

Corporate Governance in Emerging Markets: Lessons from China

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Outline

- ❑ Top-down approach
- ❑ How does public governance shape corporate governance?
- ❑ Corporate governance in emerging markets, what work?
- ❑ Challenge of sustainability of emerging market firms
- ❑ Policy implications

Myth and Reality of Corporate Governance in Emerging Markets

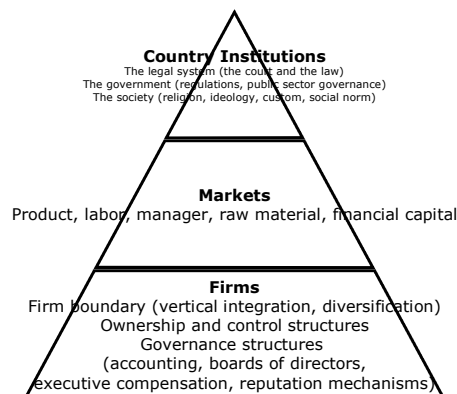
- Myth:
 - Corporate theft is primarily due to lack of modern corporate governance
 - Adopting Western governance is the cure
- Reality
 - Corporate theft is a side effect of weak institutions
 - Emerging markets have their own traditional ways of governance
 - Modern governance tools usually don't work well, because the root cause of CG problem is institutional
- A **top-down approach** focusing on institutions is needed

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Top-down Corporate Governance Framework



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Public governance and corporate governance

- ❑ In many emerging markets, governments control or influence significant resources critical to the business sector
- ❑ The quality of public governance is of first order importance in shaping the governance of the corporate sector
- ❑ Government/bureaucrat quality and how it affects corporate governance and business resource allocation should be a focus of academic and policy analyses

Government Quality

- ❑ To what extent a bureaucrat/politician would act in the best interest of citizen if his behavior is unconstrained by formal institutions
- ❑ High quality bureaucrats balance firm objectives with social objectives;
- ❑ Bad bureaucrats focus on self-interest, use their power to transfer resources to individuals and firms to win benefits and support (Shleifer and Vishny, 2002)

Bad bureaucrats are above and beyond ideology,
economic and political systems



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Bureaucrat positions for sale:
Sign of the fall of the dynasty

- ❑ Liu Hong (Han Ling Di, 156-189 AD, Emperor of Han Dynasty, China)
- ❑ The first political leader in China's history that sold bureaucrat positions to those who pay. Each position had a price tag but negotiable
- ❑ Not surprisingly, he is one of the last several emperors of Han Dynasty



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Corruption and bureaucrat quality in China

- According to China's official record, during 1997-2002, there are totally
 - 861917 corruption cases under investigation
 - 842760 corruption cases concluded
 - 846150 people punished by communist laws, of which 137711 expelled from the communist party
 - Among the punished communist party members,
 - 28996 county (县) level
 - 2422 intermediate (厅,局) level
 - 98 provincial (省, 部) level or above

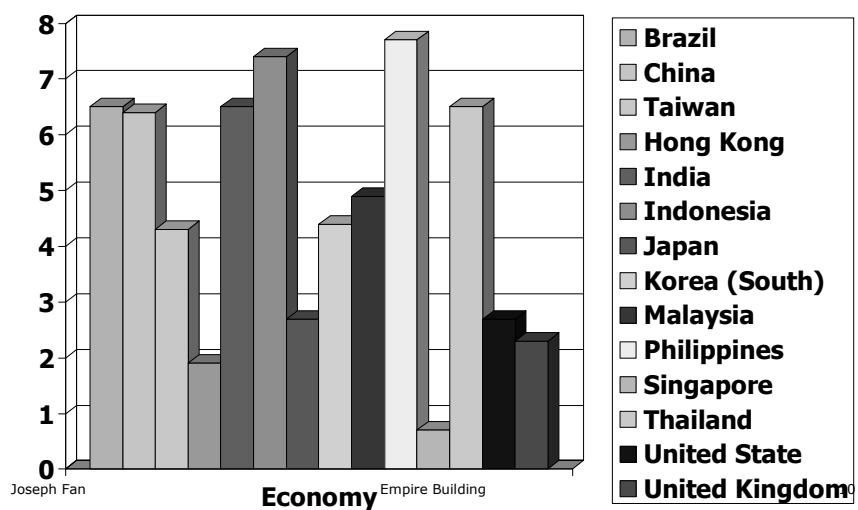
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Corruption in Asian Economies

(Source: Transparency International: Corruption Perception Index 2008)

