Property Rights and Corporate Governance in China and Asia

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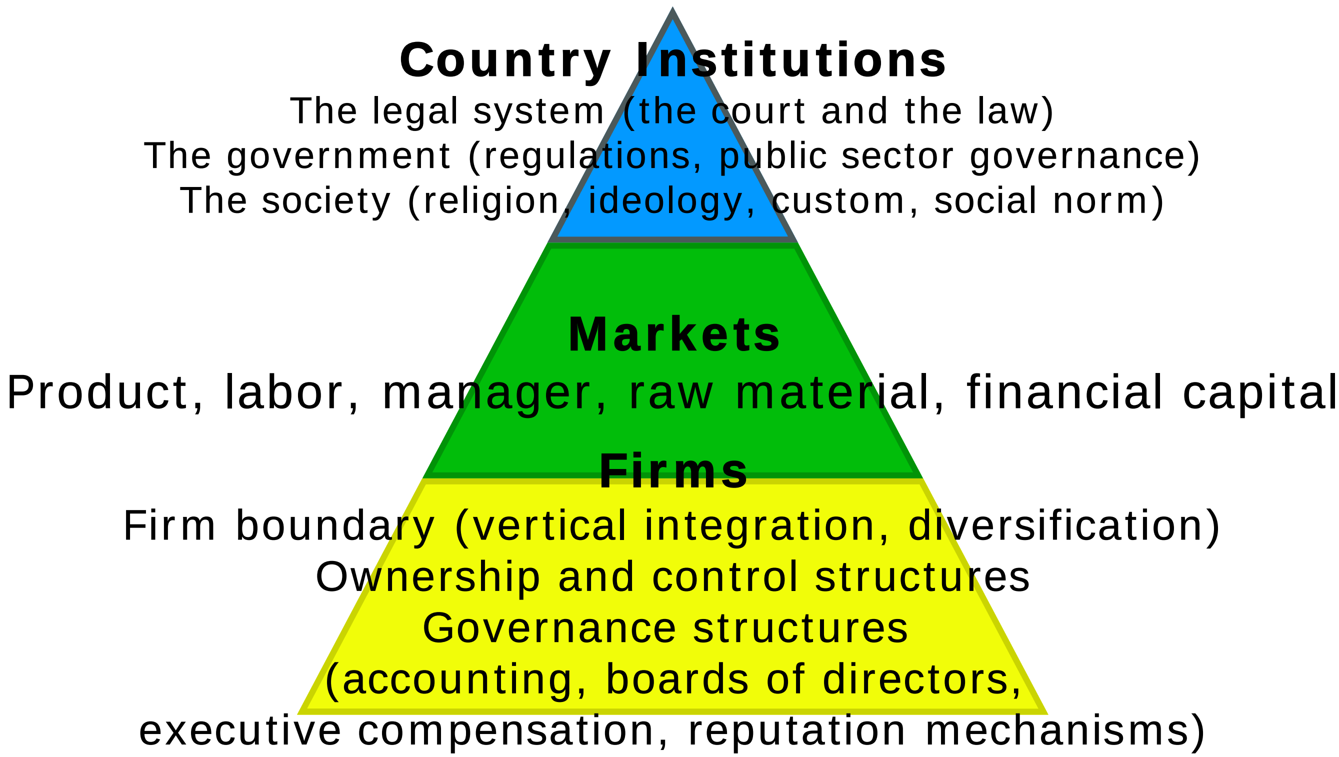
Outline

- Research framework
- Property right constraints in Asia
- Effects on
  - Performance and governance of partially privatized firms in China
  - Emergence of the pyramidal organizational structure of Chinese firms
  - Corporate finance in China
  - Family firms governance and succession issues in East Asia

Research Framework

- Corporate governance in China and Asia, like the rest of the world, is constrained by the region's institutional environments
- Corporate governance issues are property rights issues – the partition of rights between owners and other stakeholders of firms, and its economic outcomes
- A useful approach to understand corporate governance in Asia is identifying institutional constraints that affect the partition and exchange of property rights, which in terms shape corporate governance and organization
- This calls for a top-down research approach

Top-down Approach



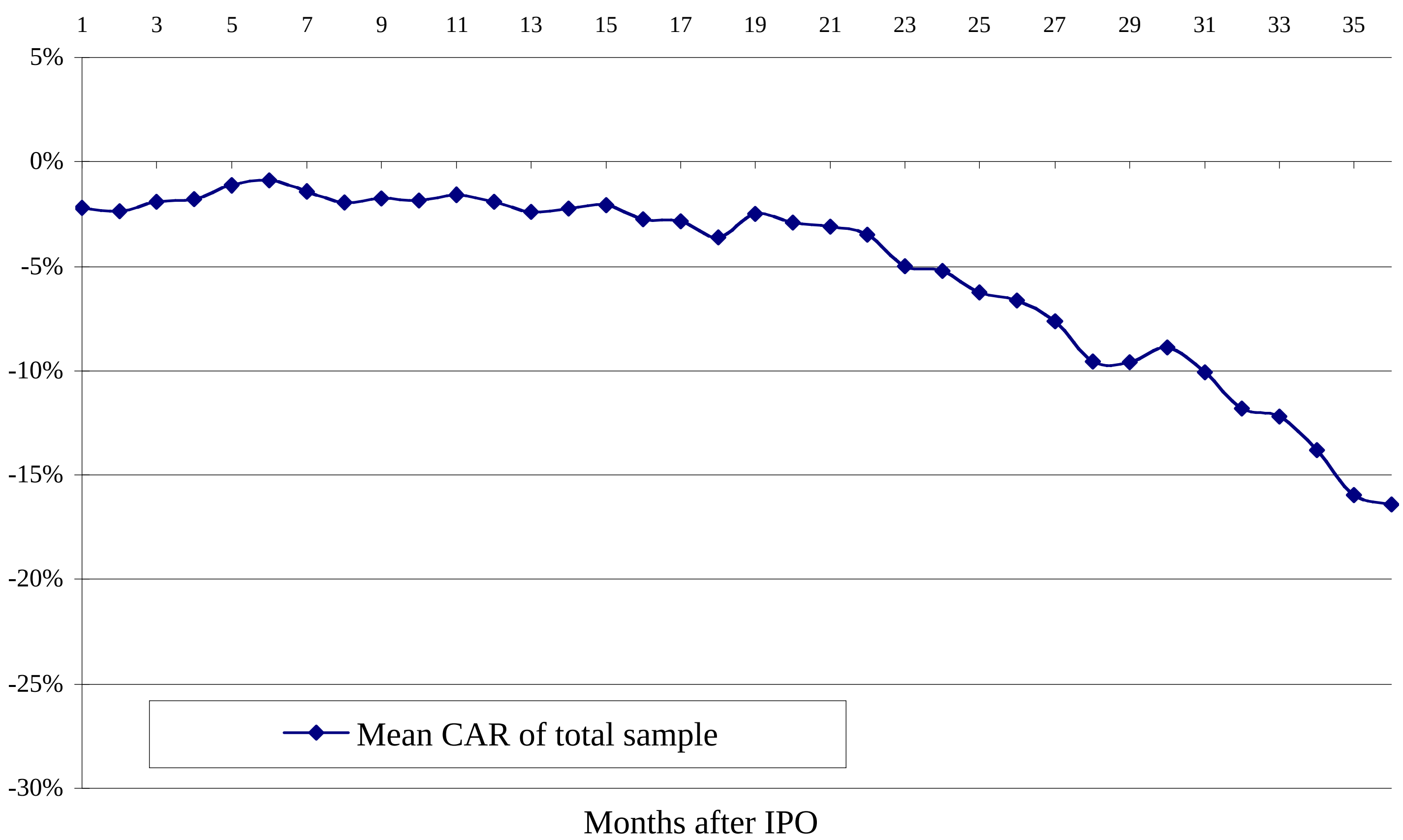
Several Key Property Right Constraints on Firms in China

- Government influence of key personnel decisions
- Highly regulated transferability of state ownership
- Rent seeking and corruption
- Government intervention in the financial (banking) system
- In the following, we use our research to illustrate the impact of these constraints on corporate governance, finance, and organization

