Clawbacks and Cronyism: Evidence from China

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Abstract

This paper is the first to examine the long-term impact on bank lending policy of clawbacks in executive compensation contracts. Using a hand-gathered database of Chinese business lending, we find evidence of reduced cronyism at the Big Four Chinese banks during the period after the introduction of a clawback program, marking a shift from earlier studies covering earlier time periods that find evidence of widespread cronyism at the Big Four banks. Politically connected borrowers received fewer and smaller loans relative to non-Big Four banks, consistent with a backlash against cronyism at the Big Four banks. In contrast, we find that cronyism persisted (i.e., politically connected borrowers received more and larger loans) at non-Big Four Chinese banks where the clawback policy was not effective.

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I. Introduction

…I have authorized Secretary of Treasury Geithner to pursue every single legal avenue to block the bonuses to AIG executives…

President Obama, March 17, 2009.

Dear AIG, I Quit!...After 12 months of hard work dismantling the company – during which AIG reassured us many times we would be rewarded in March 2009 – we in the financial products unit have been betrayed by AIG and are being unfairly persecuted by elected officials…to surrender our earnings…

Jake DeSantis, New York Times, March 25, 2009.

The issue of bonuses paid to executives at the very financial institutions at the heart of the global financial meltdown of 2007-2009 has provoked widespread outrage and public calls for clawbacks and ex post revisions of previously inviolate employment contracts. These proposals specify that executive compensation (including bonuses) can be "clawed back" if it is subsequently found that the executives knowingly provided misleading information.[1] That is, managers may be forced to return compensation payments if it becomes apparent that their past performance was based on imprudent and inappropriate activity.

While clawback provisions may provide the emotional satisfaction of allocating

1 See, for example, J. Weisman and J. S. Lublin, "Obama Lays Out Limits on Executive Pay," *Wall Street Journal*, February 5, 2009, pages A1, A10. The public furor has led financial firms to expunge the word "bonus," (i.e., representing Goldman Sachs' record 2009 bonuses as total compensation or incentive pay.

blame and punishment to the alleged perpetrators of financial fraud and irresponsibility, the long-term repercussions are unclear. For example, the abrogation of contractual obligations can undermine the fundamental underpinnings of a capitalist economy, thereby injecting legal risk into every contractual negotiation. The risk of ex post contract revision (as in clawbacks appended retroactively to previous employment contracts) could threaten a nascent economic recovery, as market participants prove reluctant to enter into contractual agreements that can be retroactively revised. Moreover, the implementation of a clawback clause in an employment contract is sufficiently vague causing potential problems in demonstrating that the employee's behavior violated industry or company standards.

Despite the current public fascination with clawbacks, these clauses in employee reimbursement plans are not new. They became more fashionable in the U.S. after the passage of the Sarbanes Oxley (SOX) Act in 2002. Rappeport (2008) states, "In 2003, just 14 companies had clawback policies in place, according to The Corporate Library's survey of 1,800 firms that year. The latest survey shows that times have changed. Looking at a sample of proxies from November [2007] to May [2008], 295 of 2,121 companies examined now have adopted clawback provisions." For instance, the first application of the SOX clawback provision in the U.S. was a $468 million payment of back compensation by William McGuire, former CEO of UnitedHealth, in a case involving the backdating of stock options.[2]

Predating the introduction of clawbacks in the U.S., however, was a policy implemented in China in 1998 at the largest four Chinese banks. Called the "lifetime responsibility" program, the Peoples Bank of China (PBOC) required bank lending agents to

[2] Deshmukh, Howe, and Luft (2006) demonstrate that greater transparency in accounting for executive stock options is associated with good corporate governance and the alignment of interests between managers and stockholders.

personally bear the responsibility for any delinquencies in the loans that they granted. If a loan defaults, then the granting loan officer can be dismissed or demoted with any bonuses clawed back, even if the loan officer has already retired from the bank; hence, the moniker lifetime responsibility. Although many banks in China gradually adopted this program, it was effectively enforced only at the Big Four, formerly state-owned Chinese banks. The decade long experience with the PBOC's clawback program in China enables us to examine its long-term consequences on Chinese bank lending by examining Chinese business lending during the post-clawback period, and comparing bank lending activity at the Big Four Chinese banks with lending at the other Chinese banks not significantly impacted by the program.

This paper is the first, to our knowledge, to examine the longer term consequences of implementing a clawback policy in banking.[3] Due to the relatively recent introduction of clawback policies in the U.S., we utilize the experience of Chinese banks in order to assess the policy's long-term impact on financial market activity. We hand collect detailed, disaggregated data on borrowing firms' bank loans from the footnotes to publicly traded Chinese companies' financial statements available after 1997. Unfortunately, we cannot directly compare Chinese bank lending before and after the introduction of clawbacks at the Big Four banks since disaggregated bank lending data are unavailable prior to 1998. Therefore, our research design compares Big Four versus non-Big Four lending activity during the time period that clawbacks were effective only at the Big Four banks.

3 Collins, Masli, Reitinga, and Sanchez (2009) find evidence of an ex post settling up process in that former CEOs from firms that restated their earnings after the passage of SOX found it more difficult to find employment. Sharfman, Toll, and Szydlowski (2009) describe the legal precedent, codified in the Ryan v. Lyondell Chemical Company case in July 29, 2008, that it is the responsibility of the Board of Directors to police excessive executive compensation.

We investigate the impact of the lifetime responsibility program by examining the prevalence of cronyism in Chinese banks. There is a substantial academic and practitioner literature that detects cronyism in Chinese bank lending policies. Earlier studies indicate that political connections, rather than economic fundamentals, drive lending activity in China, particularly at the Big Four banks (Li, Meng, Wang, and Zhou, 2005; Park and Sehrt, 2001; Lu, Thangavelu, and Hu, 2001; Brandt and Zhu 2000; Shirai, 2002; Berger, Hasan, and Zhou, 2009; Ayyagari, Demirgulc-Kunt, and Maksimovic, 2008). If clawbacks provide incentives to shift to prudent lending practices, we should observe less incidence of cronyism when clawbacks are in effect.

Contrary to earlier studies documenting cronyism at the Big Four Chinese banks, we demonstrate that economic fundamentals play important roles in bank loan decisions during the post-clawback period. Indeed, after the introduction of the lifetime responsibility system, we find a statistically significant negative relationship between political connections and loan availability (i.e., a backlash against cronyism) at the Big Four banks.[4] In contrast, politically connected borrowers obtain greater access to the bank loan market at the non-Big Four Chinese banks that are not effectively impacted by the lifetime responsibility program. Our findings are consistent with a shift from cronyism to capitalism when making lending decisions in the period following the introduction of the lifetime responsibility (clawback)

4 A shift from government to private ownership could, in theory, explain a shift away from political cronyism in bank lending policy. However, this cannot explain our findings as the transfer from State ownership at the Big Four Chinese banks occurred after the end of our sample period from 1998-2005. The Bank of China went public and issued H shares at Hong Kong Stock Exchange (HKSE) on June 1, 2006 and then issued A shares at Shanghai Stock Exchange (SHSE) on July 5, 2006. The Industrial and Commercial Bank of China went public and issued A shares at SHSE on October 27, 2006. The China Construction Bank (CCB) went public and issued H shares at HKSE on October 27, 2005 and then issued A shares at SHSE on September 25, 2007. The Agriculture Bank of China IPO was delayed by a large problem loan portfolio and took place in July 2010.

program. That is, we find that the banks that effectively implemented the clawback policy (the Big Four banks) granted loans to transparent, less risky borrowers that were not politically connected, whereas lending at banks where this policy was not effective (non-Big Four Chinese banks) was more politically motivated. Thus, clawbacks might be effective in accomplishing public policy goals to incentivize bankers to use objective and prudent lending standards. However, we also find that conditional upon loan approval, political connections significantly decrease loan spreads at all Chinese banks, suggesting that clawbacks have not completely controlled cronyism. Indeed, limitations of the effectiveness of clawbacks in controlling cronyism may result from the high cost of monitoring at Chinese banks, as demonstrated in Almazan, Hartzell, and Starks (2005) with regard to pay-for-performance executive compensation contracts.

Our paper is organized as follows. Section II describes the Chinese banking system, the lifetime responsibility system, and our hand gathered database of individual firms' borrowing activity and political connections. Section III presents the empirical analysis and the results of robustness tests. Our conclusions are provided in Section IV.

II. The Chinese Banking System

A. The Big Four Banks

The importance of a well functioning banking sector to the health of the real macro economy has been amply demonstrated by its absence during the global financial meltdown of 2007-2009. China, as the world's fastest growing economy, is dependent upon its banking industry to fund an economic growth rate that has averaged 10% annually for the last decade.

