

Value of Politically Connected Independent Directors: Evidence from the Anti-Corruption Campaign in China

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Political Connections of Firms

- Helping hand: more access to financing (Khwaja and Mian, 2005; Claessens et al., 2008); preferential regulatory treatment (Faccio, 2006); lower tax rates (Faccio, 2010).
- Grabbing hand: more political risk (Liu et al., 2017; Pástor and Veronesi, 2013); bad corporate governance (Fan et al., 2007; Cao et al., 2017).
- Evidence on the overall effect of political connections is mixing.
- Most studies focus on connections from blockholders and executives instead of independent directors.

Institutional Background of China

- Many Chinese firms appoint government officials as independent directors to build political connections.
- Chinese government started a massive anti-corruption campaign from early 2013.
- Regulation No.18: prohibits all government officials from taking part-time positions in firms.
- Since most PCIDs did not resign right after the release of Regulation No.18, we witnessed a wave of PCID resignations in the following two years.

Main Findings

- Firms with PCIDs suffer negative cumulative abnormal returns (CAR) around the release of Regulation No.18.
- Firms have positive CAR around the resignations of PCIDs, especially for non-SOEs.
- Firms' operating performance does not change after losing PCIDs. However, firm risk decrease, especially for non-SOEs.
- Replacing PCIDs improves firm's governance, especially for SOEs.

- Political connection can increase firm risk.
- Political risk is priced by investors in China.
- The effect of political connections is contingent on firm's ownership structure.
- Political connections are associated with poor corporate governance.
- The results suggest that the anti-corruption campaign is authentic.
- Different from existing studies on China's anti-corruption campaign: Ding, Fang, Li, and Shi, 2017; Lin, Morck, Yeung, and Zhao, 2016; Liu, Lin, and Wu, 2018; Griffin, Liu, and Shu, 2018.

Hypothesis

- H1: Firms with PCIDs decrease in firm value following the release of Regulation No.18.

Cash flow explanation:

- H2a: Firm value does not change around the announcement of PCID resignation;
- H2b: Firms have worse operating performance after replacing PCIDs.

Political risk explanation:

- H3a: Firm value increases around the announcement of PCID resignation;
- H3b: Firms have lower risk after replacing PCIDs.

Corporate governance:

- H4a: Board monitoring efficiency increases;
- H4b: Management entrenchment decreases;
- H4c: Expropriation from controlling shareholders decreases;
- H4d: Entertainment and traveling costs decrease.

Identification of PCIDs:

- I collect all independent director resignation reports from January 2013 to May 2017.
- If a firm reports its independent director resigns to comply with Regulation No.18, I identify the independent director as being politically connected.
- For the other resigning independent directors, I check their background profile in the annual report and identify them as PCID if they are current or former (1) government officials, (2) members of People's Congress, (3) members of People's Consultative Conference (CPPCC).

Sample:

- Treatment group: 418 firms that have PCIDs resignations.
- Control group: one-to-one propensity score matching using industry, ownership structure, and firm characteristics.

Three event dates:

- Release date of Regulation of No.18.
- Announcement date of each PCID resignation.
- Actual leaving date of each PCID.

Data sources: CSMAR and websites of SHSE and SZSE

CAR around Release of Regulation No.18

	Full sample	SOEs subsample	Non-SOEs subsample
(-1, +1)	-0.040 (0.172)	-0.235 (0.213)	0.397 (0.282)
(-1, +5)	-0.543 (0.331)	-0.167 (0.582)	-0.832** (0.377)
(-1, +10)	-2.006*** (0.371)	-1.898*** (0.493)	-2.674*** (0.778)
(-1, +15)	-1.729*** (0.414)	-1.605*** (0.573)	-2.199*** (0.798)
(-1, +20)	-0.933* (0.495)	-0.944 (0.607)	-0.920 (0.821)
N	418	230	188

	(-1,+1)	(-1,+5)	(-1,+10)	(-1,+15)	(-1,+20)
<i>PCID</i>	-0.342** (0.140)	-1.047** (0.442)	-1.267* (0.660)	-1.437** (0.551)	-0.989*** (0.306)
N	836	836	836	836	836
Adj. R ²	0.139	0.050	0.041	0.037	0.115

CAR around PCID Resignations

	Full sample	SOEs subsample	Non-SOEs subsample
(-1, +1)	1.300*** (0.341)	1.168*** (0.394)	1.462** (0.586)
(-1, +5)	2.782*** (0.650)	1.979*** (0.725)	3.764*** (1.140)
(-1, +10)	3.681*** (0.860)	2.24*** (0.832)	5.445*** (1.612)
(-1, +15)	3.579*** (0.983)	2.095** (0.888)	5.394*** (1.892)
(-1, +20)	3.025*** (1.071)	1.800* (1.009)	4.524** (2.035)
N	418	230	188

Panel A: full sample					
	(-1,+1)	(-1,+5)	(-1,+10)	(-1,+15)	(-1,+20)
<i>PCID</i>	0.519* (0.262)	1.086* (0.567)	2.413*** (0.450)	2.013*** (0.463)	1.352** (0.513)
N	836	836	836	836	836
Adj. R ²	0.026	0.030	0.035	0.035	0.028