Property right constraint I

Government influence of key personnel decisions

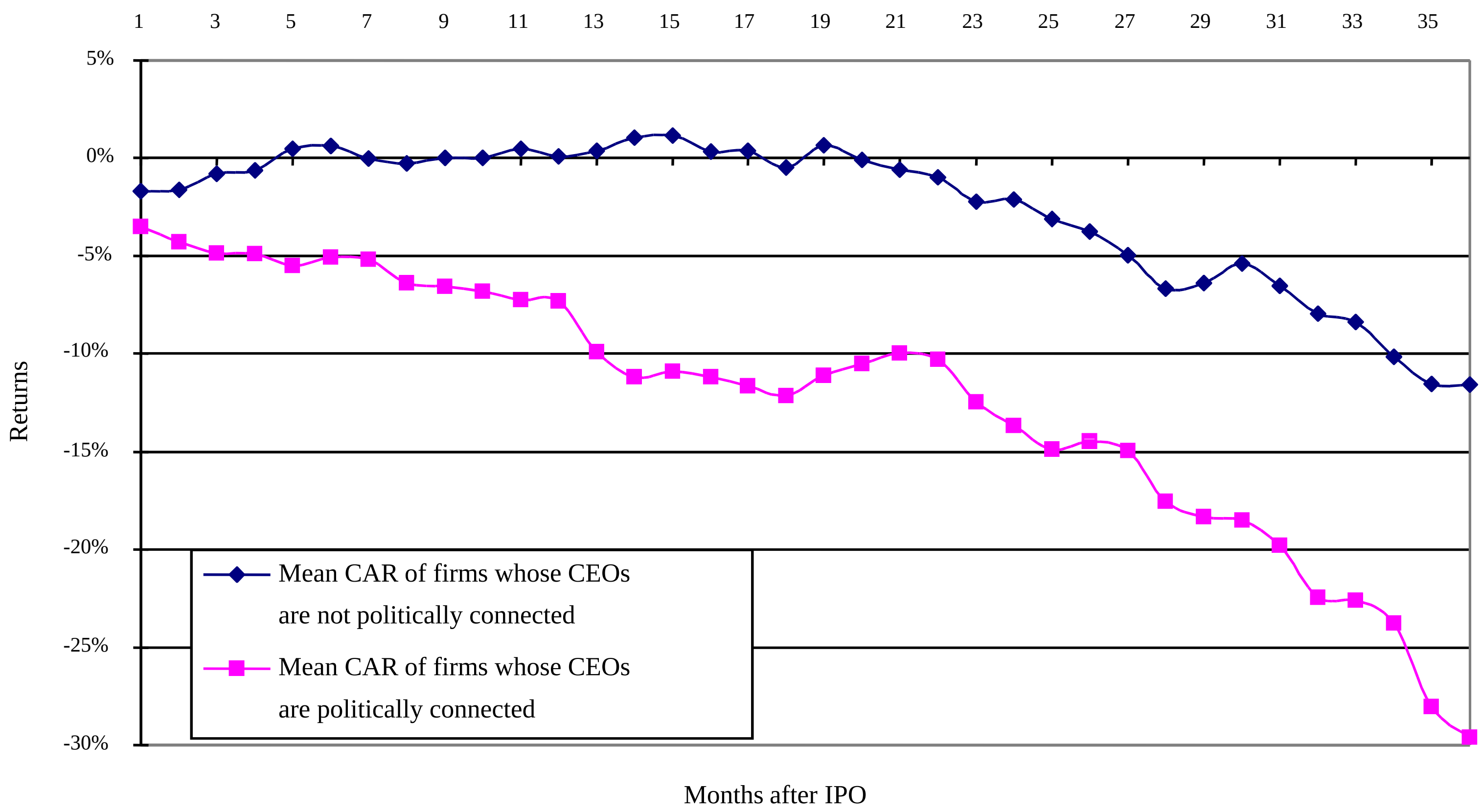
Empirical Regularity I: Poor Post-IPO stock return performance (CAR) of China's Partially Privatized Firms



Politically connected CEOs

- Multiple objectives and “grabbing hand”
  - Due to relatively stronger connection between managers’/bureaucrats’ rewards and social, political, or even personal goals
  - As a result, they use partially privatized firms to meet social objectives. Firm performance may not be even the most important goal
  - Corrupted politicians pursue selfish goals
- Our stabbing point: appointment of politically connected CEOs
  - Government can appoint current or ex-bureaucrats to be CEOs to exert direct control (almost 30% in our sample)
  - Does it affect post-IPO long-term performance?
  - Does IPO initial (first day) return reflect the impact of CEO’s government tie?

Post-IPO stock return performance (CAR) distinguished by whether CEOs are politically connected (Fan, Wong, Zhang, forthcoming)



IPO initial (first day) return and CEO's government tie

	Model (1)	Model (2)
CEO is politically-connected	-0.483	-0.336
	(2.11)**	(1.67)*
Days between offering and listing day		1.975
		(9.22)***
Ownership of largest shareholder		-0.011
		(2.62)***
Listed in Shanghai Stock Exchange		-0.291
		(1.38)
Number of Shares Issued		-1.266
		(10.28)***
Constant	2.055	16.110
	(4.73)***	(11.47)***
Observations	786	786
Adjusted R-squared	0.13	0.34

Weak Internal Governance and Low Professionalism in Chinese firms

- Over a decade since China's opening up its stock markets, the governance function and the degree of professionalism of listed companies' management and boards of directors remain weak
- Chinese boards are populated with politicians (current or ex-government bureaucrats)

Boards of directors are weak in governance: the case of China (Fan, Wong, Zhang)

Board size	9.22 (range 5 to 19)
Manager directors	34%
Largest shareholder	53%
Minority shareholders	0%
Politicians	32%
Central govt	*4%*
Local govt	*19%*
Others	*9%*

Low Director Professionalism in China
(Fan, Wong, Zhang)

Directors from unaffiliated firms (outside experts)	18%
Accountants, lawyers, finance experts	5%
Academics	14%
Woman directors	5%
Age	47
Education	*Between Junior college and university*

Board structure when CEO is politically connected

- ⇑ other politicians
- ⇓ professionals
- ⇓ academics
- ⇓ women
- ⇑ age of directors

Property Right Constraint II

Low Transferability of State Ownership

Effects of non-transferability of shares and assets on managerial incentives

- Weak link between cost and reward
  - Government cannot sell shares/assets to the private sector that are better able to run the firm
  - Managers and employees are paid like bureaucrats. They are lack of profit incentives
  - Multiple objectives and “grabbing hand”
    - Due to relatively stronger connection between managers’/bureaucrats’ rewards and social, political, or even personal goals
    - As a result, they use the firms to meet social objectives. Firm performance may not be even the most important goal
    - Corrupted politicians pursue selfish goals
- Low efficiency often arises as a result

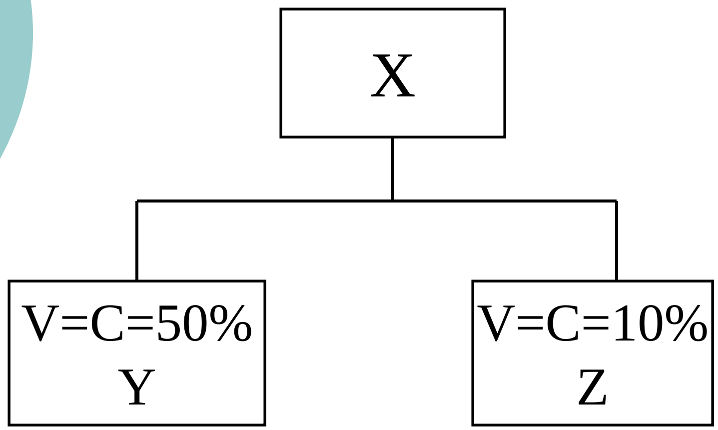
Effects of non-transferability of shares and assets on managerial incentives

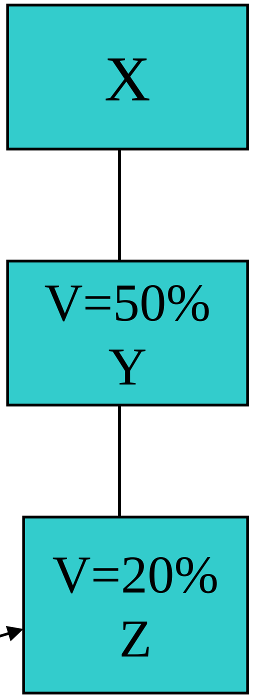
- If improving the efficiency of SOEs is desirable, a ***change*** *in the cost and reward structure* is needed. This is often done through privatization
- If privatization is **prohibited** (an obstruction of property rights transfer), their ownership and organizational structure will evolved to the second best

Empirical Regularity II: Complex Ownership / Organizational Structures

- Pyramidal business group
  - A corporate organization where a number of firms are linked through stock-pyramids and/or cross-ownership
  - Groups are the dominant form of corporate organizations in Asia. About 70 percent of publicly traded companies in Asia are group affiliated (Claessens, Fan, Lang, 2005)

Stock pyramid





V = 20%, weakest link in the chain, C = 10%. Pyramid structure allows leveraging up in control

The Emergence of Corporate Pyramids in China

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Chinese Corporate Pyramids

Number of Pyramidal Layers	Local Government-controlled Firms		Entrepreneur-controlled Firms	
	N	Percentage(%)	N	Percentage(%)
1	190	25.17	1	1.59
2	468	61.99	41	65.08
3	88	11.66	18	28.57
>=4	9	1.19	3	4.76
Total	755	100.00	63	100.00