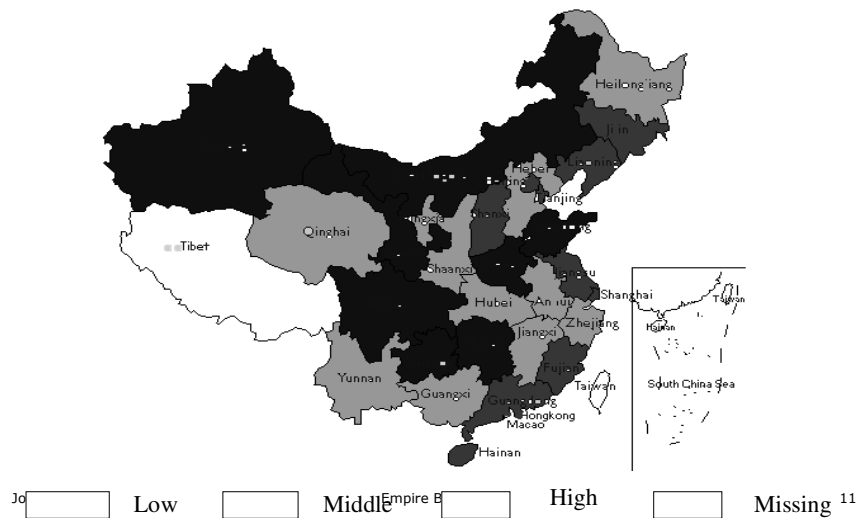


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One Country, Many Systems

Property Rights Protection in China's Various Regions



Effects of public governance on corporate governance

- Our series of research reports CG symptoms in China or East Asia
 - Internal governance and managerial professionalism
 - Post-IPO performance
 - Access to debt
 - IPO share allocation and pricing
 - Ownership and organizational structure

- We will see that in many cases poor public governance is a root cause – it's difficult to separate business from politics in emerging markets

CG Symptom 1:

Weak internal governance and low professionalism

- Weak governance and low professionalism of Chinese firms
 - Almost two decades 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 compared to the western standard.
- 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, JFE 2007)

Board size	9.22 (range 5 to 19)
Manager directors	34%
Largest shareholder	53%
Minority shareholders	0%
Bureaucrats and Politicians	32%
<i>Central govt</i>	4%
<i>Local govt</i>	19%
<i>Others</i>	9%

Boards of directors are weak in governance: the case of China

(Fan, Wong, Zhang, JFE 2007)

Directors from unaffiliated firms

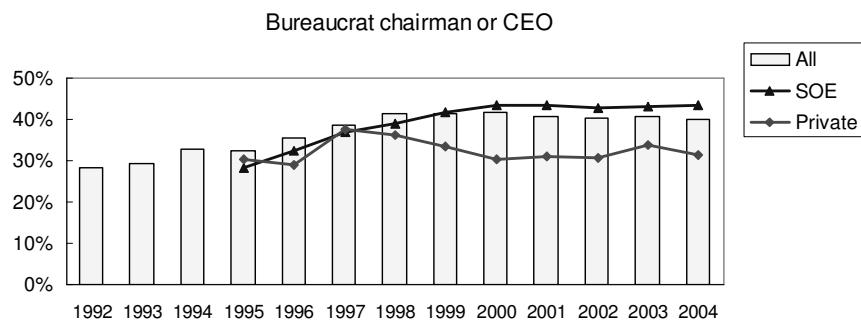
("expert" directors)	18%
Professionals	5%
Academics	14%
Woman directors	5%
Age	47
Education	<i>Between Junior college and university</i>

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Bureaucrat as chairman or CEO

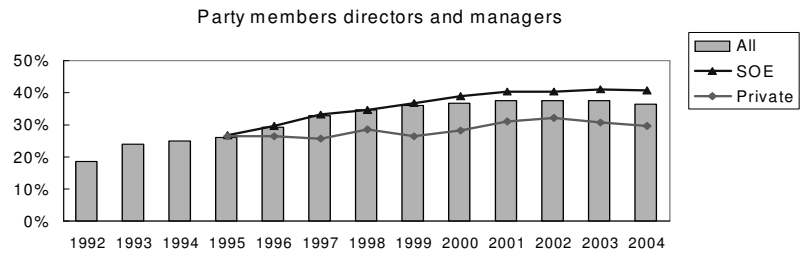


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Party members as directors and managers

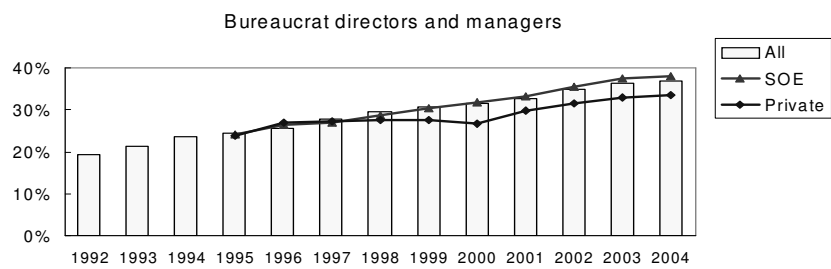


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Bureaucrats as directors and managers

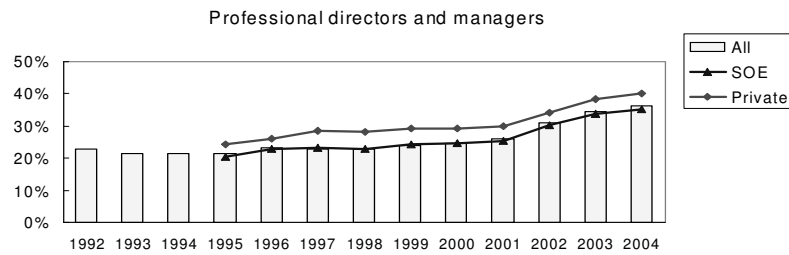


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Professional as directors and managers



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Why boards and management in China have so many politicians/bureaucrats but so few professionals?

