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On Controlling Hareholder's Equity Pledge Risk and Preventive Measures

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Abstract: In recent years, under the background of bank credit crunch, equity pledge has become a widely used financing method. In the A-share market of Shanghai and Shenzhen, there are a large number of listed companies with equity pledge, accounting for a large proportion. At the same time, equity pledge also produces many risks, which has a significant impact on the overall stability of the financial market. This paper combs the previous research on equity pledge, focuses on the analysis of the motivation and economic consequences of the controlling shareholder's equity pledge, and holds that the controlling shareholder's equity pledge is mainly due to expanding financing channels, trying to occupy the interests of enterprises and small and medium-sized shareholders, ensuring the control of enterprises and avoiding risks, The resulting risks will also have an impact on listed companies and relevant stakeholders. Based on the above analysis, this paper puts forward research suggestions, including policy support to resolve the risk of equity pledge, improve the equity financing margin system, strengthen the internal governance and supervision of the company, and improve the information disclosure system.

Keywords: Controlling shareholder, Equity pledge, Market risk.

1. Introduction

Because the controlling shareholder's equity pledge takes the equity representing the control of the enterprise as the pledge, its impact is also quite complex. First, when the stock price of the enterprise falls below the closing line agreed with the pledgee due to internal or external reasons, the pledged equity will be disposed of by the pledgee, resulting in the transfer of the control of the enterprise. At the same time, equity pledge will deepen the deviation between enterprise control right and cash flow right, and promote the controlling shareholders to "empty" the enterprise. In addition to damaging the enterprise value, it will also encroach on the interests of minority shareholders, making the agency problem more and more serious. Secondly, when the stock price falls and the pledgor cannot repay the debt in time or the pledged equity has been frozen, it is difficult for the pledgee to realize the stock as the pledge and recover the funds. Because the main pledgors of a shares are securities companies and banks, the funds involved are very wide, which is easy to induce systemic financial risks. Finally, after the implementation of equity pledge, the controlling shareholders are easy to adopt the business strategy of expanding investment in order to maximize their interests, which increases the scale of enterprise debt, increases the pressure of debt repayment, and worsens the financial indicators sharply, which may produce financial and operational risks.

Many scholars have made a lot of useful research on the risk of controlling shareholders' equity pledge. According to the previous research, Lin Jianwei and Liu Fang (2006) further concluded that it is difficult for the controlling shareholders to adhere to the principle of good faith after the pledge, and they will increase their control over the listed company by using the "secondary encirclement of money", indicating that the equity pledge will lead to the moral hazard of the controlling shareholders [1]. He Hui (2007) pointed out that due to the instability of stock price, the stock price fluctuates sharply after equity pledge, which may increase the risk of equity pledge [2]. Chen Yixuan (2015) pointed out that many shareholders of listed companies continue to make up positions, but in the end, the Pledged Shares are still sold off. The pledgee would rather sell at a discount, or transfer by auction and agreement. Especially when the shareholding dilution of the controlling shareholder is too high, its controlling position will be threatened [3].

The risk of equity pledge has reached a point that can not be ignored. As of September 2021, among 4472 listed companies with equity pledge, 13.31% of equity pledge companies have reached the closing line and 4.16% of equity pledge companies have reached the early warning line. In order to prevent the breeding of equity pledge risk, the state has issued a number of policies one after another. In 2002, China promulgated and implemented the measures for the administration of stock pledge loans of securities companies, which was revised in 2004. In this policy, strict and detailed regulations are set on the pledgor and pledgee of equity pledge, pledge period, pledge rate, warning line and closing line; In November 2013, the CBRC issued the strengthening of equity liability management of commercial banks, which included equity pledge management into the scope of risk prevention and control and corporate governance, filling the gap in supervision; In 2015, Shanghai Stock Exchange and Shenzhen Stock Exchange issued the announcement form of pledge of shares (freezing, auction or establishment of trust) by shareholders of listed companies to further standardize the disclosure of information related to equity pledge of listed companies; In 2018, the Shanghai Stock Exchange and China Securities Depository and Clearing Co., Ltd. revised the measures for stock pledge repo transaction and registration and settlement business, and made clear provisions on sales restriction conditions, financing discount rate, equity pledge proportion, equity closing sale, etc; However, although the existing supervision and approval system of equity pledge has established a certain risk prevention mechanism, it is not perfect. From the current market situation, the risk of equity pledge is still prominent.