The Chinese banking industry is dominated by four large state-owned banks (known as the Big Four, which as of 2009 owned more than 50% of total banking assets in China according to China Banking Regulatory Commission): 1) the China Construction Bank (CCB), 2) the Bank of China (BOC), 3) the Industrial and Commercial Bank of China (ICBC), and 4) the Agricultural Bank of China (ABC). As of 1995, the government of China owned 99.45% of the largest ten commercial banks (including the Big Four). Since that time, each of the Big Four have undergone privatization by selling shares to the public, although they still maintain substantial governmental ownership. For example, the Chinese government still retains more than 70% of ICBC through holdings by the Ministry of Finance (35.33%, A shares), Central Huijin Investment Company Limited (35.33%, A shares), and Social Security Funds (4.22%, H shares).

In 1994, three policy banks were created to take over the government-directed spending functions of the Big Four banks. The policy banks, the Agricultural Development Bank of China (ADBC), China Development Bank (CDB), and the Export-Import Bank of China (Chexim), are responsible for financing economic and trade development and state-invested projects. ADBC provides funds for agricultural development projects in rural areas. The CDB specializes in infrastructure financing, while Chexim specializes in trade financing. The remainder of the Chinese banking industry is comprised of smaller state-owned banks, private domestic banks, and foreign banks. As of the end of 2008, the Chinese banking sector comprised 5,634 banking institutions with approximately 193,000 outlets and 2,719,000 employees at three policy banks, four large commercial banks (the Big Four), 13 joint-stock commercial banks (12 non-state owned listed on the stock exchange

plus the Bank of Communications whose the main shareholder is China's finance ministry), 136 city commercial banks, 22 rural commercial banks, 163 rural cooperative banks, 22 urban credit cooperatives (UCCs), 4,965 rural credit cooperatives (RCCs), one postal savings bank, four asset management companies, 32 locally incorporated foreign bank subsidiaries, 54 trust companies, 84 finance companies of enterprise groups, 12 financial leasing companies, three money brokerage firms, nine auto financing companies, 91 village or township banks, six lending companies and ten rural mutual credit cooperatives.[5] (Source: The Development of Banking Industry 2008, China Banking Regulatory Commission).

There is a considerable literature indicating that political favoritism has directed Chinese bank lending behavior in the past, particularly at the Big Four banks. For example, using data from 1991-1997, Park and Sehrt (2001) found that cronyism, not economic fundamentals, drove lending decisions at the Big Four banks. Shirai (2002) uses data from 1994-2000 and found evidence of poor performance at the Big Four banks, attributed to politically connected lending decisions. Using aggregate data over the period from 1979-1993, Brandt and Zhu (2000) find that an average of 84% of all new credits from the state banking system (dominated by the Big Four banks) was allocated to state-owned enterprises. Of these loans, more than one-third were politically motivated "policy loans" that were generally not repaid. Based on data covering 268 listed companies from 1994-1999, Lu et al. (2001) found that banks lent more intensively to politically connected firms (i.e., state-owned enterprises) after controlling for default risk, collateral level, firm size, and industrial policy. That is, they found a significant positive correlation between firm leverage and political connections,

[5] Cheng and Degryse (2010) include rural credit cooperatives and urban credit cooperatives in the non-banking sector, together with 53 financial companies and 391 trust and investment companies as these groups have been subject to fewer reforms than Chinese banks.

suggesting systematic cronyism in bank lending decisions in China.

Additionally, Li et al. (2005) examine 3,258 enterprise owners and determine that "political connections help private entrepreneurs to obtain loans from banks…" Moreover, based on a survey of non-publicly traded firms, Allen, Qian, and Qian (2005) find that the high growth, entrepreneurial sector of the Chinese economy has avoided the Chinese banking system entirely, relying instead on alternative sources of financing. This may be the result of the perceived inefficiency and cronyism associated with banks in China.[6] Using bank level aggregate data, Berger et al. (2009) document this inefficiency and find that the Big Four banks are, by far, the least efficient banks in China. In this paper, we examine whether the conventional hypothesis that cronyism is driving bank lending policy, particularly at the Big Four Chinese banks, has been impacted by the introduction of the lifetime responsibility program of managerial clawbacks.

B. Financial Reforms and the Lifetime Responsibility Policy

The Chinese banking system has gone through several waves of reforms over the last thirty years. The PBOC was formed as a separate entity in 1979, together with three state-owned banks: 1) the Bank of China (BOC) specializing in transactions related to foreign trade and investment, 2) the People's Construction Bank of China (PCBC) that handled transactions related to fixed investment (in manufacturing), and 3) the Agriculture Bank of China (ABC) that dealt with all banking business in rural areas. At first, the PBOC simultaneously acted as China's central bank and as a commercial banking enterprise.

[6] However, Cheng and Degryse (2010) find that growth in provincial Chinese economies is linked to bank lending rather than non-bank sources of financing.

However, during a 1984 restructuring, the Industrial and Commercial Bank of China (ICBC) was formed to take over the PBOC's commercial transactions, thereby completing the Big Four and designating the PBOC as China's central bank.

For most of the 1980s and 1990s, the development of the financial system in China can be characterized by the rapid growth of financial intermediaries outside of the Big Four. For example, a network of credit cooperatives was established, the Rural Credit Cooperatives (RCCs) and the Urban Credit Cooperatives (UCCs), that are similar to credit unions in the U.S. Moreover, the government allowed the entry of more banks, particularly in the wake of reforms introduced by Deng Xiaoping in 1992.[7] During this boom period of expansion in private Chinese banking, the Big Four banks, accounting for about 70% of the total bank deposits and loans and 90% of all bank assets, were hampered by cronyism, poor lending decisions, and policy related lending responsibilities that amounted to politically connected lending to failing state-owned enterprises (SOEs). Dornbursh and Giavazzi (1999) estimate that 50%-70% of the Big Four banks' total loans were non-performing loans. The December 1998 issue of *Guoyou zichan guanli* (Management of State Assets, p. 38) states that, "as of year-end 1997, bad loans within the entire banking organizations (including non-state banks) of Hubei Province amounted to RMB84.5 billion, or 43.69% of all bank loans."

Concerns about these bad debts on the books of Chinese banks fueled the next wave of restructuring. The PBOC's policies focused on the Big Four banks and consisted of: 1) the restructuring of past bad debts and 2) the creation of incentives for prudent lending policies.

7 The China Merchant Bank, Hua Xia Bank, and Everbright Bank were set up in the first half of the 1990s. In 1995, Minsheng Bank was established by a tycoon, Mr. Yonghao Liu, and other wealthy businesspeople as the first domestic private bank in China. Other banks established during this economic boom period include the Guangdong Development Bank, Shanghai Development Bank, Shenzhen Development Bank, Fujian Industrial Bank, Yantai Housing Saving Bank, and Bengbu Housing Saving Bank.

In terms of debt restructuring, in 1999, the PBOC set up four asset management companies (Huarong with ICBC, Cinda with CCB, Orient with BOC, and Great Wall with ABC) to work out the bad loans of the Big Four banks. Further, the Big Four were recapitalized with 270 billion RMB of public injections of capital in 1998.

In terms of incentives, the PBOC adopted a series of policies designed to encourage more efficient, economically driven lending policies at the Big Four banks. The first of these policy changes, codified into the Commercial Bank Law of 1995, subjected the Big Four banks to prudential supervision by the PBOC in exchange for permission to pursue private, profit maximization objectives. In 1996, the PBOC adopted the Lending General Provisions to formally direct Chinese banks to make loans based on commercial standards. In 1998, the PBOC adopted the international classification of non-performing loans, and subjected Chinese banks to a non-binding indicative lending target, in contrast to the formerly binding centralized designation of working capital loans and fixed investment loans.

An important part of the reforms was the introduction in 1998 of the lifetime responsibility system at the Big Four banks. This program instituted penalties, or clawbacks, to be imposed on bank lending agents if the loans that they approved defaulted or performed poorly. Chen (2001) documents the implementation of the clawback program at the Hengshui Branch of Agricultural Bank of China (ABC). The president and vice presidents of the branch bear full responsibility for all bank loans. If a loan is not repaid, then one month after the payment due date (when the loan is 30 days delinquent), the president and vice president are reassigned to the job of collection on the loan. If more than one month passes without repayment, the president loses his position and receives only an ordinary worker's salary,

thereby losing his bonus compensation. If the bank loans are collected within the second month after the payment due date, both the president and the vice president are reinstated, but receive only a fraction of their back pay. If the loan is written off as uncollectible, both the president and vice president are dismissed immediately. Liu (2001) documents a similar procedure at ABC's Dianbai Branch, although the details vary from bank to bank and from branch to branch. Liu (2001) documents that from September 2000-May 2001, 19 presidents and vice presidents of sub-branches were punished and reassigned to collect past due bank loans at ABC. Twenty-two loan officers lost their salaries and only received compensation equal to the basic cost of living allowance. Some officers were forced to continue collecting non-performing loans even after they retired from ABC.

