparent assets. Further, we show that FIIs from countries with a common law origin are more likely to utilize trust-related information in their portfolio investments.

The rest of this paper is organized as follows. Section 2 provides an institutional background of QFII scheme in China and reviews related literature. Section 3 details our data, sample, and measures. Section 4 explains our identification strategy and reports empirical results. Section 5 summarizes and concludes.

2. Related literature

2.1. Institutional background

China has a relatively short history of equity trading, given that it opened its stock markets in the early 1990s. There are now two major stock exchanges in China: the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE). At the beginning, there were only 13 listed companies with a total market capitalization of U.S. $160 million. The Chinese stock markets have grown quickly for the past two decades. In 2014, there were around 2500 listed firms with a total market capitalization of U.S. $6 trillion.[1] The stock listings in mainland China include A-shares and B-shares. A-shares are only available for local residents, whereas B-shares are designed for foreign investors.

In order to develop the domestic capital markets gradually, China initiated the qualified foreign institutional investor (QFII) scheme in 2002. Under it, licensed foreign institutional investors are permitted to buy and sell Chinese Yuan (CNY)-denominated A-shares listed on the SSE and SZSE.[2] The QFII scheme has developed rapidly since its initiation and become a major vehicle of cross-border capital flows in the form of equity investment. In 2002, the quota for QFIIs was U.S. $10 billion and there were only 10 foreign institutions. In 2007, 2012, and 2013, the quota was U.S. $30, $80, and $150 billion, respectively. Currently, there are more than 200 active foreign institutional investors participating in the QFII scheme. In our sample period from 2005 to 2011, 72 QFIIs from 15 countries or regions made active investments in the A-share markets in China. These 15 countries include 6 countries or regions with common law origin (United States, United Kingdom, Canada, Australia, Hong Kong, and Singapore) and 9 countries or regions with civil law origin (France, Germany, Japan, Korea, Netherlands, Norway, Switzerland, Taiwan, and United Arab Emirates). For firms with foreign ownership, on average, QFIIs hold 2.5% of shares outstanding. Particularly, QFIIs with common law origin hold 1.2% of shares outstanding and QFIIs with civil law origin hold 1.3% of shares outstanding.

2.2. Social trust and foreign ownership

The international capital markets are attractive to FIIs because they present important diversification opportunities. Despite the increasing integration of global capital markets and declining barriers to international investment, institutional investors hold very limited foreign equities than many standard asset-pricing models expect (Cooper and Kaplanis, 1994; Frenkel and Poterba, 1991; Tesar and Werner, 1995). The so-called "home bias" phenomenon has received great attention from both academics and practitioners. As a result, exiting literature extensively investigates the investment behavior of foreign institutions around the world (Dahlquist and Robertsson, 2001; Ferreira and Matos, 2008; Kang and Stulz, 1997; Lewis, 1999). These studies share a common theme: efficiently processing public and private information plays an important role in FIIs' investment decisions.

However, when FIIs invest at a distance (Portes and Rey, 2005), their asset allocations are largely influenced by obstacles limiting their ability to process relevant information. For example, Grinblatt and Keloharju (2001) stress the role of language and cultural similarities on international equity investments. Chan et al. (2005) emphasize familiarity as an important determinant of home bias. The significant information asymmetry imposed by cross-border equity investment leads to a rather prudent investment strategy for FIIs (Dahlquist and Robertsson, 2001).

[1] According to World Federation of Exchanges (WFE), the ranking of domestic market capitalization of China follows that of the United States.

[2] Note that under the current regulation, the QFII scheme allows a single institutional investor to hold up to 10% of the A-shares in one listed company; total foreign shareholding held by a QFII in any one listed company should not exceed 30%.