- Boards in China are not the same as boards in the West. But is it not “optimal”?
 - Political connection is often more important than professionalism/productivity in creating value
 - We need ex-bureaucrats to help lobbying government. These activities are called *rent seeking*, some of which involve corruption
 - You do not want so many professionals around, for fear of leakages of the proprietary information which attract social/political sanctions
- Whether minority shareholders get a fair share of the rent is another issue

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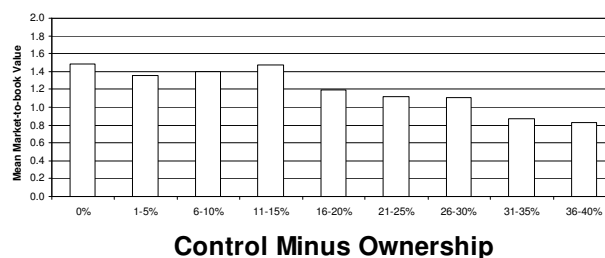
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CG Symptom 2: Undercapitalization

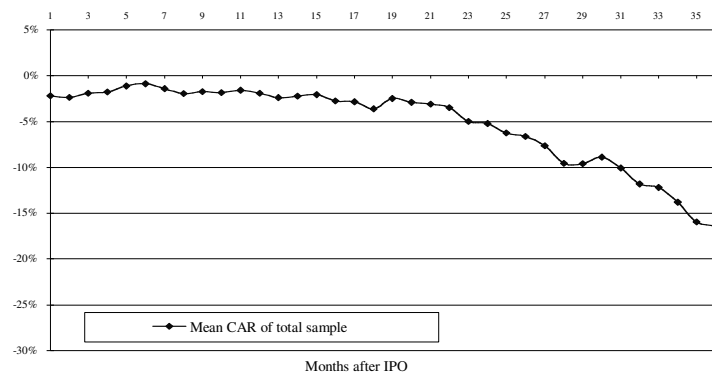
- ❑ How are investors fared in the face of weak governance?
- ❑ just like car theft depress car prices, lack of investor protection depress share prices
- ❑ Price protection – lack of trust by investors ultimately result in difficulties and high costs in external financing

Price Protection (Claessens, Djankov, Fan, Lang, JF 2002)

**Company Valuation and the Difference
between Control and Ownership**



Post-IPO stock return performance (CAR) of 625 China's partially privatized firms



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Corporate governance and post-IPO performance

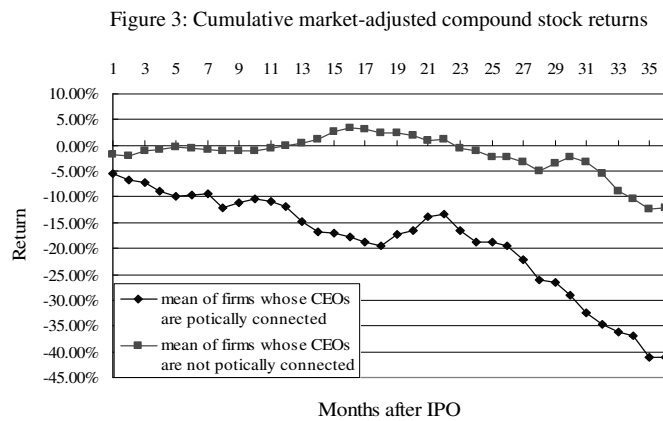
- ❑ Share issue privatization around the world is typically associated with superior performance
- ❑ China is an exception
- ❑ Why?
- ❑ Politicians and bureaucrats, not just corporate managers and owners are responsible for corporate theft

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Post-IPO stock return performance (CAR) distinguished by whether CEOs have been bureaucrats
(Fan, Wong, Zhang, JFE 2007)



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CG Symptom III:
High financial leverage

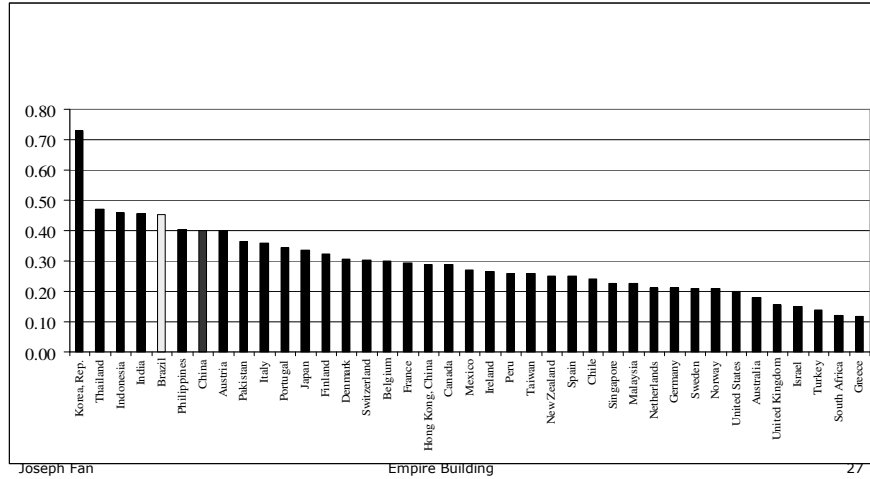
- Emerging market companies rely on debt much more than equity to finance their investment
- Moreover, they rely on short-term debt, even when they engage in long-term investment
- Banks, not capital markets, are the primary sources of funds for firms in developing countries