The lifetime responsibility program at the Big Four Chinese banks is quite characteristic of the Chinese incentive approach to the reform of its SOEs in which China has avoided outright privatization, but has focused instead on improving internal management and efficiency of the SOEs (Naughton, 1995). Reformers used incentives in their attempts to reform the political and fiscal relationship between China's central and local governments in the 1980s (Qian and Weingast, 1997). Li and Zhou (2005) indicate that provincial leaders are more likely to be promoted when the gross domestic product growth rates of their provinces are higher. Their finding suggests that China's central government uses personnel management to motivate local officials to promote local economic growth. Jin, Qian, and Weingast (2005) also find that the central government reformed the fiscal system by signing a fiscal sharing contract with each province that specified a marginal revenue retention rate for the provincial government.

Over time, some version of the lifetime responsibility system was adopted at banks other than the Big Four banks. However, in contrast to the Big Four banks, the private, collective, or local government-owned Chinese banks could not effectively implement clawback policies due to their lack of enforcement power. Only the Big Four banks had the requisite enforcement power by virtue of their centralized control and central government ownership. That is, Big Four bank branch managers are appointed and disciplined by headquarters, with centralized control over all employment matters. Indeed, there are very few alternative employment opportunities available to Big Four bank managers, thereby strengthening the enforcement of clawbacks.

In contrast, the management of collective or private banks is decentralized at the local or provincial level. Therefore, local governments exert a great deal of influence over bank managers and can circumvent enforcement of clawbacks.[8] Decentralization also offers managers alternative employment opportunities, so that the lifetime responsibility penalties are not as draconian as at the non-Big Four banks. For example, the rural credit collectives (RCCs) were formerly under the supervision of one of the Big Four banks, ABC, but attained the status of independent financial institutions in 1994. The main difference between ABC and the RCCs lies in the nature of ownership. The RCCs have a collective ownership status and are managed at the county level, allowing them more flexibility in complying with central financial policies (Li, Rozelle, and Zhou, 2007). In contrast, ABC has its headquarters in Beijing, with all branch offices tightly controlled by headquarters. Thus, clawbacks are effectively enforced at ABC, but not at the RCCs.

8 Huishang Bank is a local joint-stock commercial bank controlled by the Anhui provincial government. The Ministry of Organization of the Anhui provincial government removed the bank director (He Li) of Huishang Bank from office without the approval of the bank's Board of Directors in 2009.

As an example of the lack of enforcement of the clawback policy at non-Big Four banks, we cite the following case. From 2000-2006, executives at the Hulu Island Commercial Bank and the Tielin Commercial Bank embezzled RMB 1 billion from the bank and used the funds to speculate on the government bond market. As a result, the banks lost RMB 570 million, and the Liaoning Office of China Banking Regulatory Commission (CBRC) planned to dismiss the Director of Hulu Island Commercial Bank (Jinlin Wang), the Chairman of the Board of Directors of Tielin Commercial Bank (Dehui Zhou), as well as other managers. However, the dismissals could not be enforced due to the intervention of the local government. Thus, our research design utilizes the fact that clawback policy has been effectively implemented at the Big Four banks, but not at other Chinese banks.

C. Data and Variables

We focus on the largest Chinese companies and manually collect our bank loan sample from the footnotes of the annual reports of companies listed on China's A share market over the sample period from 1998-2005. As of 1998, publicly traded Chinese companies were required to furnish detailed accounting information in the footnotes of the financial statements in annual reports. Moreover, after 1997, the China Securities Regulatory Commission (CSRC) required all listed companies to report the background of top managers and the members of the Board of Directors in the annual reports. We utilize this background information in order to define the borrowing firm's political connections in order to measure cronyism.

To be included in our sample, the firm met the following criteria:

1) The annual reports starting from 1998 are available on

www.cnlist.com and http://finance.sina.com.cn/.

2) The firm's annual reports should consistently include detailed information regarding long-term bank loans over our sample period, including the identity of the lender, the type of bank loan (secured, collateralized, or credit), loan maturity, the lending interest rate (spread), and the amount of loan. We focus on long-term bank loans so as to exclude working capital loans that tend to be small in size and short in maturity, and because long-term bank lending is relatively scarce in China.

3) The loans are granted by Chinese commercial banks.

Our final sample includes 118 companies and 1,855 bank loan observations. Each loan observation contains the size of the loan, the identity of the lending bank, and basic loan descriptive variables. We analyze three lending policy variables. The first variable is the size of the bank loan. The second variable is the pricing of bank loans, as measured by the spread between the loan rate and the benchmark lending interest rate, which is defined as the official nominal interest rate on loans of corresponding maturity. The official lending interest rate data during 1998-2005 is extracted from the PBOC website. Since our focus is on relationship lending where there are repeated loans made over time, our third lending policy variable is the frequency of bank lending, measured as the number of bank loans from each type of bank in each year.

In measuring the impact of the public policy implications of China's lifetime responsibility program, we must control for the political interconnectedness between banking and business in China (i.e., cronyism). Due to diverse political structures and

institutional backgrounds, there is no uniformly accepted proxy to measure cronyism. For example, Faccio (2006) defines a company as politically connected if one of its large shareholders or top directors is a member of parliament, a minister, or is closely related to a top politician or party. Khwaja and Mian (2005) identify the firm who has a politician on their board of directors as a politically connected firm. Fan, Wong, and Zhang (2007) consider a Chinese listed firm to be politically connected if the CEO is either an ex- or current government bureaucrat.

Political connectedness is often defined as a binary variable. In this paper, we utilize three different measures of political connectedness, one binary and two continuous measures of the extent of political connections. The binary measurement (denoted CEO) is equal to one if the CEO of the borrowing firm is politically connected, and zero otherwise. The two continuous measurements (*TOP* and *BOD*) are the proportions of politically connected members in the top management team and the Board of Directors, respectively. To be considered politically connected, the executive must satisfy one of the following criteria: 1) be a current or former government official, 2) be a current or former People's Congress member, or 3) be a current or former People's Political Consultative Conference member.[9] The data used to determine the three political connection variables (*CEO, TOP,* and *BOD*) are obtained from the background information in the listed companies' annual reports.

Our control variables include borrower and loan characteristics to reflect the

9 Both the Peoples' Congress and Political Consultative Conference are influential organizations in the Chinese political system, with the former being the lawmaker and the latter the sole official advisory body. As the appointments of major government officials must be approved by the People's Congress and are often affected by comments from members of the Consultative Conference, these two organizations have significant influence over government officials. In fact, many members of these two political organizations are either current or former key government officials. Moreover, since terms of appointment typically last three years, the *PC* variable is remarkably persistent both across the three specifications and across time.

economic fundamentals relevant to bank lenders. The firm characteristics include the firm size measured by the natural logarithm of total assets (adjusted for inflation, with the year 2000 set as the base year CPI of 100), profitability (measured by return on assets, ROA), risk (measured by CAPM Beta), tangibility (measured by the ratio of fixed assets to total assets), and the leverage ratio (measured by the ratio of debt to total assets). These data are drawn from the China Stock Market & Accounting Research database (CSMAR).

The loan's non-pricing characteristics include maturity and loan type indicators. Three binary dummies are used to indicate loan types. *Collateralized* equals one if the loan is secured by collateral, and zero otherwise. *Secured* indicates the loan is secured by a third party. *Credit* is equal to one if the loan is granted without any collateral and not secured by any third party, and zero otherwise. Similar to Khwaja and Mian (2005), we include industry dummies (34 categories) and year dummies to control for the impact of industry and macroeconomic conditions.

D. Descriptive Statistics

Table I provides the summary description of our sample. Examining Panel A in Table I, the average loan size is about 52 million Yuan (over U.S. $6 million), most of the bank loans (59%) are secured, and the average loan maturity is less than four years. The loan spread varies considerably across different borrowers and different loans. Panel B of Table I reports that a large fraction of the loans in our sample are issued by the Big Four Chinese banks, representing 1,630 bank loans or 87.9% of our sample. Panel C of Table I indicates that the average firm size in our sample is 3.67 billion Yuan (almost U.S. $500 million in

assets).[10]

Insert Table I about here.

Panel A of Table I presents the relationship between loans and political connections in the full sample. For example, 29.1% of the 1,855 loans in the sample were made to firms in which the CEO had political connections (540 observations in which 447 loans were made by the Big Four and 93 by other Chinese banks). Table I, Panel A indicates that, at the Big Four banks, the average size of crony loans (which had higher than median numbers of politically connected management and boards) was significantly (at the 1% level) smaller than loans made to firms with fewer political connections.

The annual summary of characteristics for the 118 Chinese A share market listed firm borrowers over the 1998-2005 sample period is provided in Panel B of Table I. Over our entire sample period, around one third of the firm-year observations have politically connected CEOs (33.2%). However, we also include broader measures of firm political connections. In our sample, 365 of 416 firm-year observations have politically connected directors, averaging 27% of all board members (Panel C, Table I), and 228 of 416 firm-year observations have politically connected top managers, averaging 18% of all management (Panel C, Table I). Thus, to fully measure the extent of a firm's political connections, one must go beyond the CEO level to include the full board or top management (in contrast to Li et al. (2005) which only considers the CEO's affiliations). Among the 416 firm-year

10 By contrast, Li et al. (2005) include many small, single proprietor firms as evidenced by the average loan size of 600,000 Yuan in their sample.

observations, only 50 firm-year observations in our sample are associated with firms that have no political connections at all.[11]

III. Empirical Model and Results

A. Basic Model

In order to examine the long-term implications of the clawback policy on bank lending, we contrast the extent of cronyism in loans extended by the Big Four banks to loans granted by other Chinese banks that did not enforce the lifetime responsibility program effectively. Private market, profit maximizing incentives are indicated if loans are granted on the basis of economic fundamentals rather than political connections. Therefore, we hypothesize that loans granted by the Big Four Chinese banks in the post-clawback period will not depend on the borrowing firm's political connections, whereas political connections will impact lending by other Chinese banks.