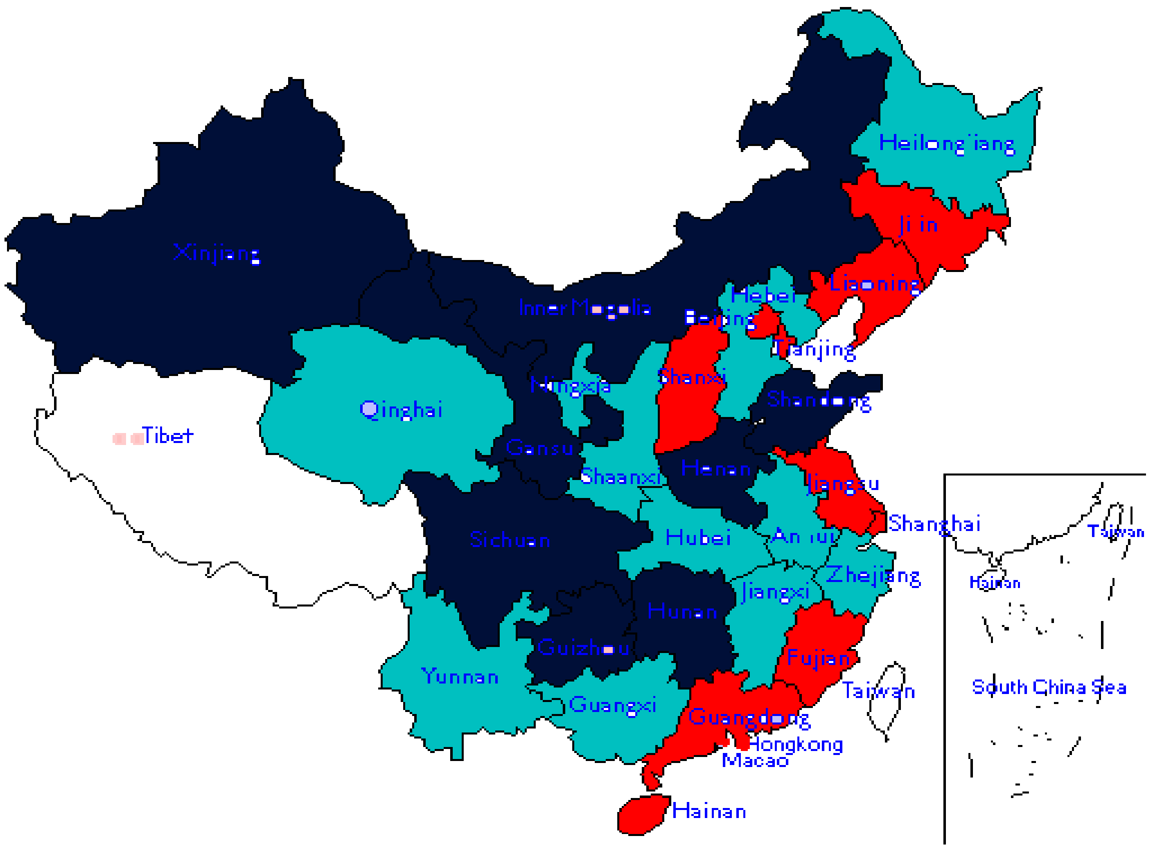
Why pyramiding?

- Be warned: few theoretical and empirical works
- Separating control from ownership
  - Pyramids facilitate the controlling owner's ability to capture private benefits, sometimes at the expense of minority investors
- Relieving financial constraints
  - Pyramids facilitate the creation of internal markets that allow cross-subsidization of funds
- Product/input/labor market frictions
  - High costs of trade due to, unionization, price control, taxation, ideology, etc.
- Credible decision rights allocation (decentralization) within organization
  - Compared with a horizontal control structure, a pyramidal structure allows local managers more autonomy in decision making

Effects of Non-transferability of Ownership on Pyramiding Incentives

- Local government owners
  - *Natural setting* to test the **decentralization** motive of pyramiding
  - Not able to decentralize firm decision rights by freely selling off firm shares or assets
  - Pyramiding as an alternative means of decentralization
  - Compared with a policy order, pyramid is more **credible** to firm management
  - Credible because of high bureaucratic costs if the government intervenes ex post
- We test this hypothesis using variations in local government incentives and institutional environments in China's different regions

Property Right Protection in China’s Different Provinces



Low Middle High Missing

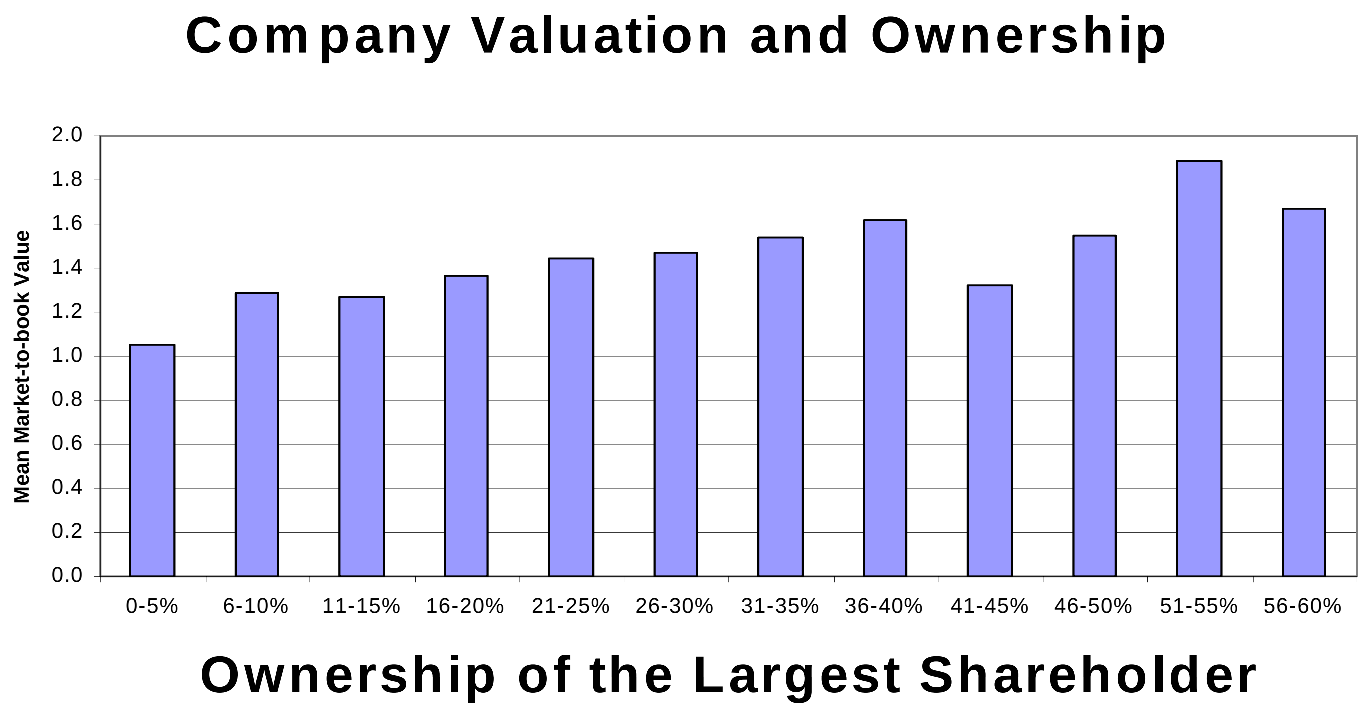
Predictions and Findings (local government controlled firms)

- Decentralization incentive affected by their **objectives** and the degrees to which these objectives conflict with those of firm mangers (agency problem)
  - Regional unemployment problem (-)
  - Fiscal health (+)
  - Government long-term incentive (R&D and education expenditure) (+)
- The degree of conflicts of interest reduces when the market and the laws provide strong **disciplines**
  - Regional market development (+)
  - Regional legal environment (+)
  - Regional property rights protection (+)
  - Government deregulation (+)

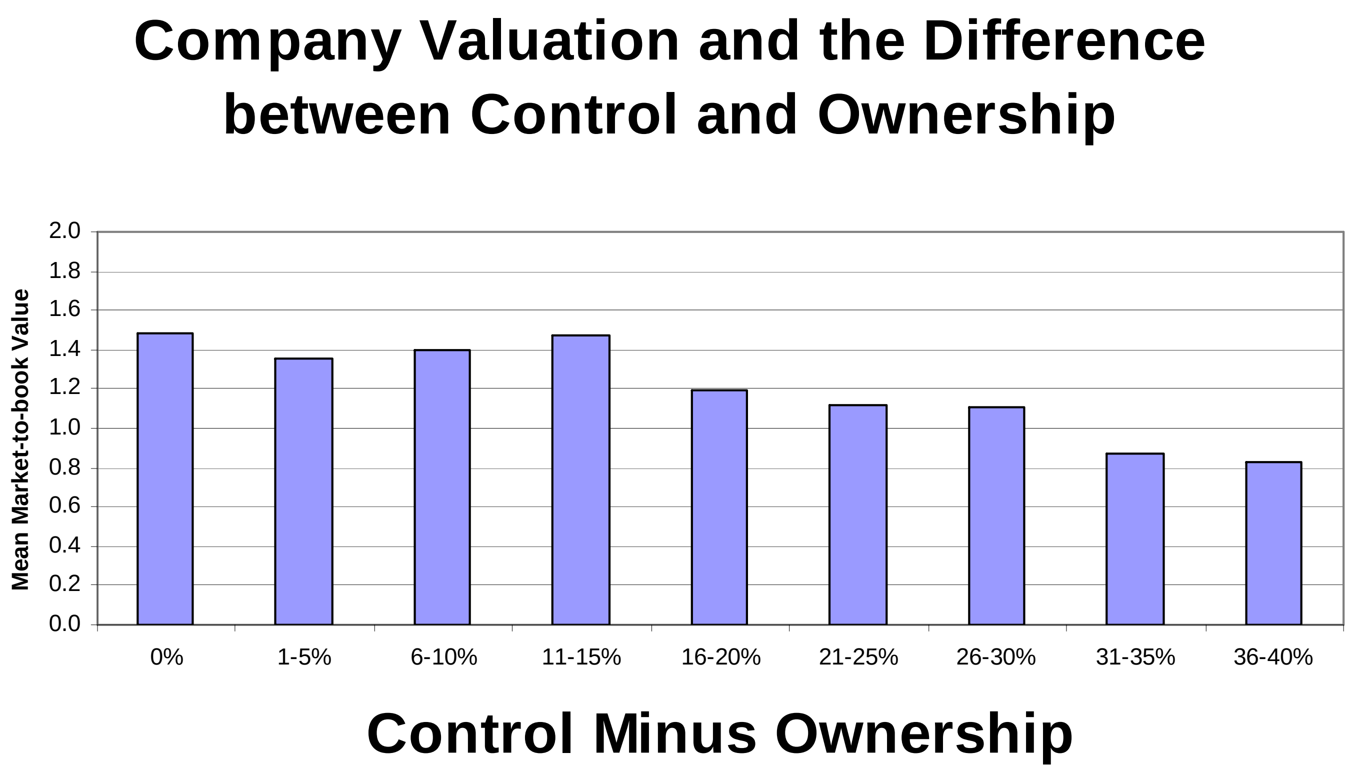
Not just SOE ownership is not easily transferable

- Ownership of private sector firms in Asia is typically concentrated and not transferred for extended periods
- Why do entrepreneurs voluntarily make their ownership non-transferable, given its negative side effects, i.e., governance problems and stock price discounts (Claessons, Djankov, Fan, Lang, 2002)?
- Below we leave China to discuss family / entrepreneurial firms in East Asia

Price Protection by Minority Shareholders in Asia Claessens, Djankov, Fan, Lang (2002)



Price Protection by Minority Shareholders in Asia
Claessens, Djankov, Fan, Lang (2002)



Why family firms and family ownership flourish?