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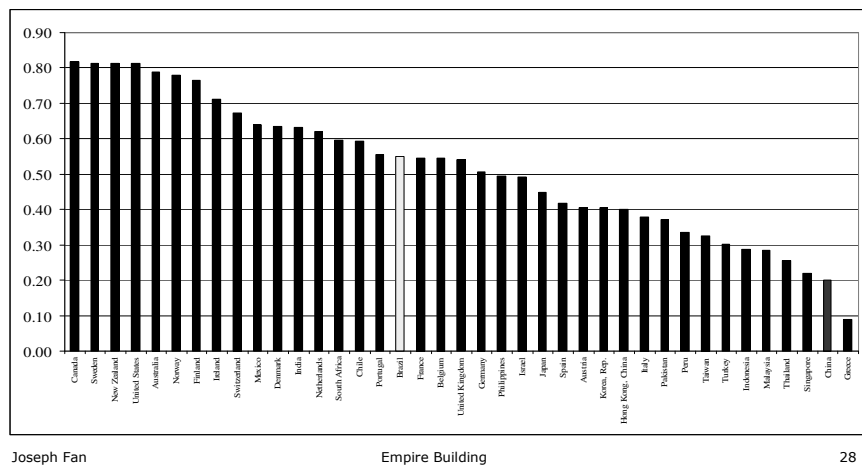
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Cross country pattern of corporate leverage (Fan, Titman, Twite, 2008)



Cross country pattern of corporate debt maturity (Fan, Titman, Twite, 2008)



Public governance and corporate finance

- ❑ Why the high leverage and lack of long-term financing instruments?
- ❑ In weak institution countries debt (bank loans) provide better private enforcement than equity
- ❑ Bureaucrats channel funds to their favored firms through banks they control
- ❑ Only well connected firms have access to long-term loans
- ❑ There are several studies in emerging markets providing consistent evidence. We offer a cleaner test using Chinese data

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A Corrupt Bureaucrat and His Publicly Listed Allies

Firm Name	Listed Market	Connection Type	Note
Beijing Development	HK	Colleague & Briber	Gao Qiming (chairman) was an ex-secretary of Chen Xitong. Besides, there were other three officials from the Beijing government sat on the company's board.
Shougang Concord Century	HK	Briber	Zhou Beifang, chairman and CEO of the controlling shareholder (Shougang Holding) of the company, was the conspirator and briber of Chen Xitong.
Shougang Concord Technology	HK	Briber	Zhou Beifang, chairman and CEO of the controlling shareholder (Shougang Holding) of the company, was the conspirator and briber of Chen Xitong.
Shougang Concord International	HK	Briber	Zhou Beifang (chairman and CEO) was the conspirator and briber of Chen Xitong.
Shougang Concord Grand Beiren Printing	HK	Briber	Zhou Beifang (chairman and CEO) was the conspirator and briber of Chen Xitong.
Beijing Auto	Shanghai	Colleague	Zhang Peng (director) was the vice mayor of Beijing City.
Beijing Urban-Rural	Shanghai	Colleague	Zhu Lining (director) was the vice president of Beijing Municipal Finance Bureau. Both its chairman and vice-chairman had working experiences in the Beijing government.
Beijing Tianqiao	Shanghai	unconnected firm	N/A
Beijing Tianlong	Shanghai	unconnected firm	N/A
Wangfujing Store	Shanghai	unconnected firm	N/A

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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 Binrong	Vice-Chairman of Municipality	19980523	19990827	Life imprisonment	12	1	3	8
Guizhou	Liu Changgu	Vice-Province Governor	20030417	20040430	11 years of imprisonment	12	1	1	10
Guizhou	Liu Fengren	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	Mang 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
Xinjiang	Anan 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

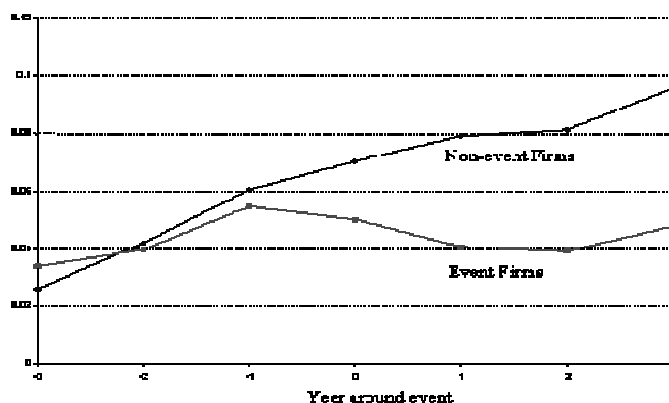
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Corruption and Access to Long-term Loans