We are interested in three major lending policy variables: 1) loan size, 2) loan spread, and 3) the frequency of repeat lending. We use an OLS model to examine the first two of these three lending policy variables (loan size and spread), estimating each dependent variable separately at the loan level as follows:

$$\begin{aligned} Log(loan\ size)\ /\ Spread = {} & \alpha_0 + \alpha_1 \times PC + \alpha_2 \times Bank + \alpha_3 \times PCBank \\ & + \beta_1 \times Beta + \beta_2 \times Size + \beta_3 \times ROA + \beta_4 \times Lev + \beta_5 \times Tangibility \\ & + \gamma_1 \times Maturity + \gamma_2 \times Collateralized + \gamma_3 \times Secured + Industry + Year + \varepsilon \end{aligned} \quad (1)$$

11 These findings are consistent with those of Wong, Opper, and Hu (2004) indicating that 56% of Chinese listed firms retain close relations with the government and ministries.

where *PC* denotes one of three possible measurements of political connections. *Bank* is equal to one for the loans borrowed from the Big Four banks and zero for the loans borrowed from the other banks. *PCBank* is the cross product term of political connectedness and the bank type dummy variable. *Beta* is the borrowing firm's CAPM Beta during the year of the loan. *Size* is the logarithm of CPI-adjusted end-of-year total assets of the borrowing firm. *ROA* measures the borrower's profitability and is calculated as annual net profit divided by assets. *Lev* is the borrower's annual debt ratio. *Tangibility* is the ratio of fixed assets to total assets of the borrowing firm. All firm characteristics are measured annually at the beginning of each year. *Maturity* is loan maturity measured in years. *Collateralized* is a dummy variable indicating whether the loan is collateralized. *Secured* is a dummy variable indicating whether the loan is secured. Although borrowing firm industry dummies and year dummies are included in the basic regression, results are not shown in the tables in order to conserve space.

To test the impact of political connections on the frequency of bank lending, we utilize a Poisson regression to estimate the following model:

$$Num = \alpha_0 + \alpha_1 \times PC + \alpha_2 \times Bank + \alpha_3 \times PCBank + \beta_1 \times Beta + \beta_2 \times Size + \beta_3 \times ROA + \beta_4 \times Lev + \beta_5 \times Tangibility + Industry + Year + \varepsilon \quad (2)$$

Where *Num* denotes the frequency of bank lending measured on firm-year bank level. For example, in the year 2000, Firm A obtained ten loans from the Big Four banks and three loans from non-Big Four banks. Therefore, our specification for Firm A in the year 2000 contains two observations, one observation with *Num* equal to ten, *Bank=1,* and another observation with *Num* equal to three, *Bank=0*. Other firm characteristics are the same for these two

observations. We control for firm characteristics, industry, and year effects, but since the dependent variable is the number of loans on firm-year bank level, we do not include any loan level characteristics.

We test our main hypothesis that the introduction of the lifetime responsibility program impacted cronyism in Chinese bank lending using the specifications in Equations (1) and (2) in three ways.[12] In Case 1, we examine the marginal impact of cronyism at the Big Four banks (*Bank*=1) on loan size (the number of loans) as the first derivative of Equation (1) [Equation (2)] with respect to the variable *PC*; that is, $a_1 + a_3$. Thus, a significant and positive estimate of $a_1 + a_3$ is consistent with cronyism at the Big Four banks during the post-clawback period.[13]

In Case 2, the marginal impact of cronyism at non-Big Four Chinese banks (*Bank*=0) is measured by the coefficient a_1 in Equations (1) and (2). We conclude that non-Big Four Chinese banks are prone to cronyism during the post-clawback period if we find a significant and positive estimate of a_1.

Finally, in Case 3, we measure the differential in cronyism at the Big Four banks as compared to other Chinese banks by calculating the difference between the marginal cronyism impact at the Big Four banks ($a_1 + a_3$) minus the marginal cronyism impact at the

12 We compare intercept terms in order to illustrate the three cases used to test our hypothesis. The intercept term for Big Four banks (*Bank=1)* with lending to politically connected borrowers (*PC=1)* is *a0+a1+a2+a3*. The intercept term for non-politically connected borrowers from Big Four banks (i.e., *PC=0, Bank=1*) is *a0+a2*. The impact of the borrowing firm's political connections on Big Four bank lending, holding firm variables constant, is the difference between these intercept terms: *a1+a3* (our first case). For non-Big Four banks (*Bank=0*), the intercept term for loans to politically connected borrowers *(PC=1)* is *a0+a1* compared to *a0* for loans to non-politically connected borrowers (*PC=0*) by non-Big Four banks. The difference in the intercept terms is *a1* (Case 2). The difference between Case 1 and Case 2 is determined by the coefficient *a3* (Case 3).

13 The signs in these tests are reversed when the loan spread is the dependent variable. That is, a sign of cronyism at the Big Four banks during the post-clawback period would be the finding of lower loan spreads to politically connected borrowers. Therefore, $a_1 + a_3$ would be negative.

non-Big Four banks (a_1). Thus, we conclude that Big Four banks are more prone to cronyism than other Chinese banks after the introduction of the clawback policy if we find a significant and positive estimate of a_3.

We run our analysis on two samples, the entire sample and the subsample of firms who have banking relationships with both the Big Four and other Chinese banks evaluating the relations for all three dependent variables: 1) loan size, 2) loan spread, and 3) loan frequency.

B. Endogeneity Issue

The OLS estimation of Equations (1) and (2) may suffer from an endogeneity problem. That is, the decision to hire a politically connected CEO, management, and/or board members may be endogenously related to loan availability and/or pricing. To address this possibility, we run the Wu-Hausman F-test and Durbin-Wu-Hausman Chi-square test on the political connection variables by testing several instrumental variables for their statistical significance. Following Chen, Li, and Su (2005), Qian and Weingast (1997), and Lau, Qian, and Roland (2000), we propose four potential instrumental variables for political connection: 1) *FISC* (the natural log of the amount of each province's government budget deficit), 2) *PSUB* (the provincial government's discretionary expenditure and subsidy divided by total expenditure), 3) *PADM* (the provincial government's administrative and penalty revenue divided by its total revenue), and 4) *MARINDEX* (a comprehensive province-level marketization index provided by the National Economic Research Institute under the China Reform Foundation. See Fan, Wong and Zhang (2005) for the province in which each

borrowing firm is located).[14] We obtain the data for *FISC*, *PSUB*, and *PADM* from the China Statistical Yearbook. However, since we find that *MARINDEX* is highly correlated with *FISC*, *PSUB*, and *PADM*, we exclude it as an instrumental variable.[15]

To perform the tests for endogeneity, we first regress the level of political connections on the borrowing firm's financial characteristics (*Beta*, *Size*, *ROA*, *Lev*, and *Tangibility*), industry dummy, year dummy, and three instrumental variables. We perform the Hausman test at the firm-year level because the political connection variables are measured at firm-year level. The fitted value of the level of political connections is computed and added to the following regression:

$$Y_{i,t} = \alpha_0 + \alpha_1 \times PC_{i,t} + \gamma \times \hat{PC}_{i,t} + \beta_1 \times Beta_{i,t} + \beta_2 \times Size_{i,t} + \beta_3 \times ROA_{i,t} + \beta_4 \times Lev_{i,t} + \beta_5 \times Tangibility_{i,t} + Industry + Year + \varepsilon_{i,t} \quad (3)$$

We perform the analysis three times, estimating Equation (3) using each of our three loan policy dependent variables: 1) the logarithm of loan size at firm-year level, 2) the firm-year level loan spread measured as the sum of the product of spread and loan size, and 3) the number of loans granted at firm-year level.

14 Chen et al (2005) finds that local governments with budget deficits have a tendency to raise revenue from administrative fines and discretionary fee charges, as well as to grant fiscal subsidies, and, as such, are more likely to exert controlling power over local companies. Extant literature also suggests that governments in regions with less developed markets can influence the local economy more significantly (Qian and Weingast, 1997; Lau et al., 2000).

15 The correlation between *MARINDEX* and other three instrumental variables is not surprising because *MARINDEX* is a comprehensive market condition index. It captures the regional market development of the following aspects: 1) the relationship between government and market, such as the role of market in allocating resources and enterprises' burden in addition to normal taxes, 2) the development of non-state businesses, such as the ratio of industrial output by the private sector to total industrial output, 3) the development of the product market via relaxation of regional trade barriers, 4) the development of the factor market such as foreign direct investment and the mobility of labor, and 5) the development of market intermediaries and the legal environment such as the protection of property rights.