- Tax avoidance, private enforcement
- Family ownership preserves the value of non-transferable property (firm specific capital)
- What are family specific capital?
  - Properties or assets jointly owned by family members
  - Idiosyncratic (non-standardized) production methods or management skills
  - Intangible assets such as trade secrets, reputation in economic and political markets
  - Ideology or amenity utilities (Demsetz and Lehn, 1985)
- By keeping it within the family, ownership preserve the value of the specific assets that are subject to low valuation if otherwise had to be transferred (sold)

Internal enforcement / governance of family firms

- Authority
  - Clear managerial authority that is efficient in decision making and resolving conflicts
  - The authority (power) structure is consistent with family hierarchy (father – eldest son – other brothers - sisters, etc)
- Family codes
  - Common believes and family codes of conduct mitigate transaction costs within organization
  - An example of family codes is “family members should help each other”. This greatly improve cross-subsidization among family members’ different businesses
- Back-end loaded compensation
  - Family members receive below market compensation in the near term while receiving family wealth later through inheriting family wealth
  - Wealth is accumulated and passed on to the future generation
  - The long-term incentive provided by family firm is suitable for business with long-term objectives or cannot be capitalized in the near term

External enforcement / governance of family firms

- Family reputation / prestige is important in relationship based business
  - Family may stand for quality (e.g. Gucci) or political connections (Agnellis, Thaksin)
  - Family members (managers) have strong incentives to invest and safeguard family name that facilitate relationship based transactions.
  - Such reputation capital is credible to other corporate stakeholders because
    - (1) Serious consequence of violation – loss of future business
    - (2) Imitation is difficult because investment in reputation building is highly costly and takes a long time
- Other governance mechanisms that help building/acquiring reputation are also used, such as
  - High quality external auditors (Fan and Wong, 2006), cross listings, strategic alliances, etc.

Succession of Entrepreneurial / Family Firms in Asia

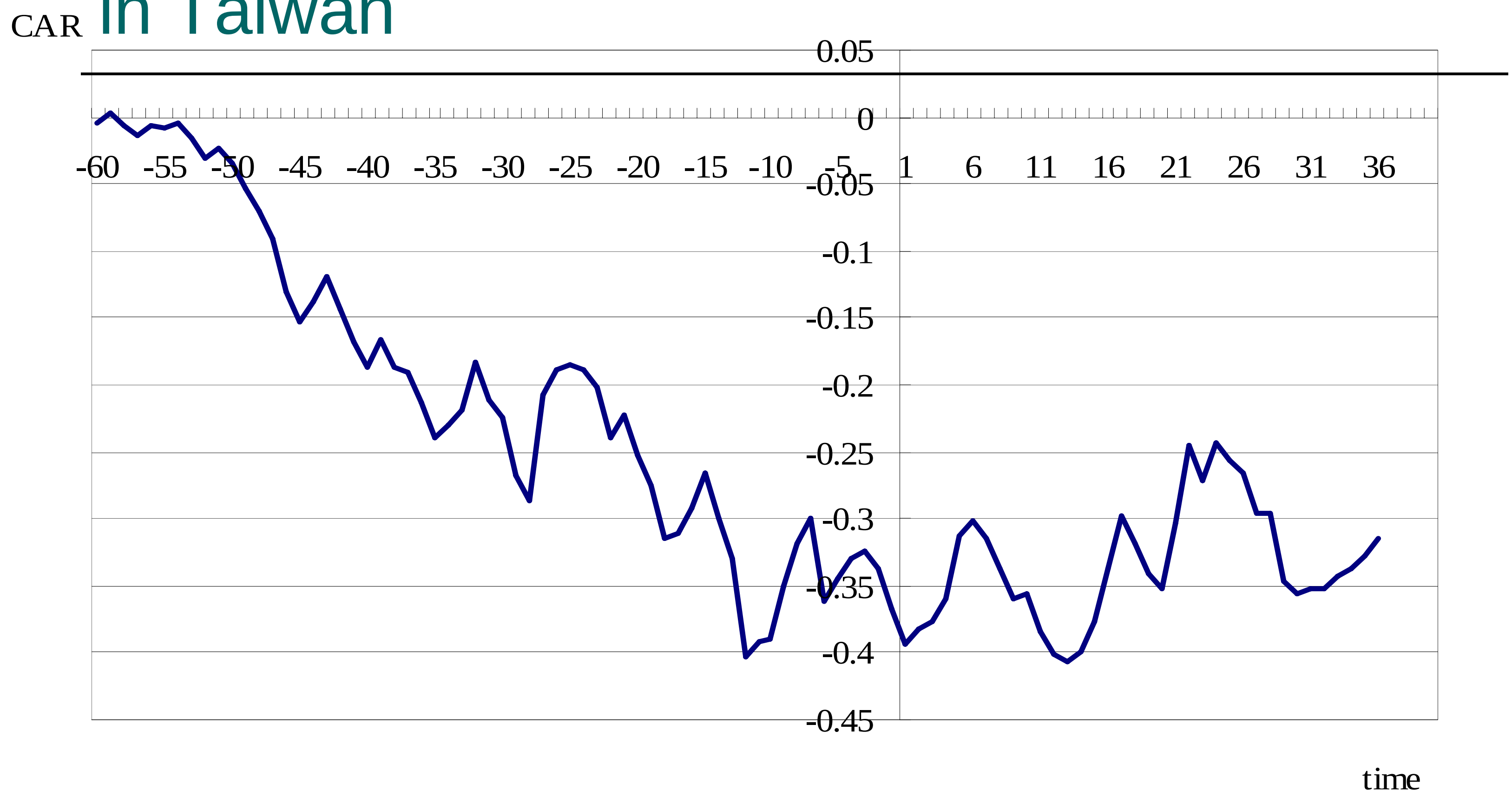
- Succession is a good opportunity to examine causes and consequences of ownership transferability
- Can family wealth be passed on to the next generation? Why or why not?
- Heir or outside succession?
- We are studying listed entrepreneurial/family firms in Hong Kong, Taiwan, Singapore, and Japan experienced succession

Succession of Entrepreneurial / Family Firms in Taiwan

Table 1A: The Sample by Successor Type

Definition	Frequency	Percentage (%)
Sold out *The founder sold most of his shares.*	28	17.83
Heir *The successor is a founding family member.*	97	61.78
Professional manager *The successor is an outsider or a professional manager.*	32	20.38
Total	157	100