(Fan, Rui, Zhao, JCE 2008)



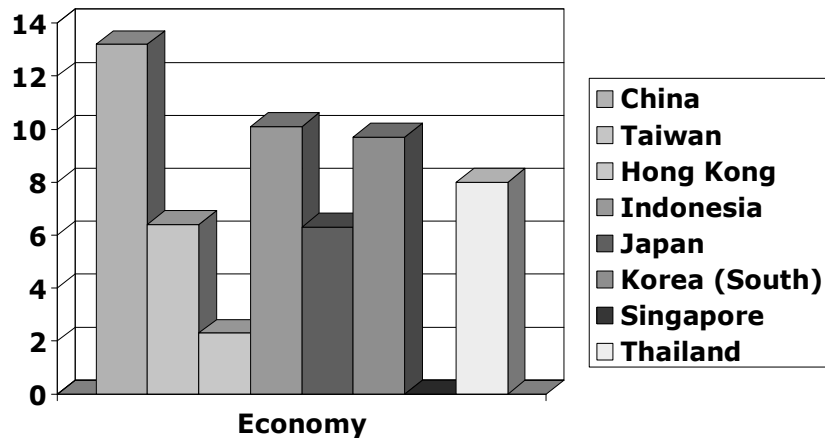
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CG Symptom IV: Poor Transparency

Opacity Premium in Asia (Source: PricewaterhouseCoopers)



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Why are emerging market firms opaque?

- Complex organizational and ownership structures
- Covering up: rent seeking, corruption, or difficulties of putting investors' interests before family interest (Fan and Wong, JAE 2002)
- Measurement difficulty: Relationship-based business post difficulty of measuring benefits and costs
- If these institutional constraints cannot be relieved, it would be difficult to improve corporate transparency even with new accounting standards, laws, and regulations

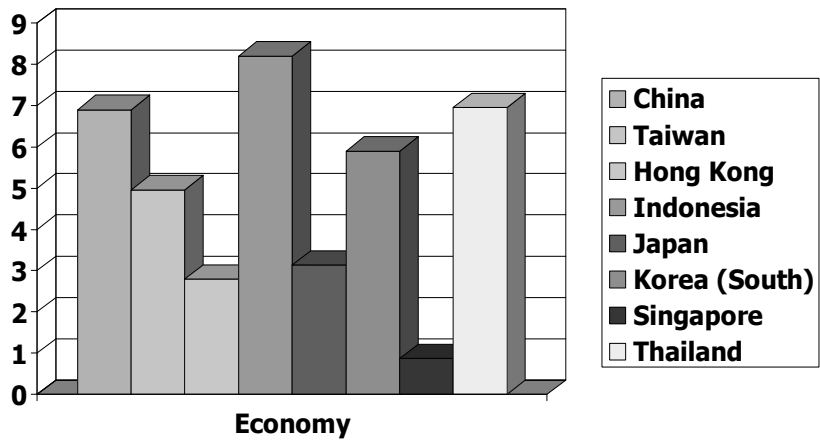
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Corruption in Asian Economies

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



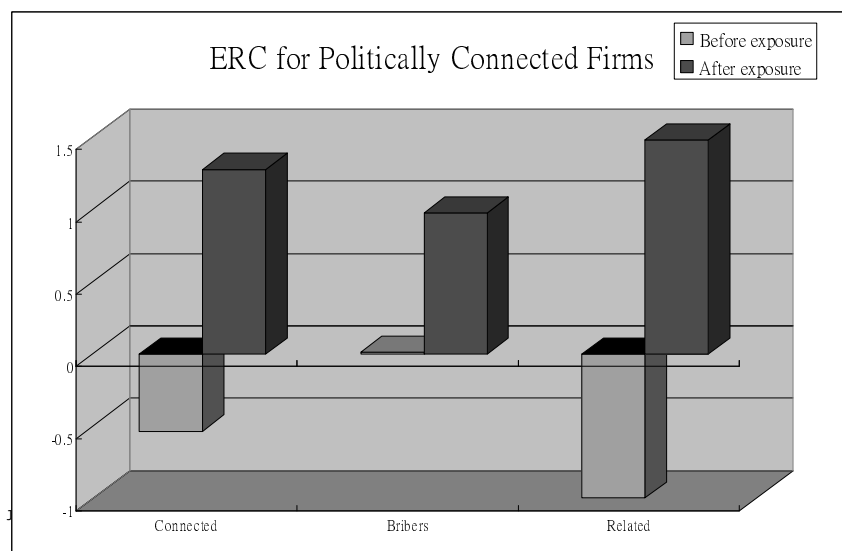
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Earnings informativeness of politically connected firms before and after corruption exposure

(Fan, Yang, Zhang, 2009)



CG Symptom V:

Complex organizational and business structures

- ❑ Many emerging market firms are diversified, group affiliated, and controlled by complex ownership
- ❑ Why?
- ❑ Benefits and costs?