In order to test whether we can estimate Equation (3) using OLS analysis, we test for potential endogeneity. Estimation of Equation (3) using loan size as the dependent variable yields Wu-Hausman F statistics (Durbin-Wu-Hausman Chi-square statistics) for the fitted value of *CEO, TOP*, and *BOD* of 1.83 (2.06), 1.21 (1.37), and 2.00 (2.25), respectively. Estimation of Equation (3) using loan spread as the dependent variable yields Wu-Hausman F statistics (Durbin-Wu-Hausman Chi-square statistics) for the fitted value of *CEO, TOP*, and *BOD* of 1.18 (1.33), 1.49 (1.68), and 0.55 (0.62), respectively. Estimation of Equation (3) using the number of granted loans as the dependent variable yields Wu-Hausman F-statistics (Durbin-Wu-Hausman Chi-square statistics) of 0.58 (0.65), 0.34 (0.38), and 0.06 (0.06), respectively. Since all of these tests are statistically insignificant at meaningful levels, we conclude that our model does not have an endogeneity problem. Therefore, we present our results using ordinary least squares analysis.

C. Results: Loan Size as the Dependent Variable

Table II presents the OLS estimation of Equation (1) examining the relationship between loan size and political connections for the entire sample (first three columns) and for a subsample of observations comprised of firms that borrow from both the Big Four and other Chinese banks (last three columns). To determine whether political connections drive lending at the Big Four banks in the post-clawback period, we examine the statistical significance of coefficients, $a_1 + a_3$ (Case 1), which is the first derivative of Equation (1) with respect to the *PC* variable for *Bank=1*. The results in all columns of Table II indicate that this sum is negative and statistically significant at the 5% level or better. This result is consistent with a

backlash against cronyism in that firms with political connections receive smaller loans than non-connected firms from the Big Four banks. Moreover, the finding of a statistically insignificant coefficient on five of the six estimates of a_1 (the coefficient on political connections under Case 2) is consistent with the absence of such a backlash against cronyism at non-Big Four Chinese banks.

Insert Table II about here.

To compare the relationship between political connections and lending at the Big Four banks to non-Big Four banks (Case 3), we examine the coefficient on a_3, which is the coefficient on *PCBank*, the cross-product term for each political connection measure and the Big Four indicator variable. Table II reports that this coefficient is statistically significant (at the 5% level or better) and negative for all six regressions, consistent with the conclusion that Big Four banks make smaller loans to politically connected firms than do non-Big Four Chinese banks.[16]

Borrowing firms' financial characteristics also have significant effects on bank loan sizes. Larger loans are granted to larger firms with more growth opportunities (lower tangibility) and less risk (lower Beta and lower leverage ratios). Consistent with our expectations, collateralized loans and secured loans are smaller in size than unsecured, uncollateralized credit loans.

16 To address the possibility that the relationship between bank loan variables and *TOP* and *BOD* may be nonlinear, we use another two binary variables to redefine political connections. *DUMTOP* is equal to one if the fraction of politically connected top managers exceed sample median of *TOP*, and zero otherwise. *DUMBOD* is defined similarly. As a robustness check, we repeated all the analysis using *DUMTOP* and *DUMBOD* to replace *TOP* and *BOD* with virtually no change in our results. Results are available upon request.

D. Results: Loan Spread as the Dependent Variable

Turning to the relationship between political connections and the pricing of bank loans, Table III examines whether firms benefit from political connections by getting lower cost loans, as indicated by lower bank loan spreads. First, when investigating the relationship at Big Four banks (Case 1), we examine the coefficient estimates of $a_1 + a_3$, the sum of the coefficients on the political connection measures (a_1) and *PCBank*, the cross-product term for each political connection measure, and the Big Four indicator variable (a_3). Table III indicates that the $a_1 + a_3$ term is negative in five of the six regressions and statistically significant (at the 5% level or better) in three regressions. This provides mixed results implying that when crony loans are made at the Big Four banks, their loan spreads are lower than for non-politically connected borrowers. Moreover, Table III provides similar mixed results for non-Big Four banks (Case 2) in that the coefficient on a_1 is negative in five of the six regressions, but statistically significant (at the 10% level or better) in only three of the cases.

Insert Table III About Here.

Indeed, the coefficient estimates on a_3 (Case 3) are all statistically insignificant, suggesting that there is no statistically significant difference between the price of loans from both the Big Four banks and the other banks in the post-clawback period. Thus, our results suggest that the clawback policy has no significant impact on loan pricing.

The control variables have results consistent with our theory. For example, larger

firms obtain bank loans at lower spreads. Moreover, longer maturity bank loans have lower spreads. When compared to credit loans, collateralized and secured loans pay significantly higher spreads. All of these results are consistent with larger, lower risk borrowers receiving loans with longer maturities and less collateral and security requirements.[17]

E. Results: Lending Frequency as the Dependent Variable

Relationship lending entails repeated interaction between the bank and the borrowing firm. Thus, an important indication of whether cronyism persists in Chinese banking is the number of loans granted to politically connected firms. That is, cronyism can be implemented via repeated, politically motivated loans that are each relatively small in size. Moreover, the deep pockets of government patrons behind politically motivated lending may make borrowers insensitive to loan rates. Thus, our tests on loan spreads and loan size may not be sensitive to cronyism in Chinese banking.

In this section, we examine the number of loans granted by the bank to determine whether the frequency of lending is impacted by political connections. Since the dependent variable is a positive integer, we employ a Poisson regression methodology to estimate Equation (2). As a robustness check, we use the logarithm of the number of loans from each type of bank as our dependent variable and run OLS estimation. Our findings are qualitatively similar.

Table IV presents the results of that analysis.

17 We also controlled for bank size (using overall bank asset size rather than lending branch size as an independent variable). There was virtually no change in the results presented in Tables II and III, except that the statistical significance of the negative coefficient on the *Bank* dummy variable increased to the 1% level in four of the six loan spread regressions (presented in Table III), suggesting that Big Four banks charged lower spreads, all else being equal. Results are available upon request.

Insert Table IV About Here.

As in previous sections, we first examine the coefficient estimates of $a_1 + a_3$ (Case 1). Table IV indicates that this measure is statistically insignificant in all six regressions suggesting that the Big Four banks do not repeatedly lend to firms with political connections. We then examine the coefficient on a_1 (Case 2) in order to measure the coefficient on political connections for non-Big Four Chinese bank lenders. In all six of the regressions, the coefficient was positive and statistically significant at the 1% level, consistent with the finding of cronyism at non-Big Four banks. That is, politically connected firms borrowed more frequently from the non-Big Four banks during the post-clawback period, consistent with the results of Bhabra, Liu, and Dogan (2008) that government ownership is positively related to the long-term debt ratio of listed Chinese firms.

Combining these results, we examine the coefficient on the cross-product term *PCBank*, a_3 (Case 3), and find that it is negative in all regressions and statistically significant (at the 10% level or better) in five of six cases. This is consistent with less frequent lending to politically connected borrowers at Big Four banks than at other Chinese banks during the post-clawback period. The results on the control variables are consistent with theory. Table IV demonstrates that larger, more highly leveraged firms with relatively large amounts of fixed assets receive repeated loans from all banks.

These findings may resolve an unanswered question in Berger et al. (2009) that although the Big Four banks are the least profit efficient banks, they are relatively more cost efficient (i.e., less cost inefficient than average) when compared to other Chinese banks.

Berger et al. (2009) conclude that Big Four banks are "'skimping' on underwriting and monitoring costs, … spend[ing] little on screening and investigating potential borrowers prior to granting credit and/or monitoring borrowers after loans are issued. As a result, many of the loans do not perform and loan revenues are very low…" Our findings of a differential lending focus for the different banking sectors in China may offer an alternative explanation. Since Big Four banks make repetitive loans to relatively transparent (non-crony) borrowers, the costs of processing, screening, and monitoring these loans may be lower than for non-Big Four banks that specialize in smaller, politically connected, and infrequently recurring loans. This reduces the costs to Big Four banks, but commensurately reduces revenues since informational rents tend to be lower in this market segment comprised of less informationally opaque borrowers.

Indeed, the Big Four banks' pricing based on loan characteristics is not consistent with a skimping conclusion, but is instead consistent with our findings of a different production technology and lower cost function for the market segment served by the Big Four banks. This is particularly relevant when drawing policy conclusions as our findings suggest that the Big Four banks have been more successful than other Chinese banks in freeing themselves of much of the cronyism and non-competitive behavior that has undermined the efficiency of the Chinese banking system. Thus, rather than reaching the pejorative conclusion that the Big Four are somehow shirking their responsibilities, they may have actually chosen to enter a different market niche, serving larger, more transparent firms with lower screening and monitoring costs, thereby leaving the more troubled firms to obtain loans through political connections and cronyism from non-Big Four Chinese banks. Our study

suggests that the lifetime responsibility program of clawbacks encouraged this shift in behavior.