Succession of Entrepreneurial / Family Firms in Taiwan

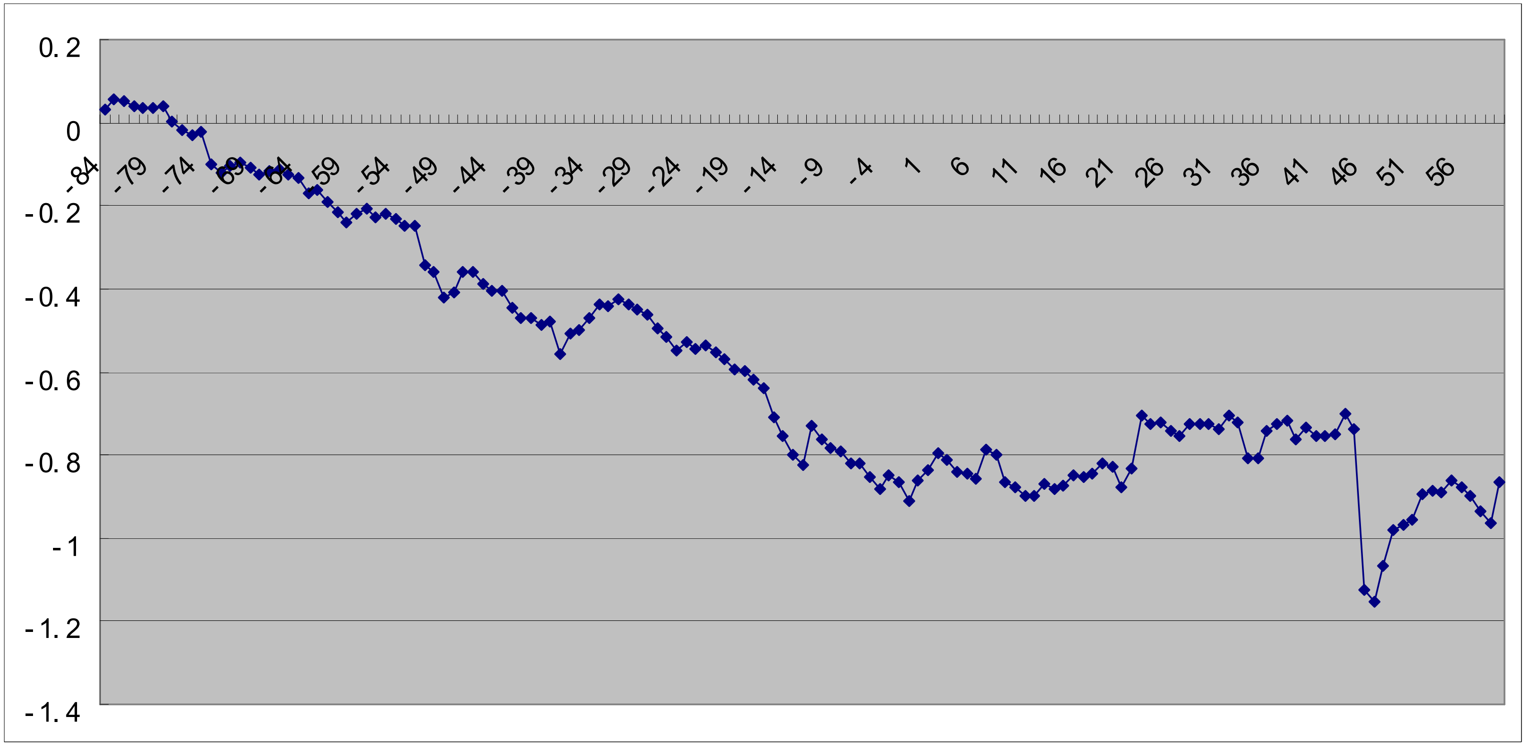


Average monthly cumulative market adjusted stock return of Taiwan family firms around succession - the full sample (157 firms)

Succession of Entrepreneurial / Family Firms in Hong Kong

Definition	Frequency	Percentage (%)
Sold out The owner sold most of his shares	10	26
Heir The successor is a family member	22	58
Outsider The successor is an outsider	6	16
Total	38	100

Succession of Entrepreneurial / Family Firms in Hong Kong



Average monthly cumulative market adjusted stock return of
Hong Kong family firms around succession – the full sample (38 firms)

Why did family firm value vaporize in succession?

- Few research evidence exist, we are investigating a few possibilities
- Infighting among family members for ownership and control
  - When the founder gets old, his authority weakens
  - Family codes are not sufficient when the stake is large
- Lost of family reputation in succession induces governance problems with stakeholders
  - Conflicts between the successor and senior employees
  - Lower trust between the successor and suppliers of raw materials and funds
- Entrenchment
  - It is difficult to remove an underperforming founder until he/she is very old or dead. Firm value deteriorate until the entrenchment problem is corrected by succession

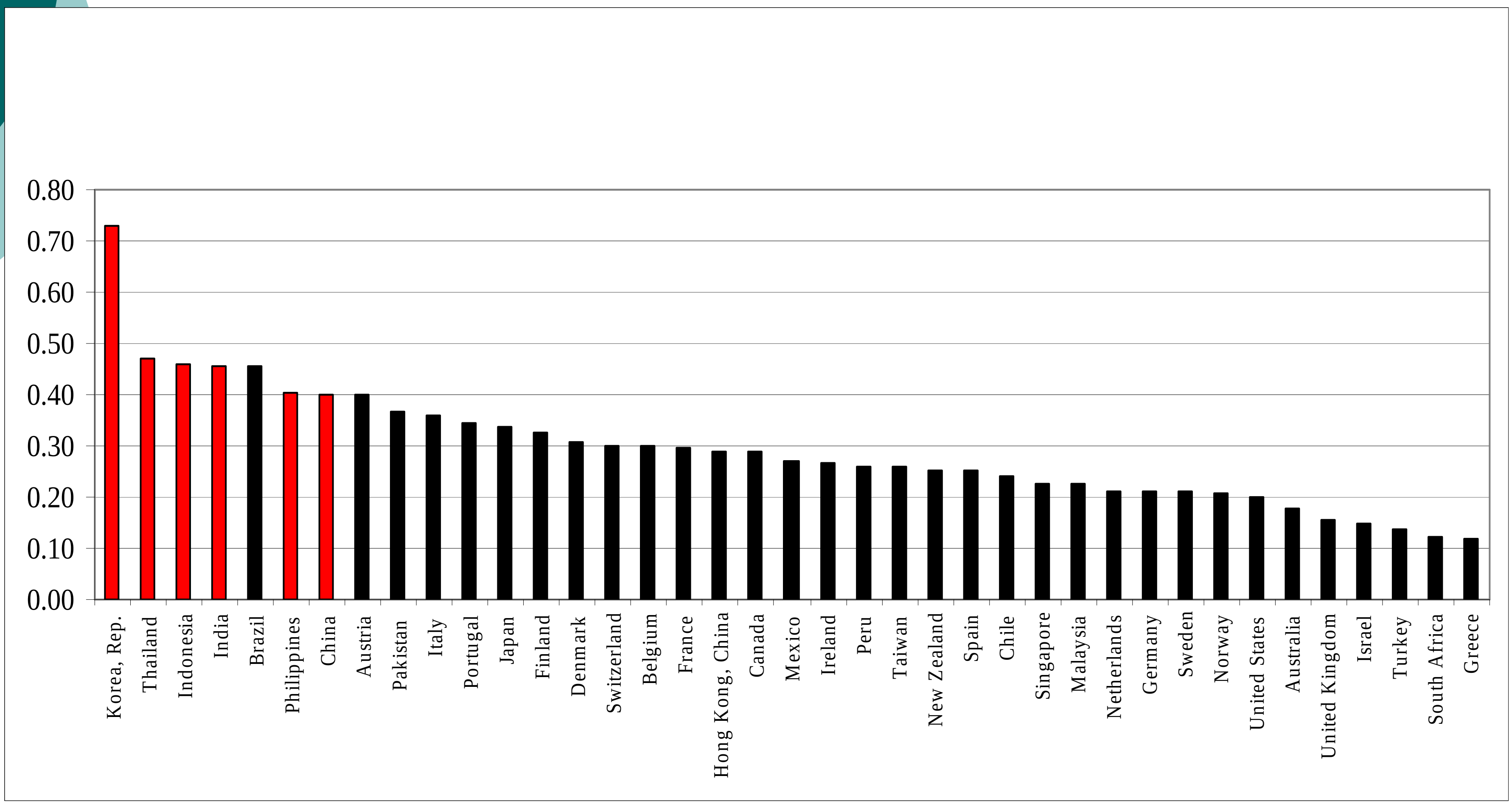
Property Right Constraint III

Corruption

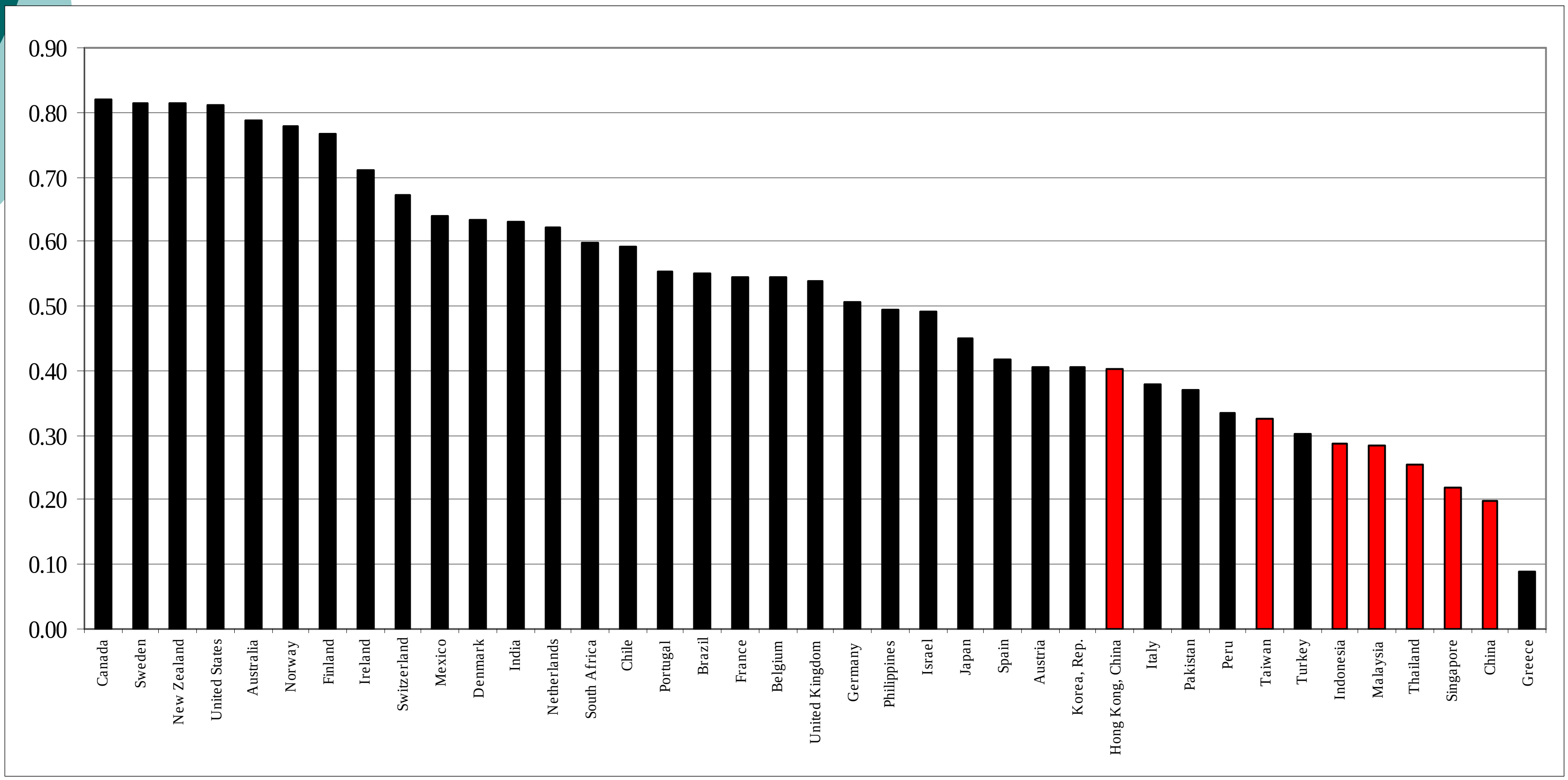
Empirical Regularity III: High Financial Leverage in Asia