Diversification of a bureaucrat affiliated firms



Good Business is More Businesses?

1998



1999



2001



2002



2003



rice

medicine

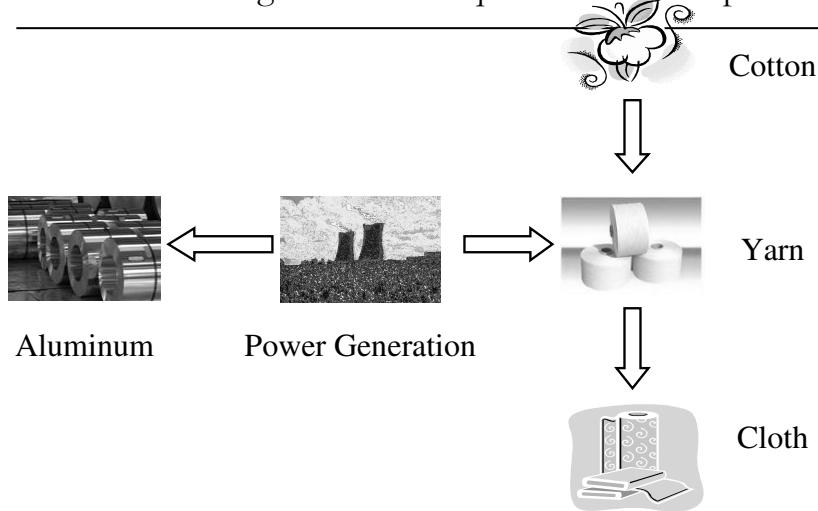
real estate

milk

electricity

sewage works

We make everything ourselves -
Vertical integration of Weiqiao Textile Group



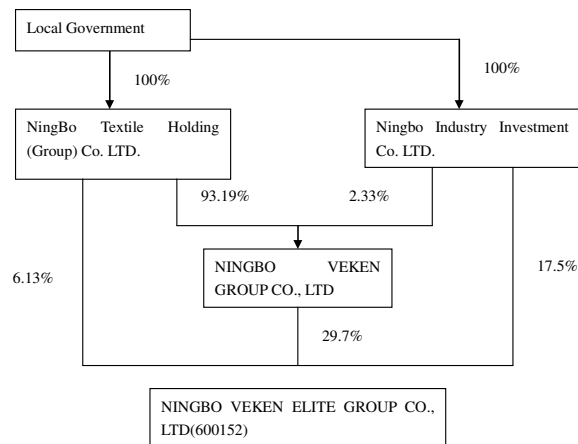
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Pyramidal Ownership/Organizational Structure

(Fan, Wong, Zhang, 2008)

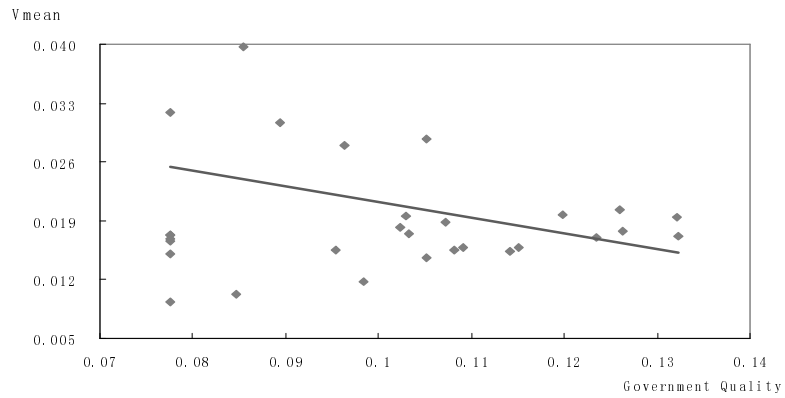


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Government quality and vertical integration (Fan, Huang, Morck, Yeung, 2008)

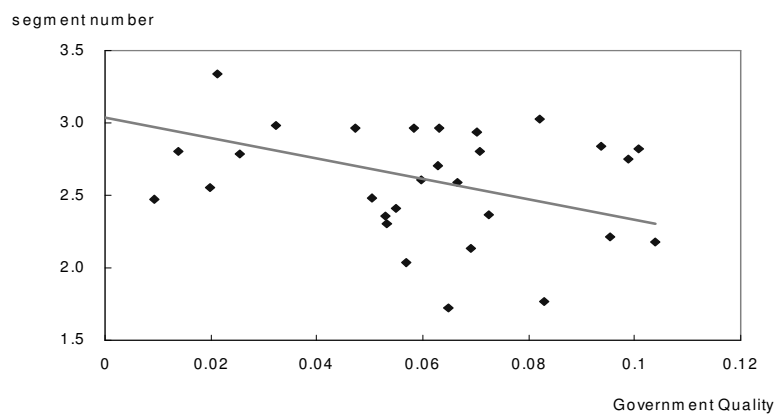


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Government quality and diversification