F. Robustness Tests

A test of the robustness of our result that Big Four lending in the post-clawback period has been less focused on political connections can be performed by testing a subsample of Big Four loans. That is, we drop the *Bank* and *PCBank* variables and re-estimate the model using only the subsample of loans from the Big Four banks. We find that the coefficient on each of the political connections measures is negative and statistically significant (at the 5% level or better) for the loan size dependent variable, and statistically insignificant for the loan frequency dependent variable. However, the coefficient is negative and statistically significant (at the 5% level) for the *CEO* and *TOP* variables using loan spread as the dependent variable. This suggests that in the post-clawback period, the Big Four banks granted smaller crony loans, with lending frequency unaffected by political connections, but when crony loans were granted, the spreads tended to be smaller.

As another robustness check, we test whether cronyism drives credit lending at different banks. Credit loans are unsecured, uncollateralized loans granted to borrowers at relatively low rates of interest. Due to concerns about credit quality, the PBOC explicitly discouraged the use of credit loans in its Lending General Provisions adopted in 1996. Thus, if banking reforms such as the lifetime responsibility program are ineffective, these loans would be most likely to exhibit evidence of cronyism.

We test whether access to credit loans is driven by political connections or underlying

firm characteristics. There are only 218 (12% of the total number of observations) credit loans in our sample. Of this total, six (of 118) firms were granted 109 credit loans, representing 50% of the credit loan subsample. Because of this concentration of credit lending across a few firms, we control for firm fixed effects in our analysis of credit loans.[18] We utilize two measures of the availability of credit loans. The first is the ratio of the number of credit loans to the total number of bank loans at the firm-year bank level. For example, if Firm A borrows ten loans from the Big Four banks in 2000 and two of the ten are credit loans, then *CL* equals 0.2. The model is specified as:

$$CL = \alpha_0 + \alpha_1 \times PC + \alpha_2 \times Bank + \alpha_3 \times PCBank + \beta_1 \times Beta + \beta_2 \times Size + \beta_3 \times ROA + \beta_4 \times Lev + \beta_5 \times Tangibility + Year + \varepsilon \quad (4)$$

The second measure of the dependent variable *CL* in Equation (4) is the ratio of credit loan amounts to total bank loan amounts at the firm-year bank level. Our measures of the fraction of credit loans at the firm-year bank level are, by definition, censored, ranging from between zero and one. To obtain consistent estimates, we estimate Equation (4) as a Tobit regression with double censoring. As in our specification of Equation (2), we do not include loan characteristics in the regression.

Insert Table V About Here.

18 The full sample does not suffer from this concentration problem. The six firms receive only 14% (255) of the total number of loans in the sample. Given the dominance of firm-specific concentration in the credit loan subsample, the model does not converge if industry fixed effects are used together with firm fixed effects.

The results of the estimation of Equation (4) presented in Table V, indicate that although two estimates of a_3 (Case 3) are significant and positive (using the *TOP* measure of political connections), the sum of the estimates of a_1 and a_3 (Case 1) are insignificant at any conventional levels in all of the regressions. This result suggests that the granting of credit loans by Big Four banks in the post-clawback period was not based on political connections. Similarly, five of six estimates of the a_1 coefficient on *PCBANK* (Case 2) indicate that there was no cronyism in the credit loans granted by non-Big Four Chinese banks. Thus, cronyism does not appear to be a significant determinant of credit lending in the post-clawback period.

Instead, we find that credit loans are granted on the basis of fundamental firm characteristics. The findings are very robust across six regressions. That is, we find that firms with lower risk (lower Beta) and higher profitability (higher *ROA*) are granted more credit loans. This result is consistent with the use of prudent lending policies by Chinese banks, in contrast to the history of cronyism that predated the introduction of the lifetime responsibility program.

IV. Conclusion

This paper is the first, to our knowledge, to examine the long-term impact on bank lending policy of the introduction of a policy of executive compensation clawbacks. In 1998, a lifetime responsibility program was implemented at the Big Four banks in China. This program made bank loan officers responsible for the subsequent performance of the loans that they approved. If the loans performed poorly, then managers would find their bonuses

would be clawed back even after retirement.

There is a considerable academic and practitioner literature suggesting that lending at the Big Four banks was rife with cronyism and inefficiency. In this paper, we test whether this is still the case during the period of time after clawbacks were introduced. We obtain a hand collected database of individual loans to test whether political connections determine bank lending decisions from 1998-2005 after the introduction of the lifetime responsibility program. We are unable to test the pre-clawback period because of data unavailability. However, by comparing the Big Four banks to non-Big Four banks, where the clawback program was not effectively implemented, we test whether executive compensation programs impact bank lending policy.

Our results imply that bank managers respond to compensation incentives. In particular, we find evidence suggesting that the size and availability of lending at the Big Four banks during the post-clawback period is not based on political connections and cronyism, but rather on economic fundamentals. This contrasts with the evidence from the pre-clawback period in the literature regarding Big Four Chinese banks. Moreover, it differs with our evidence from the post-clawback period for non-Big Four banks. That is, since the lifetime responsibility program was not effectively enforced at non-Big Four banks in China, we find that these banks are still subject to cronyism in their lending decisions.

Our results indicate a backlash against cronyism in the Big Four Chinese banks. Politically connected borrowers have less access to bank loans and get smaller loans at the Big Four banks under the incentives of the lifetime responsibility program. Instead, we find that larger and less risky borrowers with more growth opportunities are granted larger and

more frequent loans by the Big Four banks. These results are consistent with a shift toward more prudent and conservative lending policies in response to the penalties imposed in the clawback system. Thus, clawbacks could be effective in accomplishing public policy goals to incentivize bankers to use objective and prudent lending standards. However, we also find that, conditional upon loan approval, politically connected borrowers pay lower loan spreads at all Chinese banks suggesting that clawbacks are unable to completely control cronyism.

Moreover, there is a caveat in banks' reaction to the Chinese clawback policy in that prudent lending is accomplished at the expense of reduced lending to the informationally opaque, risky firms with high growth potential firms that are typically the focus of bank activity. Under the incentives provided by a clawback system, bank lending tends to look more like arms-length lending (e.g., publicly traded debt), thereby sacrificing the private informational advantages associated with relationship bank lending. This result is consistent with the lending officer’s focus on loans that can be objectively analyzed using hard, rather than soft information, and, therefore, less likely to present a picture of malfeasance even if there is a subsequent default (Stein, 2002). Although testing this hypothesis is beyond the scope of this paper, public policy makers should note that the bankers’ shift away from relationship lending under a clawback system may reduce the benefits to both bank and borrower of mobilizing soft information in the course of bank lending activity.

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Table I. Summary Statistics

The sample includes 118 listed companies that contain detailed information about bank loan contract terms including the identity of the lender, the type of bank loan (secured, collateralized, or credit), loan maturity, the interest rate, and the amount of loan. The total sample includes 1,855 bank loans. *Amount* reported here is the size of bank loans (in RMB million). *Maturity* is measured by years. *Spread* is defined as the interest rate on the bank loan minus the benchmark interest rate, measured by The People's Bank of China's official nominal interest rates on loans of various maturity. *CEO* is equal to one if the CEO of the borrowing firm is politically connected, and zero otherwise. *TOP* and *BOD* are proportions of politically connected members in the Top Management Team and Board of Directors, respectively. *Size* is measured by the log of inflation adjusted total assets (base year = 2000). *Beta* is CAMP Beta. *ROA* is the ratio of net profit to total assets. *Lev* is the leverage ratio defined as the ratio of liability to total assets. *Tangibility* is the ratio of fixed assets to total assets. *Collateralized* is equal to one for the loan secured by collateral, and zero otherwise. *Secured* is equal to one for a loan secured by a third party. *Credit* is equal to one if the loan is not secured by collateral or by a third party. For each type of lender, the equality test results for all bank loan characteristics across different political connections status are reported. ***, **, and * denote the significance level 1%, 5%, and 10%, respectively.

Panel A

	Number of Loans		**Amount (million)**		**Maturity (year)**		**Spread (Basis Point)**		**Collateralized (%)**		**Credit (%)**		**Secured (%)**	
Mean (Full Sample)	**1855**		**52.11**		**3.67**		**0.08**		**0.29**		**0.12**		**0.59**	
	Big 4	**Others**	**Big 4**	**Others**	**Big 4**	**Others**	**Big 4**	**Others**	**Big 4**	**Others**	**Big 4**	**Others**	**Big 4**	**Others**
CEO=1	447	93	51.87	36.04**	3.90**	3.43	-0.01*	0.03	0.36***	0.28	0.13	0.19	0.52***	0.53
CEO=0	1,183	132	52.51	60.71	3.65	3.29	0.11	0.16	0.27	0.27	0.10	0.15	0.62	0.58
TOP>Median(TOP)	788	139	41.46***	47.35	3.71	3.30	0.06	0.09	0.36***	0.29	0.14***	0.17	0.50***	0.53
TOP<Median(TOP)	842	86	62.51	55.62	3.72	3.41	0.10	0.14	0.24	0.24	0.08	0.16	0.68	0.59
BOD>Median(BOD)	796	122	43.85***	48.45	3.58**	3.07**	0.05	0.22**	0.33**	0.30	0.16***	0.27***	0.51***	0.43***
BOD<Median(BOD)	834	103	60.43	52.95	3.85	3.67	0.10	-0.03	0.26	0.25	0.06	0.05	0.68	0.70

Panel B.