This paper focuses on the research on the risk of controlling shareholders' equity pledge. By summarizing the current situation of equity pledge, using the methods of literature research and case analysis, this paper focuses on the motivation and economic consequences of controlling shareholders' equity pledge, and finally obtains the research suggestions to resolve the risk of equity pledge. This paper can enrich the relevant research on the equity pledge of controlling shareholders, and play a certain practical role in resolving the pledge risk for listed companies with high pledge proportion.

2. Motivation of controlling shareholders' equity pledge

2.1 Financing demand motivation

In the existing studies, some scholars believe that equity pledge is for financing needs. AI Dali and Wang Bin (2012) believe that enterprises will choose to implement equity pledge when there is a shortage of funds [4]. This is particularly reflected in the equity pledge activities of Baofeng Group. Since its listing, Baofeng Group has carried out expansion strategy and diversified investment to seize market share, resulting in a significant reduction in the company's working capital. With the increasing corporate debt ratio, the loans it can obtain from banks are also decreasing. Therefore, Baofeng Group needs other financing channels, Thus, as many as 30 equity financing activities were carried out from 2015 to 2018. Therefore, one of the main purposes of controlling shareholders' equity pledge is to realize investment.

2.2 Motive of usurping interests

Some scholars also pointed out that the equity pledge is motivated by the "tunneling" of major shareholders and the infringement of the rights and interests of minority shareholders. Li Xiaoqing and Yang Fan (2020) believe that, in fact, by taking advantage of information asymmetry, the pledgor hollowed out the capital of the listed company through illegal means such as related party transactions, thereby damaging the interests of other stakeholders of equity pledge and triggering the moral risk of equity pledge [5]. A typical case in this regard is the illegal operation of Mingxing power company. After acquiring shares with RMB 380 million, the controlling shareholder of Mingxing power company obtained a loan of RMB 300 million from the bank as a pledge, and then invested the borrowed funds in other aspects by means of new subsidiaries, illegal disassembly and illegal guarantee, realizing the tunneling of enterprises and minority shareholders [6].

2.3 Motivation to ensure control

Equity pledge can also ensure that the controlling shareholder still retains the actual control over the enterprise during the period of equity pledge, so that the controlling shareholder can obtain the "double harvest" of mastering capital and control, and continue to lead the operation decision of the company. For example, in the stock pledge operation of Baofeng Group, the controlling shareholder implemented a short-term circular pledge when the stock price fell and there was a risk of closing positions. He obtained financing through continuous pledge and release of the pledge while retaining control over the company, resulting in a sharp increase in the pledge ratio. It can be seen that the main purpose of the controlling shareholder's implementation of high ratio circular pledge is to avoid damaging the control right while obtaining financing.

2.4 Transfer risk motivation

The motivation of controlling shareholders to implement equity pledge is also to transfer risks. Due to the separation of control right and cash flow right, the controlling shareholders will pursue investment projects with high risk and high return for the benefit of the enterprise, and implement financial policies and business strategies completely contrary to the development status of the enterprise, which increases the risk of enterprise financial crisis and affects the normal operation of the enterprise. At this time, the business risk will fall on the pledge. Therefore, the controlling shareholders choose to pledge when the stock price is high. While obtaining more financing funds, the pledgee can also bear the operation risk. In addition, when the stock price falls to the warning line or closing line, the controlling shareholders may choose not to redeem out of their own interests, which is equivalent to completing the disguised cash out, greatly reducing the risk of their investment.

3. Economic consequences of controlling shareholders' equity pledge

3.1 The impact of equity pledge on Listed Companies

Existing studies mainly analyze the impact of equity pledge on listed companies through corporate performance and the implementation of earnings management measures. Because there are two basic propositions in the research of equity pledge: the agency problem caused by the separation of two rights and the transfer of control right, there are two opposite views on the impact of equity pledge on the company's performance: first, after equity pledge, the agency problem caused by the separation of two rights destroys the enterprise value; Second, after the equity is pledged, the controlling shareholders actively operate in order not to transfer the control right, so as to promote the growth of the company's performance. The first point is the idea that equity pledge affects enterprise value from the perspective of separation of two rights. The transmission chain of existing studies in this regard is: "equity pledge of controlling shareholders - separation of two rights - promoting tunneling behavior - increasingly serious agency problem - damage to the value of listed companies". After the equity pledge, the controlling shareholders' control over the enterprise remains unchanged, but their control over cash flow weakens. On the premise of the separation of the two rights, the controlling shareholders may infringe on the interests of the company and plunder the resources of the company by means of illegal disassembly, excessive investment and occupation of funds. The second point is to analyze the impact of equity pledge on corporate value from the perspective of control transfer. The transmission chain of this aspect is: "controlling shareholder's equity pledge - negative news causes stock price decline - causes position closing risk or control transfer risk - earnings management activities - affects the value of listed companies". If the stock price falls sharply after the equity pledge, the controlling shareholders will have the risk of closing positions or the risk of control transfer, resulting in damage to their interests. Therefore, the controlling shareholders' meeting took earnings management measures to maintain the stock price.