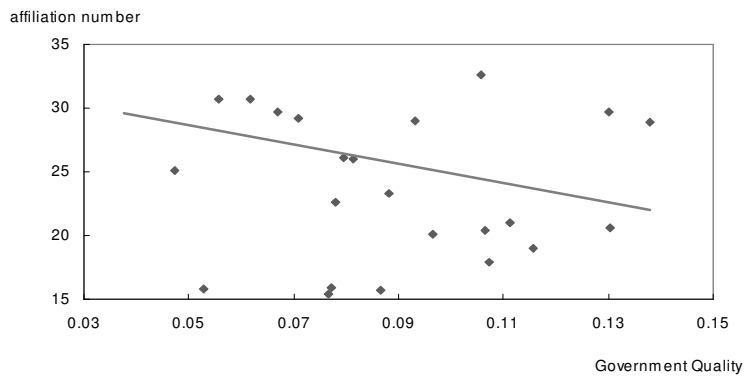


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Government quality and the span of business group



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Emerging market corporate governance – what is the reality?

- ❑ Relationship based (instead of market based) business model
- ❑ Investors' threat is not just from managers/controlling owners, but also bad politicians and bureaucrats
- ❑ Family controlled, complex, diversified, network (instead of diffusely owned, focused, and free-standing) organizations
- ❑ Research is just beginning to emerge

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Why Family Governance Works in Emerging Markets?

- Typical family firms in emerging markets
 - Multiple family members involved in business
 - Concentrated ownership and control
 - Little separation between ownership and management
 - Family succession
- Family relationship networks allow self-enforcement thus bypassing weak institutions
- Internal governance enforced by family ties and back-end loaded compensation
- Relationship based transactions with stakeholders enforced by family reputation and connections
- We need a lot of research in the future

Business Group – Network of Companies

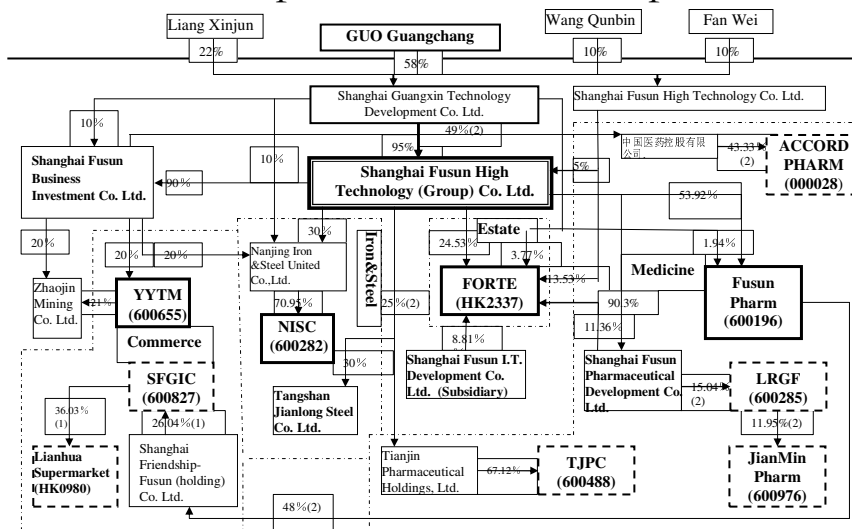
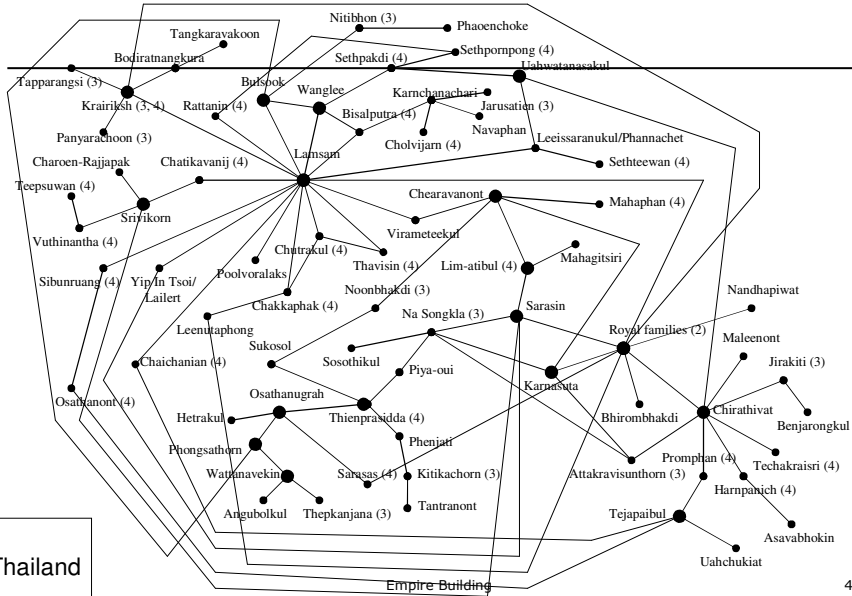