	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**Total**
No. of Loans from the Big 4 Banks	105	132	246	194	211	233	280	229	1,630
No. of Loans	110	135	257	205	248	307	325	268	1,855
Fraction (%)	95.45	97.78	95.72	94.63	85.08	75.90	86.15	85.45	86.52

Table I. Summary Statistics (Continued)

Panel C.																		
	1998		**1999**		**2000**		**2001**		**2002**		**2003**		**2004**		**2005**		**1998-2005**	
	Mean	**St.Dev**	**Mean**	**St.Dev**	**Mean**	**St.Dev**	**Mean**	**St.Dev**	**Mean**	**St.Dev**	**Mean**	**St.Dev**	**Mean**	**St.Dev**	**Mean**	**St.Dev**	**Mean**	**St.Dev**
Total Assets (RMB billion)	1.88	1.83	1.87	1.85	2.68	5.37	2.46	2.3	4.22	6.77	4.28	7.36	5.92	10.7	4.98	7.46	3.67	6.66
ROA	4.83	9.04	4.60	3.81	3.68	3.98	0.79	5.8	0.84	6.97	2.79	3.15	2.28	6.23	2.66	2.67	2.72	5.88
Lev	44.50	16.99	43.61	14.27	48.51	15.12	52.7	14.69	51.55	16.9	52.19	15.54	54.62	14.76	58	18.72	50.86	16.28
Tangibility	40.27	19.83	39.56	19.05	35.47	18.25	37.46	21.82	39.2	21.47	42.3	21.83	43.43	22.7	40.48	22.63	39.68	20.97
CEO	0.33	0.47	0.30	0.46	0.31	0.47	0.30	0.46	0.37	0.49	0.30	0.46	0.38	0.49	0.37	0.49	0.33	0.47
TOP	0.16	0.25	0.16	0.20	0.17	0.22	0.18	0.23	0.19	0.2	0.16	0.21	0.2	0.22	0.18	0.21	0.18	0.22
BOD	0.24	0.23	0.29	0.21	0.29	0.2	0.23	0.19	0.27	0.19	0.27	0.19	0.28	0.2	0.26	0.19	0.27	0.20
Obs	40		44		64		53		57		63		52		43		416	

Table II. Political Connections and Individual Loan Size: The OLS Results

The dependent variable is the logarithm of loan size. The regression model is specified as:

$$Log(loan) = \alpha_0 + \alpha_1 \times PC + \alpha_2 \times Bank + \alpha_3 \times PCBank + \beta_1 \times Beta + \beta_2 \times Size + \beta_3 \times ROA + \beta_4 \times Lev + \beta_5 \times Tangibility + \gamma_1 \times Maturity + \gamma_2 \times Collateralized + \gamma_3 \times Secured + Industry + Year + \varepsilon$$

Political connection is measured by *CEO*, *TOP*, or *BOD*. *CEO* is equal to one if the CEO of the borrowing firm is politically connected, and zero otherwise. *TOP* and *BOD* are defined as the proportions of politically connected members in the Top Management Team and Board of Directors, respectively. *Bank* is equal to one if the lending bank is one of the Big Four banks, and zero otherwise. *PCBank* is the cross-product term of political connection and *Bank*. *Beta* is defined as CAMP Beta. *Size* is measured by the logarithm of total assets. *ROA* is defined as the ratio of net profit to total assets. *Lev* is the ratio of liability to total assets. *Tangibility* is defined as the ratio of fixed assets to total assets. *Maturity* is measured by years. *Collateralized* is equal to one for a loan secured by collateral, and zero otherwise. *Secured* indicates the loan is secured by a third party. Industry dummies and year dummies are included in the regressions. Subsample only includes the firms that borrow from both Big Four banks and non-Big Four banks. ***, **, and * denote the significance level 1%, 5%, and 10%, respectively. The numbers in the bracket are the robust t statistics.

	Log(loan)					
	Full Sample			**Subsample**		
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**
CEO	0.24			0.23		
	(1.23)			(1.02)		
TOP		0.17			-0.37	
		(0.35)			(-0.62)	
BOD			-0.65			-1.69
			(-1.30)			(-3.00)***
Bank	0.03	0.02	0.12	0.07	0.04	0.19
	(0.17)	(0.14)	(0.68)	(0.38)	(0.23)	(1.03)
PCBank	-0.55	-1.15	-1.12	-0.60	-1.17	-1.41
	(-2.51)**	(-2.36)**	(-2.29)**	(-2.53)**	(-2.07)**	(-2.68)***
Beta	-0.34	-0.33	-0.24	-0.55	-0.61	-0.46
	(-2.18)**	(-2.20)**	(-1.62)	(-2.42)**	(-2.71)***	(-2.14)**
Size	0.28	0.28	0.32	0.02	0.02	0.11
	(5.83)***	(5.81)***	(6.67)***	(0.31)	(0.32)	(1.35)
ROA	0.00	0.00	0.00	-0.02	-0.03	-0.03
	(0.22)	(0.19)	(0.14)	(-1.26)	(-1.61)	(-1.71)*
Lev	-0.01	-0.01	-0.01	-0.02	-0.02	-0.02
	(-2.49)**	(-2.60)***	(-2.99)***	(-3.15)***	(-3.24)***	(-3.65)***
Tangibility	-0.01	-0.01	-0.01	-0.01	-0.01	-0.01
	(-3.37)***	(-3.37)***	(-3.10)***	(-2.30)**	(-2.47)**	(-1.53)

Table II. Political Connections and Individual Loan Size: The OLS Results (Continued)

	Log(loan)					
	Full Sample			**Subsample**		
	(1)	**(2)**	**(1)**	**(2)**	**(1)**	**(2)**
Maturity	0.01	0.01	0.01	-0.02	-0.02	-0.03
	(0.60)	(0.47)	(0.44)	(-0.93)	(-0.87)	(-1.01)
Collateralized	-0.19	-0.22	-0.29	-0.30	-0.39	-0.49
	(-1.60)	(-1.89)*	(-2.52)**	(-1.95)*	(-2.58)**	(-3.29)***
Secured	-0.30	-0.37	-0.43	-0.46	-0.55	-0.65
	(-2.96)***	(-3.64)***	(-4.23)***	(-3.37)***	(-4.15)***	(-5.08)***
Industry	Included	Included	Included	Included	Included	Included
Year	Included	Included	Included	Included	Included	Included
$a_1 + a_3$	-0.31	-0.98	-1.77	-0.38	-1.54	-3.10
$H_0 : a_1 + a_3 = 0$ (One tail, F-test)	9.50***	20.10***	48.03***	6.08**	14.05***	59.83***
Obs	1,855	1,855	1,855	1,231	1,231	1,231
R^2	0.31	0.31	0.32	0.32	0.32	0.35

Table III. Political Connections and Spread: The OLS Results

Spread is defined as interest rate on bank loan minus the benchmark interest rate. The regression model is specified as:

$$Spread = \alpha_0 + \alpha_1 \times PC + \alpha_2 \times Bank + \alpha_3 \times PCBank + \beta_1 \times Beta + \beta_2 \times Size + \beta_3 \times ROA + \beta_4 \times Lev + \beta_5 \times Tangibility + \gamma_1 \times Maturity + \gamma_2 \times Collateralized + \gamma_3 \times Secured + Industry + Year + \varepsilon$$

Political connection is measured by *CEO*, *TOP*, or *BOD*. *CEO* is equal to one if the CEO of the borrowing firm is politically connected, and zero otherwise. *TOP* and *BOD* are defined as the proportions of politically connected members in the Top Management Team and Board of Directors, respectively. *Bank* is equal to one if lending bank is one of the Big Four banks, and zero otherwise. *PCBank* is the cross-product term of political connection and *Bank*. *Beta* is defined as CAMP Beta. *Size* is measured by the logarithm of total assets. *ROA* is defined as the ratio of net profit to total assets. *Lev* is the ratio of liability to total assets. *Tangibility* is defined as the ratio of fixed assets to total assets. *Maturity* is measured by years. *Collateralized* is equal to one for a loan secured by collateral, and zero otherwise. *Secured* indicates the loan is secured by a third party. Industry dummies and year dummies are included in the regressions. Subsample only includes the firms that borrow from both Big Four banks and non-Big Four banks. ***, **, and * denote the significance level 1%, 5%, and 10%, respectively. The numbers in the bracket are the robust t statistics.

