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Share Pledging in China: Funding Listed Firms or Funding Entrepreneurship?

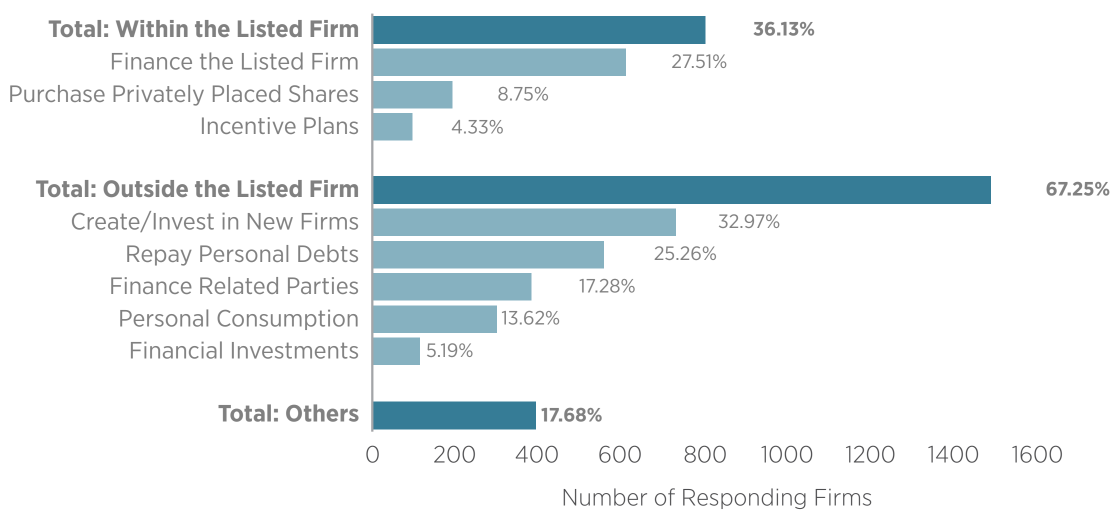
Based on BFI Working Paper 2022-06, "Share Pledging in China: Funding Listed Firms or Funding Entrepreneurship?," by Zhiguo He, Chicago Booth; Bibo Liu, Tsinghua University; and Feifei Zhu, Central University of Finance and Economics

This analysis shows that natural person shareholders increased their entrepreneurial activities significantly following the 2013 launch of the exchange market, relative to legal entity shareholders; additionally, shareholders with better access to share pledging invested more heavily in industries with above-median growth potential.

The financial system affects economic growth via a variety of channels, including through the evaluation of prospective entrepreneurs, financing productive projects, diversifying risks, and encouraging innovation. There is also a unique financing vehicle at the intersection of the banking system and the stock market called share pledging, in which shareholders obtain loans with their shares as collateral and use the proceeds to finance various activities.

Share pledging is employed throughout the world; this work focuses on the role of share pledging in promoting entrepreneurial activities in China. Relentless market reform in the Chinese economy in the past several decades has witnessed an upsurge of entrepreneurship in the private sector. However, financing for this growth has likely not come from China's largely state-owned banking system. Rather, this work focuses on the role of China's share pledging market, with its enormous relative size, as an important financing vehicle for entrepreneurship.

Figure 1 • Survey Results on the Use of Share Pledging Funds



Note: This figure plots the frequencies of usages of share pledging proceed based on the Tsinghua PBCSF-CSRC 2019 survey. The item "total: within the listed firm" is the union of "finance the listed firm," "purchase privately placed shares," and "incentive plans." The item "total: outside the listed firm" is the union of "financial investments," "personal consumption, "finance related parties," "repay personal debts," and "create/invest in new firms."

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Broadly, this novel research challenges the common wisdom that share pledging funds circle back to listed firms. Share pledging funds are at the discretion of the shareholders who pledge their shares (of the listed firms), and these funds therefore could be used to finance privately owned enterprises and entrepreneurs. Since China's economic growth is largely driven by non-listed, small- and medium-sized firms rather than listed firms, the authors focus on identifying the driving forces behind China's entrepreneurship.

China's share pledging system was established in the mid-1990s, with the volume of newly pledged shares growing at an annual rate of 18.6% between 2007 and 2020. At the market's peak in 2017, more than 95% of the A-share listed firms had at least one shareholder pledged, with the total value of pledged shares amounting to 6.15 trillion RMB (more than 10% of the total market capitalization).

Before 2013, share pledging was solely organized in the over-the-counter (OTC) market, where commercial banks and trust firms were major lenders. In 2013, share pledging was introduced to the Shanghai and Shenzhen stock exchanges, with securities firms as the major lenders. This initiative, which the authors use as a quasi-natural experiment, greatly expedited the development of share pledging: After this policy shock, the annual transaction volume between 2013 and 2020 reached 204 billion shares (1,057 billion RMB), compared to 39 billion shares (192 billion RMB) per annum during the period of 2007 and 2012.

What has this growth meant for listed firms? Is share pledging, as conventional wisdom suggests, an alternative financing tool? The authors find that during this same period, there was an upsurge of entrepreneurship and privately owned enterprises in China. New startups emerged in various industries, and some grew into today's business giants. This leads the authors to the following key conjecture:

- Major shareholders of Chinese listed firms, with proven business acumen and strong social connections, have used the share pledging funds to finance their entrepreneurial activities *outside* listed firms.

And the following findings:

- Funds from only 7.8% of the pledging transactions are used for listed firms.
- A major fraction of firms (67.3%) reported their largest shareholders used the pledging funds outside the listed firms.
- These shareholders used the funds to repay personal debts (25.3%), for personal consumption (13.6%), and to make financial investments (5.2%).
- Importantly, 33% of firms reported that their largest shareholders invested the funds in firms other than the listed firm and created new firms.
- Finally, this data pattern, though descriptive, points to a positive relation between share pledging and entrepreneurial activities.

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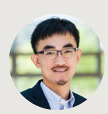

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