CAR of SOEs and Non-SOEs

Panel B: sub-samples by ownership structure

	SOEs					non-SOEs				
	(-1,+1)	(-1,+5)	(-1,+10)	(-1,+15)	(-1,+20)	(-1,+1)	(-1,+5)	(-1,+10)	(-1,+15)	(-1,+20)
<i>PCID</i>	0.445 (0.587)	0.750 (1.307)	1.186 (1.089)	0.929 (1.015)	0.912 (0.883)	0.707* (0.379)	2.025** (0.778)	4.554*** (0.993)	4.009*** (1.058)	2.529* (1.420)
N	460	460	460	460	460	376	376	376	376	376
Adj. R ²	0.052	0.059	0.073	0.066	0.059	0.045	0.052	0.067	0.077	0.073

Operating Performance

<u>Panel A: ROE</u>			
	(1)	(2)	(3)
	Full sample	SOEs subsample	Non-SOEs subsample
<i>PCID</i>	0.009 (0.006)	0.017* (0.009)	0.003 (0.006)
<i>PCID</i> × <i>Post</i>	-0.000 (0.004)	-0.006 (0.006)	0.004 (0.008)
N	4,871	2,747	2,124
Adj. R ²	0.089	0.096	0.100

<u>Panel B: cash flow from operations (CFO)</u>			
	(1)	(2)	(3)
	Full sample	SOEs subsample	Non-SOEs subsample
<i>PCID</i>	0.001 (0.002)	0.001 (0.003)	0.001 (0.004)
<i>PCID</i> × <i>Post</i>	0.002 (0.003)	0.004 (0.005)	0.001 (0.003)
N	4,871	2,747	2,124
Adj. R ²	0.118	0.109	0.138

Panel A: stock price volatility			
	(1)	(2)	(3)
	Full sample	SOEs subsample	Non-SOEs subsample
<i>PCID</i>	-0.002 (0.011)	0.001 (0.010)	0.012 (0.026)
<i>PCID</i> × <i>Post</i>	-0.022 (0.014)	-0.010 (0.019)	-0.054*** (0.016)
N	4,867	2,745	2,122
Adj. R ²	0.741	0.754	0.720

Political sensitivity: The sum of absolute cumulative abnormal return over the three-day window around announcements of the new regulatory documents issued by China Securities Regulatory Commission (CSRC) estimated using market model.

Panel B: political sensitivity			
	(1)	(2)	(3)
	Full sample	SOEs subsample	Non-SOEs subsample
<i>PCID</i>	-0.028 (0.023)	0.018 (0.045)	-0.027 (0.046)
<i>PCID</i> × <i>Post</i>	-0.114 (0.072)	-0.058 (0.122)	-0.190*** (0.054)
N	4,862	2,743	2,119
Adj. R ²	0.286	0.267	0.304

Panel A: independent director busyness			
	(1)	(2)	(3)
	Full sample	SOEs subsample	Non-SOEs subsample
<i>PCID</i>	0.017 (0.038)	0.069 (0.065)	-0.054 (0.032)
<i>PCID</i> × <i>Post</i>	-0.113*** (0.038)	-0.164** (0.054)	-0.049 (0.030)
N	4,871	2,747	2,124
Adj. R ²	0.047	0.037	0.081

Panel B: executive compensation			
	(1)	(2)	(3)
	Full sample	SOEs subsample	Non-SOEs subsample
<i>PCID</i>	0.001 (0.002)	0.003* (0.002)	0.001 (0.005)
<i>PCID</i> × <i>Post</i>	-0.002 (0.002)	-0.007*** (0.002)	0.004 (0.003)
N	4,865	2,741	2,124
Adj. R ²	0.412	0.478	0.392

Panel C: related party transactions (RPT)			
	(1)	(2)	(3)
	Full sample	SOEs subsample	Non-SOEs subsample
<i>PCID</i>	-0.002 (0.023)	0.000 (0.028)	-0.004 (0.055)
<i>PCID</i> × <i>Post</i>	-0.027 (0.017)	-0.053** (0.020)	0.000 (0.027)
N	4,750	2,720	2,030
Adj. R ²	0.139	0.118	0.199

Panel D: entertainment and traveling costs (ETC)			
	(1)	(2)	(3)
	Full sample	SOEs subsample	Non-SOEs subsample
<i>PCID</i>	0.013 (0.008)	0.018 (0.012)	0.003 (0.013)
<i>PCID</i> × <i>Post</i>	-0.011* (0.006)	-0.023*** (0.007)	0.014 (0.014)
N	4,871	2,747	2,124
Adj. R ²	0.153	0.181	0.111

- The anti-corruption campaign provides a quasi-natural experiment to examine the effects of political connections.
- Firms with PCIDs decrease in value following release of Regulation No.18 because of increase in political risk.
- Both SOEs' and non-SOEs' operating performance does not change after losing PCIDs, but non-SOEs' political risk decreases, leading to increase in firm value.
- Replacing PCIDs improves firm's governance, especially for SOEs, suggesting the anti-corruption campaign is authentic.