	Spread					
	Full Sample			**Subsample**		
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**
CEO	-0.15			-0.26		
	(-1.17)			(-2.16)**		
TOP		-0.78			-0.67	
		(-2.15)**			(-1.87)*	
BOD			-0.01			0.33
			(0.03)			(0.94)
Bank	-0.12	-0.20	-0.08	-0.10	-0.20	-0.11
	(-1.34)	(-1.84)*	(-0.67)	(-1.18)	(-1.94)*	(-0.98)
PCBank	-0.01	0.46	-0.16	-0.04	0.52	-0.01
	(-0.10)	(1.22)	(-0.46)	(-0.31)	(1.41)	(-0.03)
Beta	0.14	0.14	0.13	0.42	0.37	0.34
	(0.97)	(1.01)	(0.93)	(3.30)***	(2.80)***	(2.63)***
Size	-0.13	-0.13	-0.12	-0.11	-0.12	-0.12
	(-4.25)***	(-4.28)***	(-3.93)***	(-2.75)***	(-2.82)***	(-2.94)***
ROA	0.00	0.00	0.00	0.02	0.02	0.02
	(0.05)	(0.12)	(0.10)	(2.14)**	(1.80)*	(1.98)**
Lev	0.00	0.00	0.00	0.00	0.00	0.00
	(0.06)	(0.04)	(0.18)	(0.96)	(0.84)	(0.63)
Tangibility	0.00	0.00	0.00	0.00	0.00	0.00
	(0.60)	(0.50)	(0.57)	(0.82)	(1.48)	(1.66)*

Table III. Political Connections and Spread: The OLS Results (Continued)

	Spread					
	Full Sample			**Full Sample**		
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**
Maturity	-0.06	-0.06	-0.06	-0.05	-0.06	-0.06
	(-2.91)***	(-2.98)***	(-2.89)***	(-1.99)**	(-2.10)**	(-2.07)**
Collateralized	0.51	0.50	0.50	0.58	0.60	0.63
	(4.97)***	(4.99)***	(5.06)***	(7.78)***	(7.62)***	(8.24)***
Secured	0.30	0.28	0.29	0.32	0.33	0.36
	(2.86)***	(2.73)***	(2.95)***	(4.65)***	(4.55)***	(5.27)***
Industry	Included	Included	Included	Included	Included	Included
Year	Included	Included	Included	Included	Included	Included
$a_1 + a_3$	-0.16	-0.32	-0.17	-0.30	-0.15	0.32
$H_0 : a_1 + a_3 = 0$ (One tail, F-test)	4.32**	4.83**	0.89	10.01***	0.48	2.32
Obs	1,855	1,855	1,855	1,231	1,231	1,231
R^2	0.18	0.18	0.17	0.20	0.20	0.20

Table IV. The Number of Bank Loans: The Poisson Regression Results

The dependent variable is the number of bank loans from each type of bank for each firm-year. The regression model is specified as:

$$Num = \alpha_0 + \alpha_1 \times PC + \alpha_2 \times Bank + \alpha_3 \times PCBank + \beta_1 \times Beta + \beta_2 \times Size + \beta_3 \times ROA + \beta_4 \times Lev + \beta_5 \times Tangibility + Industry + Year + \varepsilon$$

Political connection is measured by *CEO*, *TOP*, or *BOD*. *CEO* is equal to one if the CEO of the borrowing firm is politically connected, and zero otherwise. *TOP* and *BOD* are defined as the proportions of politically connected members in the Top Management Team and Board of Directors, respectively. *Bank* is equal to one if the lending bank is one of the Big Four banks, and zero otherwise. *PCBank* is the cross-product term of political connection and *Bank*. *Beta* is defined as CAMP Beta. *Size* is measured by the logarithm of total assets. *ROA* is defined as the ratio of net profit to total assets. *Lev* is the ratio of liability to total assets. *Tangibility* is defined as the ratio of fixed assets to total assets. Industry dummies and year dummies are included in the regressions. Subsample only includes firms that borrow from both Big Four banks and non-Big Four banks. ***, **, and * denote the significance level 1%, 5%, and 10%, respectively. The numbers in the bracket are the robust t statistics.

	Number of Bank Loans					
	Full Sample			**Subsample**		
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**
CEO	0.44			0.51		
	(2.65)***			(2.61)***		
TOP		1.64			2.07	
		(4.13)***			(4.45)***	
BOD			1.08			1.77
			(2.72)***			(3.71)***
Bank	1.01	1.07	1.13	1.06	1.16	1.23
	(8.53)***	(8.14)***	(6.81)***	(8.59)***	(8.16)***	(6.95)***
PCBank	-0.47	-1.46	-1.06	-0.30	-1.29	-1.02
	(-2.16)**	(-3.50)***	(-2.07)**	(-1.27)	(-2.16)**	(-1.69)*
Beta	0.02	0.01	0.01	-0.03	0.01	-0.02
	(0.12)	(0.06)	(0.05)	(-0.16)	(0.03)	(-0.10)
Size	0.21	0.23	0.21	0.27	0.29	0.28
	(2.80)***	(3.18)***	(3.14)***	(2.74)***	(2.78)***	(2.57)**
ROA	0.01	0.01	0.01	0.02	0.02	0.03
	(0.57)	(0.62)	(0.61)	(1.75)*	(2.02)**	(2.05)**
Lev	0.01	0.01	0.01	0.01	0.01	0.01
	(2.09)**	(2.25)**	(2.05)**	(2.17)**	(2.24)**	(2.04)**
Tangibility	0.01	0.01	0.01	0.01	0.01	0.01
	(2.74)***	(2.88)***	(2.80)***	(1.45)	(1.83)*	(1.48)

Table IV. The Number of Bank Loans: The Poisson Regression Results (Continued)

	Number of Bank Loans					
	Full Sample			**Full Sample**		
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**
Industry	Included	Included	Included	Included	Included	Included
Year	Included	Included	Included	Included	Included	Included
$a_1 + a_3$	-0.03	0.18	0.02	0.21	0.78	0.75
$H_0 : a_1 + a_3 = 0$ (One tail, χ^2 test)	0.04	0.27	0.00	0.86	1.37	1.69
Obs	493	493	493	317	317	317

Table V. The Determinants of Credit Loans: Tobit Regression

The dependent variable is the fraction of credit loans from each type of bank for each firm-year. *CEO* is equal to one if the CEO of the borrowing firm is politically connected, and zero otherwise *TOP* and *BOD* are defined as the proportions of politically connected members in the Top Management Team and Board of Directors, respectively. *Bank* is equal to one if the lending bank is one of the largest four state-owned banks, and zero otherwise. *Beta* is defined as CAMP Beta. *Size* is measured by the log of total assets. *ROA* is defined as the ratio of net profit to total assets. *Lev* is the ratio of liability to total assets. *Tangibility* is defined as the ratio of fixed assets to total assets. Year dummies and firm dummies are included in the regressions. The Tobit regression results are reported here. ***, **, and * denote the significance level 1%, 5%, and 10%, respectively. The numbers in the bracket are the absolute value of robust t statistics

	Full Sample					
	Fraction of the Number of Credit Loans			Fraction of the Amount of Credit Loans		
	(1)	(2)	(3)	(4)	(5)	(6)
CEO	-0.62			-0.59		
	(-0.90)			(-0.85)		
TOP		-3.51			-3.64	
		(-1.62)			(-1.67)*	
BOD			-0.76			-0.70
			(-0.37)			(-0.34)
Bank	-0.48	-0.88	-0.39	-0.54	-0.94	-0.47
	(-1.25)	(-2.07)**	(-0.72)	(-1.42)	(-2.24)**	(-0.86)
PCBank	0.71	4.07	0.58	0.72	4.07	0.64
	(1.17)	(2.18)**	(0.38)	(1.19)	(2.20)**	(0.42)
Beta	-1.13	-1.09	-1.10	-1.08	-1.04	-1.05
	(-2.30)**	(-2.28)**	(-2.25)**	(-2.22)**	(-2.20)**	(-2.17)**
Size	0.65	0.72	0.61	0.52	0.60	0.49
	(1.02)	(1.18)	(0.92)	(0.83)	(1.00)	(0.75)
ROA	0.18	0.18	0.18	0.18	0.18	0.18
	(4.41)***	(4.36)***	(4.24)***	(4.36)***	(4.30)***	(4.17)***
Lev	-0.01	-0.01	-0.01	-0.01	0.00	-0.01
	(-0.42)	(-0.33)	(-0.46)	(-0.30)	(-0.21)	(-0.35)
Tangibility	0.03	0.03	0.03	0.03	0.03	0.03
	(1.25)	(1.20)	(1.22)	(1.20)	(1.15)	(1.18)
$a_1 + a_3$	0.09	0.56	-0.18	0.13	0.43	-0.06
$H_0 : a_1 + a_3 = 0$						
(One tail, F-test)	0.03	0.25	0.01	0.05	0.17	0.00
Firm	Included	Included	Included	Included	Included	Included
Year	Included	Included	Included	Included	Included	Included
Obs	493	493	493	493	493	493