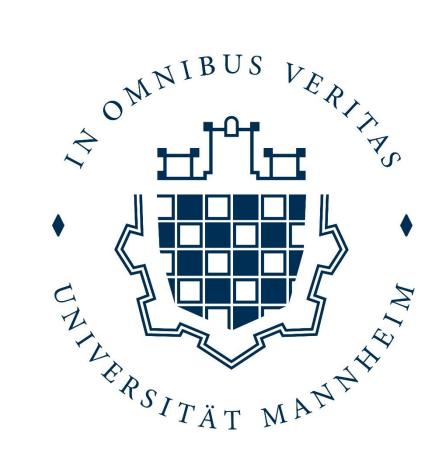# Connections over Competence: The Impact of Political Ties on Sell-Side Research Quality

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Motivation

Examine the existence and social efficiency of hiring based on cronyism in a governmentally-controlled private sector.

Setting:

– Brokerages in China

– Sell-side analyst reports on the healthcare industry
   o Publicly available products and technology enable the assessment of analyst performance

– Sample period: 2013-2019

Data (Sources)

- Hand-collected analyst and brokerage director data
- Analysts' and officials' photos from the Internet
- Brokerage and A-Share healthcare firm data
- Reports for A-share healthcare industry/ firms
  – Downloaded from Chinese financial terminals
  – # of reports: around 35,000

Methodology

Measurement of political connections

– Whether the analysts work in SOE

– Kinship with the personnels in the management level of China Securities Regulatory Commission (CSRC)
   o Determined by machine learning by training with pictures of 310 Asian parent-child pairs (the dataset will be extended) (Howard et al., 2019; zhangxin, 2019; Lu et al. 2012/ 2014)

Measurement of analyst performance

– Report length (in pages)
– Plagiarism
– Recommendation profitability
– Industry knowledge
   o # occurrences of medical terms in reports
– Technical knowledge
   o # occurrences of CFA vocabulary in reports

Analysis
Difference-in-Differences

– $Performance_{i,t} = a + \beta_1 Post_t + \beta_2 Post_t \times Kinship_{i,t} + \beta_3 Kinship_{i,t} + Control_{i,t} + \varepsilon_{i,t}$

– $DirectorPromotion_{i,t} = a + \beta_1 Post_t + \beta_2 Post_t \times BrokerKinship_{i,t} + \beta_3 BrokerPerformance_{i,t} + Control_{i,t} + \varepsilon_{i,t}$

i: analyst/director level or brokerage level
Post: after anti-corruption campaign, i.e. after 2015
$DirectorPromotion_{i,t}$: Dummy variable, equals 1 if Director i was promoted in Year t, equals 0 if otherwise

Cox Proportional-Hazards Model:
$DirectorPromotion(t)$
$= DirectorPromotion_0(t)$
$\times \exp(\beta_1 BrokerKinship$
$+ \beta_2 BrokerPerformance + \beta_3 Controls)$

Key Takeaway

- We use the government-initiated anti-corruption campaign as an exogenous shock that significantly impacts the political connections between analysts and financial regulators.

- Brokerage managers and directors hire unqualified financial analysts who are connected to financial regulators so that they receive promotions.

- Cronyism negatively affects sell-side research quality and hence brokerage profitability.

- Bureaucrats/ directors at SOEs are more accountable to citizens and top political elites when top-down monitoring becomes stronger, which forces them to change their political incentives.

Results

Anti-corruption campaign causes the politically connected analysts to improve their performance:

	(1) Industry Knowledge	(2) Technical Knowledge	(3) Report Length	(4) Plagiarism	(5) ABR hold for 3 months (Threshold: Neutral)
Post	-6.198	2.167	-2.867*	0.013*	-6.571
	(5.320)	(2.655)	(1.567)	(0.008)	(4.080)
Kinship	-6.587	1.371	-1.543	0.004	-7.645
	(6.353)	(3.136)	(1.878)	(0.010)	(4.908)
Post × Kinship	**15.756***	**2.873**	**5.702****	**-0.017**	**9.606***
	(9.244)	**(4.003)**	**(2.656)**	**(0.012)**	**(5.290)**
Analyst Experience	0.157	-0.202*	0.079	0	0.013
	(0.307)	(0.111)	(0.088)	(0)	(0.074)
Analyst Education	-6.372	-1.924	-1.940	0.005	-0.701
	(4.222)	(1.810)	(1.403)	(0.006)	(1.463)
Portfolio Complexity	0.048*	0.019	-0.032***	0***	-0.005
	(0.028)	(0.015)	(0.009)	(0)	(0.009)
Obs.	956	956	956	956	658
R-squared	0.015	0.031	0.021	0.011	0.012

Cox proportional-hazards model finds that brokerage directors with more politically connected analysts working under them are more likely to get promoted:

	(1) DirectorPromotion	(2) DirectorPromotion
Brokerage-level Kinship	**1.392****	**-0.775**
	(0.710)	**(0.744)**
Director Age	-0.005	-0.001
	(0.009)	(0.009)
Controlling for other Director and Brokerage Characteristics	Yes	Yes
Controlling for Performance	No	Yes
Obs.	2667	2400
Pseudo R^2	0.015	0.027

Diff-in-Diff finds that brokerage directors with more politically connected analysts working under them are less likely to get promoted after the anti-corruption campaign:

	(1) DirectorPromotion	(2) DirectorPromotion
Post	0.379**	0.538***
	(0.155)	(0.173)
Brokerage-level Kinship	0.218	0.181
	(0.143)	(0.149)
Post × Brokerage-level Kinship	**-0.442****	**-0.657*****
	(0.204)	**(0.226)**
Director Age	-0.007***	-0.007***
	(0.001)	(0.001)
Controlling for other Director and Brokerage Characteristics	Yes	Yes
Controlling for Performance	No	Yes
Obs.	2559	2392
R-squared	0.016	0.036

Background 1: SOE in China

Prevalence of state-owned enterprises (SOE) in profitable industries in China

– E.g. 74% of brokerages are SOEs

Inefficiency of SOEs in China due to subsidized super-profitability (i.e. administrative monopoly) (Brødsgaard and Li, 2013; Unirule Institute of Economics, 2015/2016)

➢ Little need for efficiency, competence and innovation

➢ Rampant corruption, esp. through cronyism

Background 2: Anti-Corruption Campaign

"Chinese Communist Party has consistently favored an enforcement-centered anti-corruption strategy" (Pei, 2018)

– 2012 - 2021: 8.83 million / 12.92 million party members investigated and handled accordingly corruption (total number of party members in 2022: 93.66 million) (Ministry of Justice of the People's Republic of China, 2021)

– 2013 – 2015: $ 6.28 billion / $ 40.58 billion confiscated (Xinhuanet, 2015; China National Radio, 2016)
   o 2021: $ 2.5 billion confiscated from offshore account holders (CCDI and SSC of PRC, 2021)
   o 2018: illegal proceeds of $ 454.2 million confiscated from a politician

For our purpose: Anti-corruption campaign reached the financial sector in 2015 due to personal turnover in the management level of the China Securities Regulatory Commission (CSRC)

Economic Story

Unqualified analysts may get hired at brokerages by connections to e.g. China Securities Regulatory Commission (CSRC) officials

– Exchange of favors: Brokerage directors receive promotions in return
   o SOEs' management level consists of party members

– For analysts
   o Job with above-average pay and welfare

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