

Chapter 1

Introduction

Connections are pervasive around the world.¹ In the context of family business groups and a weak law enforcement system, connections help reduce asymmetric information problems and increase contract enforcement. Individuals and firms tend to develop connections based on reputation and trust in order to complement a lack of formal institutions and effective contracting (Powell and Smith-Doerr, 1994; McMillan and Woodruff, 1998). Lower cost of searching information and higher quantity and reliability of information can be achieved from connected parties (Granovetter, 1973). However, connections may also lead to corporate governance problems in some circumstances in that the connected parties may collude and hinder transparency (Rajan and Zingales, 1998), which may lead to an unfair treatment of non-connected parties.

In this study, we focus on the presence of connections between firms and banks and the impact of bank connections on firm restructurings around the crisis period. In the Anglo-Saxon, the Japanese, and the German financial systems, banks play a key role in monitoring firms, complementing a lack of incomplete contract and mitigating free-rider problems and agency problems. Examples of studies that pronounce the significance of banking relationships are those by Ongena and Smith (2000) and Elyasiani and Goldberg (2004).

Banks act as firms' external financing providers and bank financing plays an important role in developing a country's financial system (Mayer, 1990). In practice, banks adopt a monitoring role in ensuring that firms are able to repay their loans, and in gathering updated information to review firms' financial status and operations. In Germany, banks take an active role in monitoring and governing firms according to the agency theory (Edwards and Fischer, 1994; Chirinko and Elston, 2006). Aoki (2000) uses the concept of information asymmetry and document that Japanese banks work closely with firms to gain information and to monitor firms' investments.

¹ Connections are defined as the relationship between two people or more. In the literature of Social Economics, connections are known as the network of related parties.

Firms benefit from bank relationships in terms of access to external funds (Gugler, 2001; McCahery, 2002; Espenlaub et al., 2010). In addition, the benefits of bank monitoring increase firms' access to other sources of external funds (Diamond, 1991). Bank connections also help firms obtain a lower cost of external funds (Berger and Udell, 1995; Greenbaum and Thakor, 1995; Charumilind et al., 2006) and survive during the financial distress (Sheard, 1994).

Bank connections might increase the possibility that firms will engage in restructuring actions in response to firm performance deterioration and macro-economic crisis. Connected banks are likely to closely monitor top management and advise distressed firms to help them recover from financial difficulty. Bank-connected firms might also be able to negotiate with banks, enhancing the restructuring incidence. There are several types of restructuring actions, which firms can choose to practice. Generally, restructuring actions are documented as a corporate strategy responsive to a crisis, including a firm-specific crisis, i.e., (sharp) performance decline and economy-wide crisis. Firms also undertake restructuring actions in order to avoid bankruptcy. Taken together, studying the impact of bank connections on the likelihood of corporate restructurings will shed light on the role of banks on a firm's financial strategies.

This study contributes to the literature on bank connections and corporate restructuring in several aspects. First, unlike previous studies (Lai and Sudarsanam, 1997; Gilson, 2001; Baek et al., 2002; Faccio and Sengupta, 2006; Kang et al., 2010), we investigate the impact of bank connections on firm restructurings, covering three periods (pre-, during and post-economic crisis). Thailand was first hit severely by the East Asian crisis in 1997, which can be characterized by a large decline in the currency and stock values, and a substantial rise in the interest rates. In response to the crisis, a majority of firms implement restructuring activities. We use the 1997 East Asian financial crisis as a setting for economic shocks, and examine how bank-connected firms experiencing an economic shock undertake restructuring actions and what factors determining the likelihood of such actions. In addition, the 1997 financial crisis allows us to investigate the impact of bank connections on firm restructuring activities before (1996) and after crisis (1999 - 2000).

Second, we define bank connections that are occurred as a result of family relationships and social relations in Thailand, in addition to the settings of the Anglo-Saxon, the Japanese, and

the German financial systems. Previous research investigates the impact of bank connections on corporate restructurings only in the Anglo-Saxon, the Japanese, and the German financial systems (Bulow and Shoven, 1978; Sheard, 1989; Diamond, 1994; Kaplan and Minton, 1994; Aoki et al., 1994; Sheard, 1994). Many Thai firms are connected with banks through family ownership and board of directors. In particular, Espenlaub et al. (2010) find that connected firms account for 80% of total non-financial listed firms in the pre-crisis period. This characteristic of Thai firms allows us to examine how bank connections influence the restructuring decision of the firms in a difficult time.

Using univariate analyses and probit estimations, we examine the effect of bank connections on the likelihood of restructuring activities in Thailand, covering three periods: the pre-crisis, during the 1997 economic crisis and the post-crisis periods. We further investigate the effect of the strength of connections on the probability of firms engaging in restructurings. In this study, we separate the strength of connections into ownership and director connections. Moreover, we examine the impact of connections on firm performance following restructuring actions.

Our results support the role of connected banks on corporate restructurings. More precisely, univariate analyses show that bank-connected firms engage in restructuring activities more often than non-connected firms in the pre-crisis period. Such activities are dividend cut and capital raising. During the crisis and in the post-crisis period, connected firms are more likely to replace their top management and raise new capital. However, we find only little impact of the strength of connections on the restructuring incidence.

Consistent with the findings of univariate analyses, our probit estimations show that the presence of bank connections is associated with the likelihood of restructuring activities. In the pre-crisis period, connected firms are more likely to cut dividend payment to restructure; while they are more likely to engage in management turnover activity during the crisis. Although connected banks play an important role on a firm's financial strategy, we document that bank connections are not valuable to the firms since changes in operating performances after restructurings are not significantly different between connected and non-connected firms.

The research suggests that policy makers should be aware of the presence of bank connections because it might lead to unfair treatments among firms. To be more specific, connected firms might have easier access to bank loans and obtain valuable information and advices from the connected banks for their restructurings. It also implies that banks might provide higher opportunity to restructure for connected firms because of lower asymmetric information problems between banks and firms.

The rest of the study is structured as follows. Chapter 2 reviews the significance of bank connections and the efficiency of restructuring actions taken in response to a crisis. It also describes the effect of bank connections and other factors on the likelihood that a firm engages in restructuring activities. Chapter 3 discusses data, variables, and methodology used in this study. Chapter 4 analyzes the empirical results from our developed models and examines the impact of bank connections and other factors that determine restructuring choices of Thai firms over the economic crisis. Finally, Chapter 5 concludes the study and provides suggestions for future research.