- Companies in Asia rely on debt much more than equity to finance their investment
- Moreover, they rely on short-term debt, even when they engage in long-term investment
- Banks, not capital markets, are the primary sources of funds for firms in Asia and other developing countries
- Why are these?
  - Owners' desire to maintain control
  - More fundamentally caused by institutional factors

Cross Country Pattern of Corporate leverage (Fan, Titman, Twite, 2004)



Cross Country Pattern of Corporate Debt Maturity (Fan, Titman, Twite, 2004)



What explain the cross-country corporate financing patterns?

	R^2	
	Leverage	Debt maturity
Country+Industry+Firm	0.32	0.23
Industry+Firm	0.24	0.09
Firm	0.21	0.07

- Where a firm is located has a greater effect on its capital structure and debt maturity than its industry affiliation.
- Country factors and firm factors are both important

Rent Seeking and Corporate Finance: Evidence from Corruption Cases

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Effects of Rent Seeking/Corruption on Corporate Finance

- Rent seeking and corruption bias capital structure toward more debt as opposed to equity
  - (1) Contractual structure of debt limits the potential for the expropriation of investor rights (Smith and Watts, 1979)
  - (2) It is easier for a corrupt bureaucrat to channel cash to its favored firms through banks (often also controlled by the government) than through the equity market (La Porta et al., 2002; Sapienza, 2004)
- Debt maturity
  - (1) Short-term debt provides better investor protection
  - (2) Politically favored firms have better access to long-term debt
- This study examines the second explanation

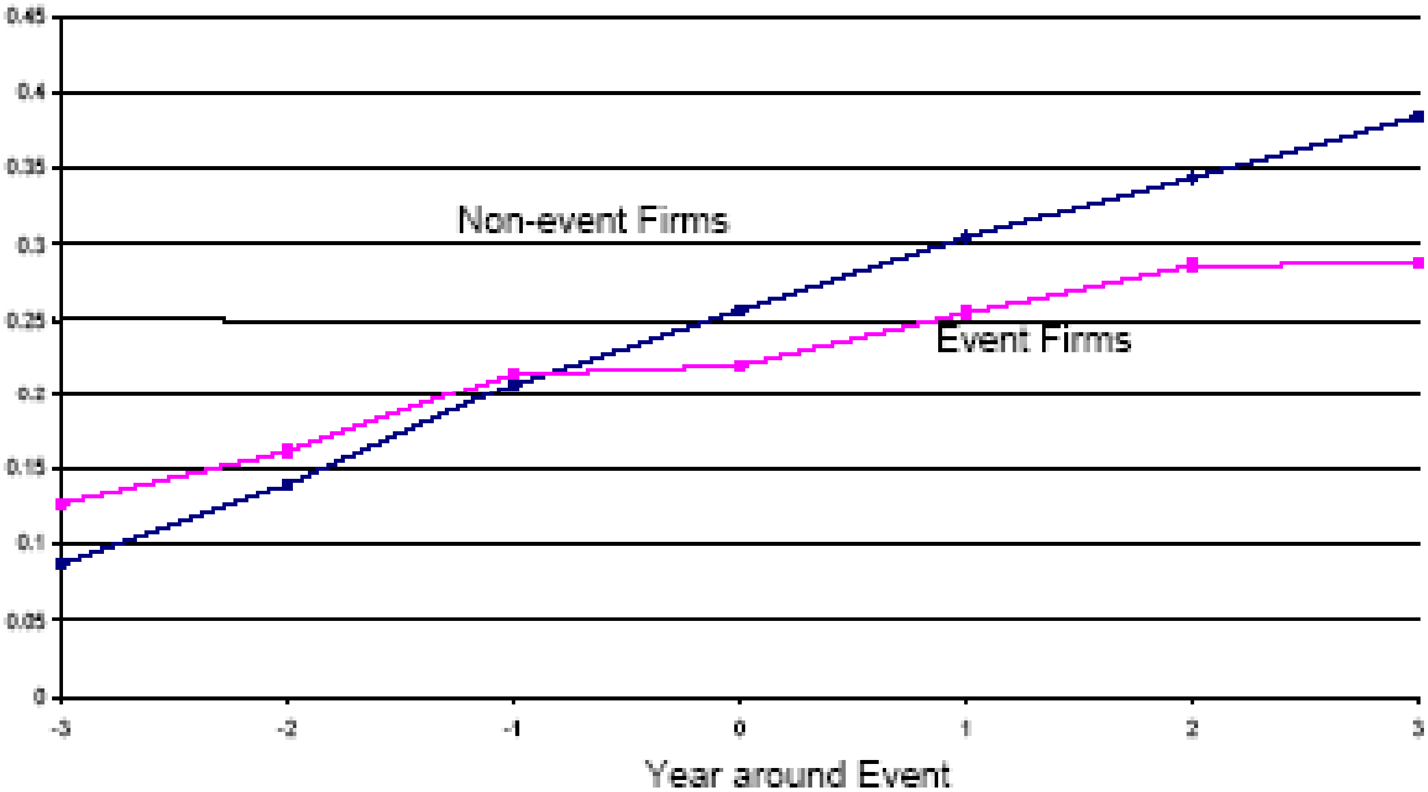
Empirical Design

- Identifying 23 high (provincial) level government officer corruption cases during 1995-2003
  - Tracking publicly listed companies in China that are bribers or are connected with the corrupted bureaucrats
- Track changes in financial leverage and debt maturities of the event (bribing or connected) firms from 3 years before to 3 year after the corruption event
- Are financial leverage and debt maturity of the event firms more affected by the corruption cases than non-event firms?
- Is any change in financing advantage reflected in the stock price reactions around the corruption events?