3.2 The impact of equity pledge on Stakeholders

In addition to the impact of equity pledge on enterprises, it also has an impact on investors, minority shareholders, pledgors and pledgees. For bond investors, the return is limited and the risk is unlimited, so bond investors will ask for higher interest to compensate; For stock investors, the earnings management policies implemented by controlling shareholders in order to maintain high stock prices will benefit them in a short time, but when the risks caused by equity pledge are released, their interests will also be damaged.

The information between minority shareholders and controlling shareholders is asymmetric, which provides an opportunity for controlling shareholders to implement tunneling behavior. Controlling shareholders can use the separation of control right and cash flow right to occupy the interests of minority shareholders. And because many listed enterprises have concentrated equity and imperfect corporate governance structure, this process is easier.

The pledgor mainly faces the risk of control transfer. If the controlling shareholder is still unable to redeem the shares as the pledge at the expiration of the pledge, the pledgee will carry out compulsory liquidation in order to recover the investment, and the controlling shareholder will lose control of the enterprise. There is a disposal risk for the pledgee. If the stock price of equity pledge is greatly reduced, and the pledgor is unable to repay the debt, or the shares as collateral have been frozen, the pledgee will not be able to realize the shares, and it will become very difficult to recover the funds, which will bring great economic losses.

4. Risk Prevention Measures

4.1 Reduce the proportion of equity pledge and resolve the risk of equity pledge with policy guidance

In 2019, the notice on matters related to stock pledge repo issued by Shanghai Stock Exchange and Shenzhen Stock Exchange cancelled the upper limit of the pledge proportion of a single a share and the upper limit of the pledge rate of 60%, which relaxed the restrictions on equity pledge business to a certain extent and directly led to the expansion of the pledge scale in the market in recent years. The regulatory authorities shall strengthen the restrictions on equity pledge, moderately tighten the proportion of equity pledge and prevent the excessive expansion of pledge scale. At the same time, the regulatory authorities should also launch relevant policies to resolve the risk of equity pledge, support financial institutions as the main body, and take various means to alleviate the pressure of closing positions faced by controlling shareholders after equity pledge.

4.2 Improve the equity financing margin system

When the enterprise is faced with great financing constraints and financing needs, it should clearly specify that the enterprise needs to reduce capital investment in expansion investment and innovation investment, and set aside sufficient funds to deal with the early warning and position closing risks faced by the pledge. In the audit report of equity pledge postponement, the part of funds reserved by the enterprise should be taken as the audit focus, And as an important condition for financing thereafter.

4.3 Improve the company's internal governance mechanism and strengthen internal supervision

The imbalance of ownership structure will make the rights of controlling shareholders of listed companies unable to be effectively restricted, lead to the problem of information asymmetry, and lead to the opportunity for controlling shareholders to infringe on the interests of other stakeholders. Establishing and improving the ownership structure, appropriately introducing institutional investors and representatives of minority shareholders, and limiting the shareholding ratio of controlling shareholders can fundamentally control the equity pledge. At the same time, enterprises should improve the board of supervisors system, stipulate the frequency and proportion of equity pledge by controlling shareholders, and the supervision department should issue risk warning instructions for high proportion of equity pledge, so as to prevent the risks brought by equity pledge.

4.4 Improve the information disclosure system

At present, there are no detailed provisions on the disclosure of equity pledge information, but the integrated funds are required to be used in production and operation, but there is no detailed degree of disclosure. This leads to the gradual intensification of information asymmetry between controlling shareholders and minority shareholders, so that stakeholders question the authenticity of the company's information and have a negative impact on the company's value. Moreover, if the major shareholders recklessly pledge their equity to cash out to empty the company without paying attention to the operation and development of the company, it is not conducive to the healthy development of the market. We can strengthen the management of the disclosure of matters related to the equity pledge of listed companies, and help investors better understand the operating conditions of the company by increasing the financing amount and the specific purpose of funds, and disclosing them phase by phase according to the actual use of funds.

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