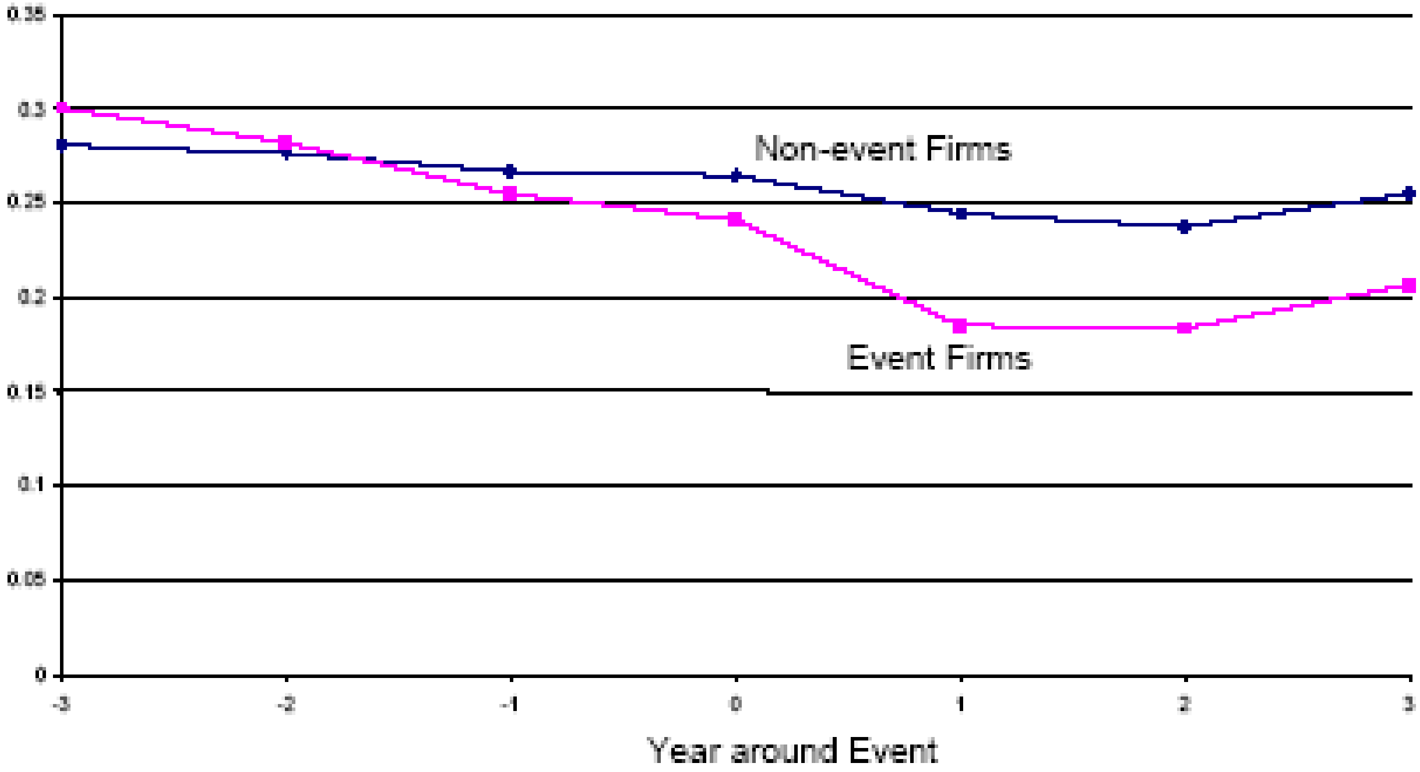
The Scandal List

Province	Name	Position	Event Day	Sentence Day	Sentence	Number of firms in the province	The Bribing Firms	The Connected Firms	The Non-event Firms
Anhui	Wang Huizhong	Vice-Province Governor	20010407	20031229	Death Penalty	25	1	1	23
Bank	Liu Jingbao	Vice-Chairman & CEO of Bank Of China (HK)	20030525	N/A	N/A (Still under investigation)	10	2	1	7
Bank	Wang Xuebin	CEO of China Construction Bank	20020111	20031210	12 years of imprisonment	25	1	3	21
Beijing	Chen Xitong	CPC Secretary	19950426	19980731	16 years of imprisonment	12	5	4	3
Central	Xu Penghang	Vice chairman of national defense technology commission and national economics and trade commission	20001011	20001011	Dismissal from the service	24	0	2	22
Fujian	Shi Zhaobin	Vice-CPC Secretary	19990818	20010927	Dismissal from the service and CPC	12	0	2	10
Guangxi	Chen Kejie	Chairman of Municipality	20000111	20000731	Death Penalty	13	0	0	13
Guangxi	Liu Zhibin	Vice-Chairman of Municipality	20000319	20020624	15 years of imprisonment	2	2	0	0
Guangxi	Wang Qinglu	Vice-Chairman of PPCC	20010222	20010222	Dismissal from the service and CPC	17	1	4	12
Guangxi	Xu Binsong	Vice-Chairman of Municipality	19980523	19990827	Life imprisonment	12	1	3	8
Guizhou	Liu Changgui	Vice-Province Governor	20030417	20040430	11 years of imprisonment	12	1	1	10
Guizhou	Liu Fangren	CPC Secretary & PC Chairman	20030422	20040629	Life imprisonment	10	2	2	6
Hainan	Xin Yejiang	Vice-PC Chairman	19961227	19980526	5 years of imprisonment	33	1	4	28
Hebei	Chen Weigao	CPC Secretary & PC Chairman	20000301	20030809	Dismissal from CPC	51	5	6	40
Hebei	Cong Fukui	Vice-Province Governor	20000627	20010518	Dismissal from the service and CPC	34	5	3	26
Hebei	Jiang Dianwu	Vice-PC Chairman	19971101	19981207	10 years of imprisonment	27	1	2	24
Hubei	Li Daqiang	Vice-Province Governor	20000925	20000925	Dismissal from the service and CPC	13	0	1	12
Hubei	Meng QingPing	Vice-Province Governor	19980410	19991201	10 years of imprisonment	5	5	0	0
Jiangxi	Hu Changqing	Vice-Province Governor	19990808	20000215	Death Penalty	10	2	0	8
Liaoning	Mu TuoXing	Vice-Province Governor	20010321	20011113	Death Penalty	6	0	1	5
Xingjiang	Aman Haji	Vice-Province Governor	20031015	N/A	N/A (Still under investigation)	1	1	0	0
Yunnan	Li Jiating	Vice CPC Secretary & Province Governor	20010620	20030509	Death Penalty	35	2	3	30
Zhejiang	Xu Yunhong	Vice-Province Governor	19990922	20001017	10 years of imprisonment	5	5	0	0
Total						**394**	**43**	**43**	**308**

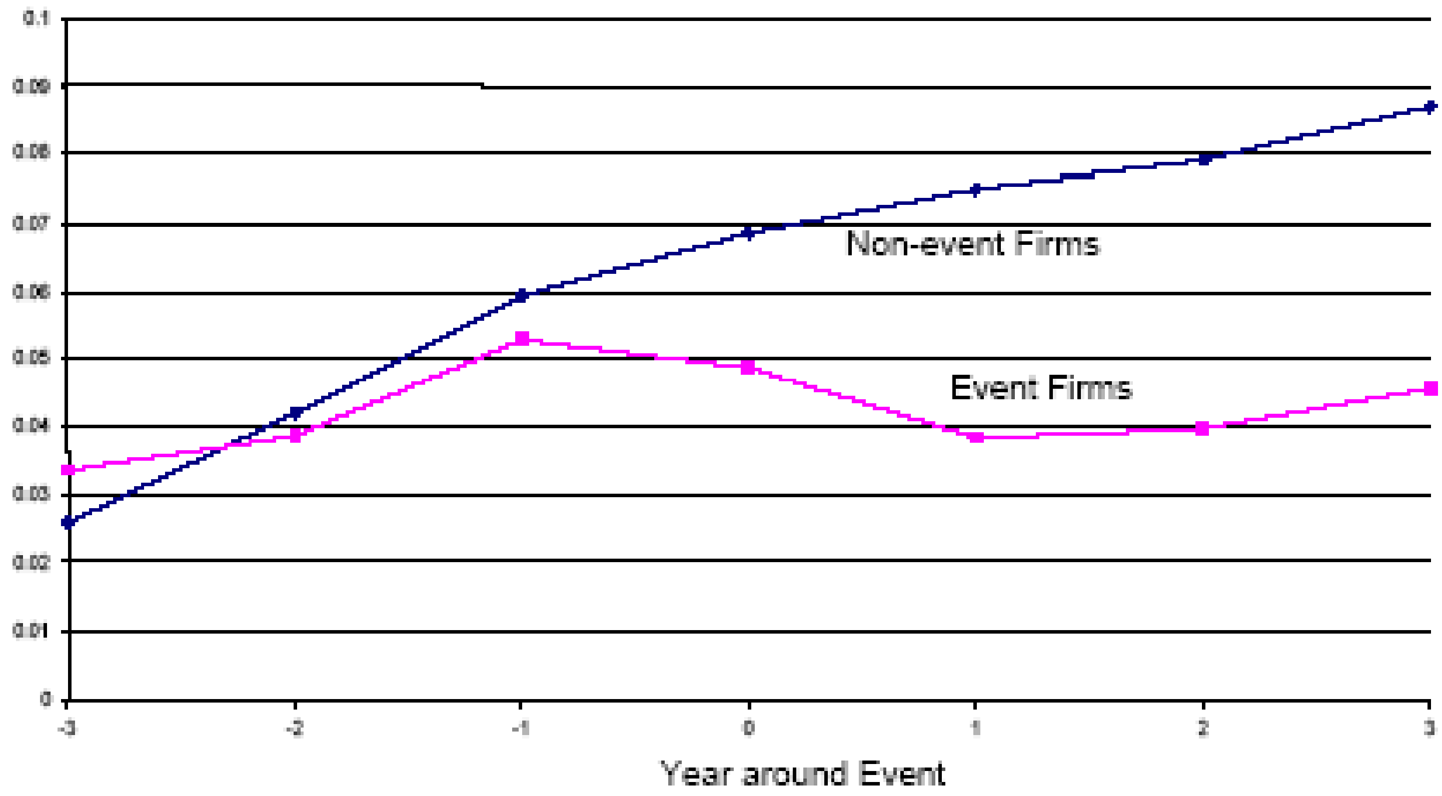
Mean Leverage Ratio around Corruption Events



Mean Debt Maturity Ratio around Corruption Events



Mean Long-term Debt Ratio around Corruption Events



Institutional causes of corporate finance in China

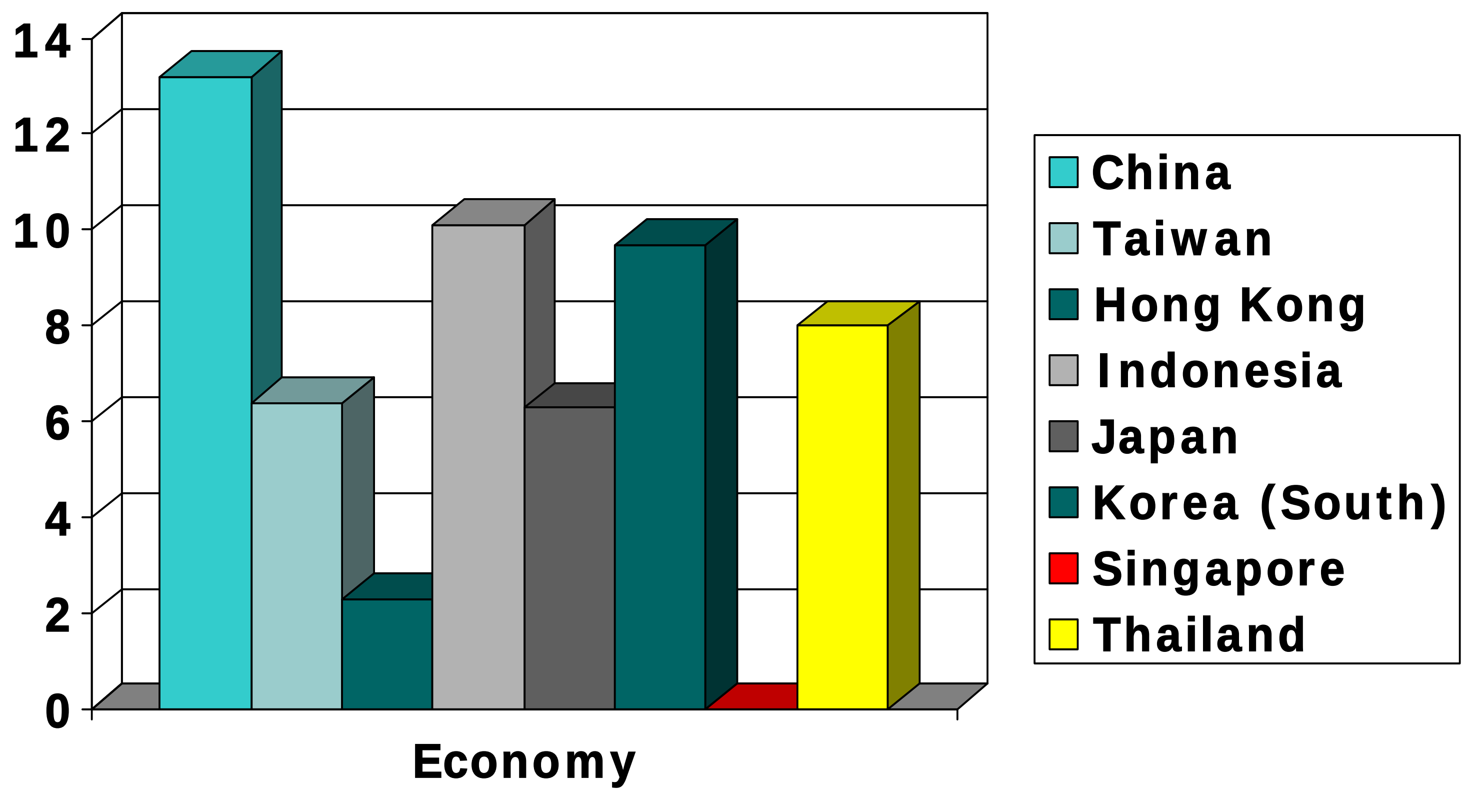
- Corporate financing policies are importantly affected by rent seeking and corruption activities
- Connections with government bureaucrats provide firm financing advantages, in particular access to long-term bank debt
- Compared with the prior studies, this paper provides more direct links between rent seeking and corporate finance, and the empirical design less subject to endogeneity issues
- The overall evidence is consistent with recent cross-country studies' findings that country-level institutional factors matter to corporate financing decisions

Empirical Regularity IV: Opaqueness

- Why are Asian companies opaque?
  - Complex organizational and ownership structures
  - Covering up: difficulties of putting investors' interests before family interest
  - Relationship-based business dealings, rent seeking, or even corruption
  - Prevent predation and expropriation (sometimes by governments) in weak property rights systems
- Fan and Wong (2002) documents that, in East Asia, a listed company's financial transparency is related to
  - its controlling owner's conflicts of interest with minority shareholder
  - Protection of proprietary information

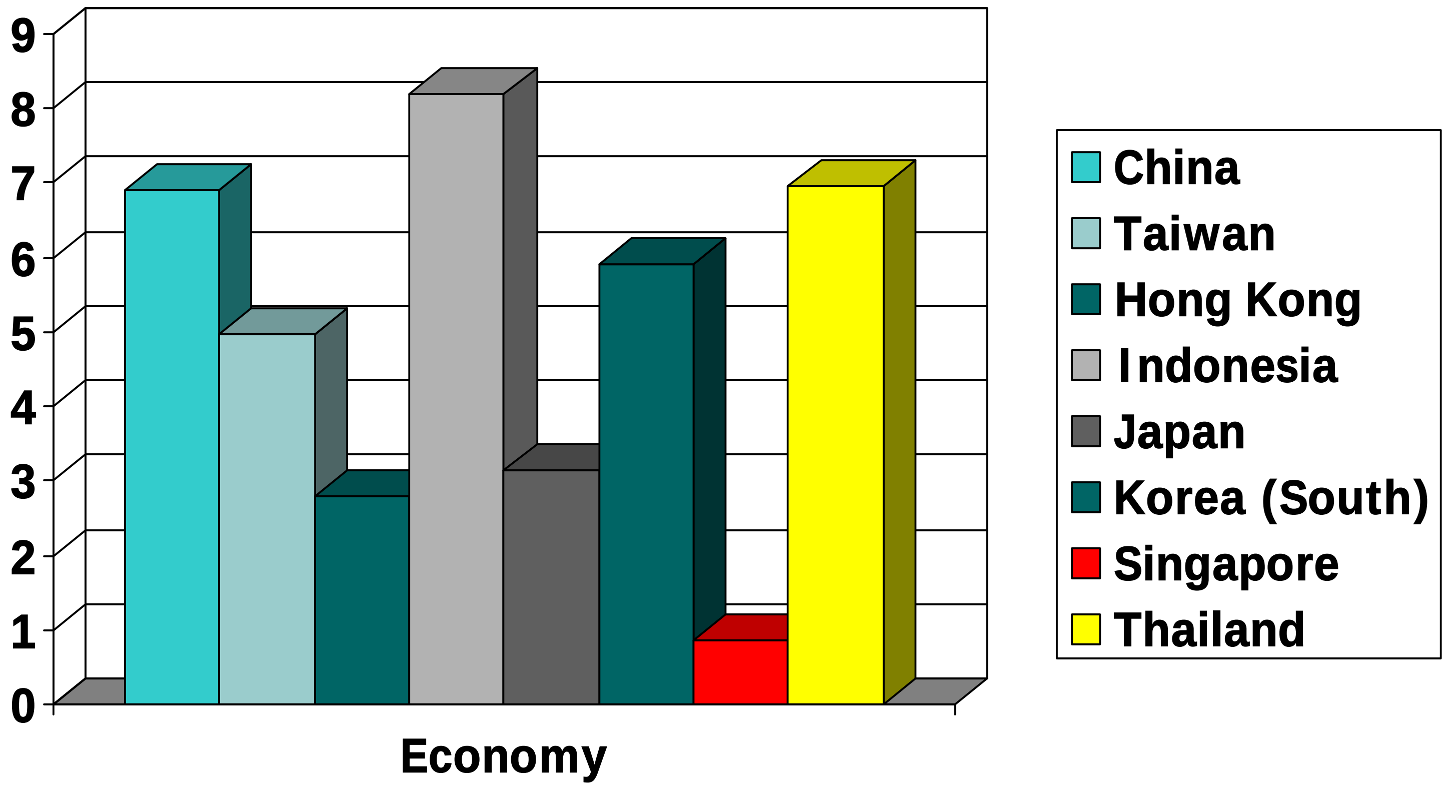
Opacity Premium in Asia

Source: PricewaterhouseCoopers



Corruption in Asian Economies

(Source: Transparency International: mean Corruption Perception Index 1992-2000)



Conclusions:
Property Rights and Institutions Matter

- Country institutional factors are important in understanding firm behaviors in Asia's emerging markets and transitional economies
- A lot of research opportunities if we can look at questions top-down
- We have demonstrated that several property right constraints (rent seeking, "right to sell", etc.) are important angles to look at governance, finance, and organizational issues in China and Asia
- Property rights is a useful tool

List of papers

Working papers can be downloaded from the website of Center for Institutions and Governance (http://www.baf.cuhk.edu.hk/research/cig/)

- Stijn Claessens and Joseph P.H. Fan, “Corporate Governance in Asia: A Survey,” **International Review of Finance**, 3, June 2002, 71-103.
- Stijn Claessens, Joseph P.H. Fan, and Larry Lang, “The Benefits and Costs of Group Affiliation,” **Emerging Market Review** 7, March 2006, 1-26.
- Stijn Claessens, Simeon Djankov, Joseph P.H. Fan, and Larry Lang, “When Does Corporate Diversification Matter to Productivity and Performance? Evidence from East Asia,” **Pacific-Basin Finance Journal**, 3, July 2003, Special Issue on Corporate Governance, 365-392.
- Stijn Claessens, Simeon Djankov, Joseph P.H. Fan, and Larry Lang, “Disentangling the Incentive and Entrenchment Effects of Large Shareholdings,” **Journal of Finance**, 57, December 2002, 2741-2771.
- Joseph P.H. Fan, Sheridan Titman, and Garry Twite, “An International Comparison of Capital Structure and Debt Maturity Choices,” Working Paper.
- Joseph P.H. Fan and T.J. Wong, “Corporate Ownership Structure and the Informativeness of Accounting Earnings in East Asia”, **Journal of Accounting and Economics**, Vol. 33, No. 3, August 2002, pp. 401-425.
- Joseph P.H. Fan and T.J. Wong, “Do External Auditors Perform A Corporate Governance Role in Emerging Markets? Evidence from East Asia,” **Journal of Accounting Research,** May 2005, Vol. 43, no. 1, 35-72.
- Joseph P.H. Fan, T.J. Wong, and Tianyu Zhang, “Politically Connected CEOs, Corporate Governance and Post-IPO Performance of China’s Partially Privatized Firms,” forthcoming in the **Journal of Financial Economics**.
- Joseph P.H. Fan, T.J. Wong, and Tianyu Zhang, “The Emergence of Corporate Pyramid in China,” Working Paper.
- Joseph P.H. Fan, Mengxin Zhao, and Meng Rui, “Rent Seeking and Corporate Finance: Evidence from Corruption Cases,” Working Paper.