Figure 1: Organization Framework of Fusun Group

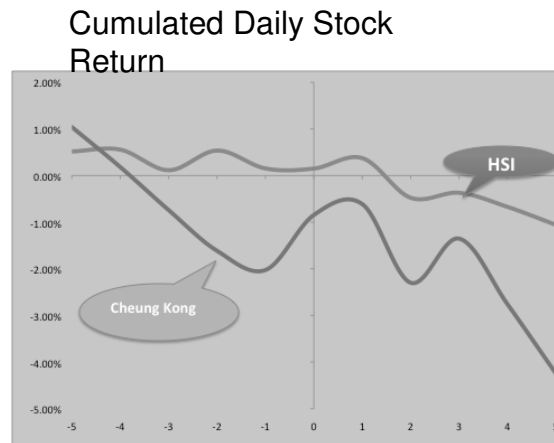
Family Network by marriages



Challenges of family firms

- ❑ Sustainability of the relationship based business model is questionable
 - Relationship is difficult to partition and transfer across individuals and firms
- ❑ Moving from the relationship based to market based model is a common challenge to most emerging market firms
 - Specialized assets difficult to standardized
 - Managerial entrenchment
 - Political entrenchment - politicians and bureaucrats do not want to lose their influences on the corporate sector

Li Ka-shing (77) was sent to hospital on Sep. 6th, 2005.



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Family successions dominate

(Fan, Jian, Li, Yeh, 2009)

	Hong Kong		Singapore		Taiwan		Total	
Family member	43	69%	17	36%	80	74%	140	65%
Heir	18	29%	4	9%	57	53%	79	36%
Relative	25	40%	13	28%	23	21%	61	28%
Outsiders	6	10%	17	36%	24	22%	47	22%
Sold-out	13	21%	8	17%	4	4%	25	12%
Unknown	0	0%	5	11%	0	0%	5	2%
Total	62	100%	47	100%	108	100%	217	100%

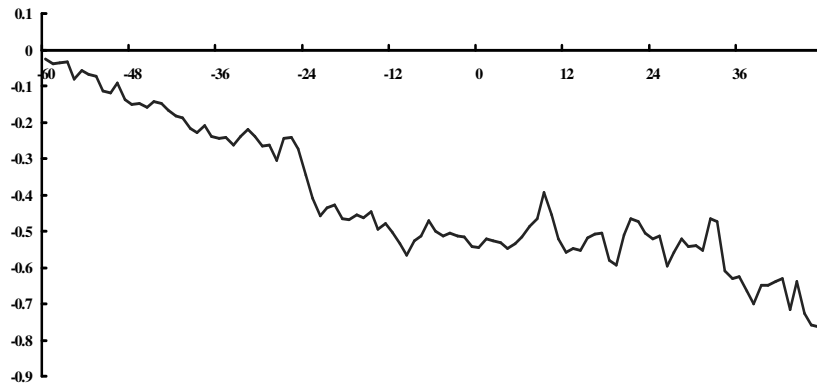
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Succession and firm value (Fan, Jian, Li, Yeh, 2009)

Monthly cumulative abnormal stock return (CAR) around succession



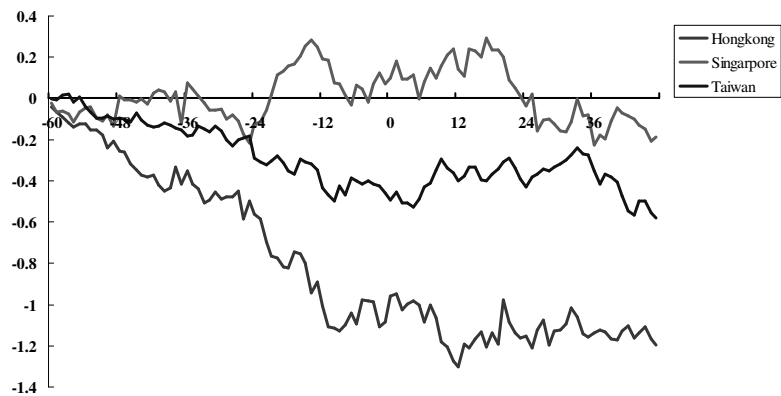
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Succession and firm value (Fan, Jian, Li, Yeh, 2009)

Monthly cumulative abnormal stock return (CAR) around succession, by economy



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How can wealth be passed on to the next generation?

- ❑ Professionalize/standardize
- ❑ Preserve core value
- ❑ Secure ownership and control
- ❑ Embrace changes, remove entrenchment
- ❑ Cultivate a competitive successor
- ❑ Transition to market-based corporate governance

Successful transition – Improving corporate governance

- ❑ A governance structure that provides objective and professional **advices**, and provides **credibility** and protection to stakeholders is needed
- ❑ If successor cannot completely inherit his/her previous generation's credibility to stakeholders, he/she will likely subject to tighter governance constraints
 - More outside independent members on board
 - More professional management
 - Separating chairman and CEO positions
 - More concentrated ownership
 - More transparency in accounting and organization
 - Higher dividend payment

Conclusions and policy implications

- Institutional environment determines corporate governance model
- Public governance quality is critical to CG
- New CG laws and regulations without considering local institutional environment are bound to be ineffective
- CG evolves to adapt to the credibility of new corporate leadership, new political leadership, and new institutional quality
- How to prevent entrenchment of managers, bureaucrats, and politicians and allow creative destruction is an important task to enhance CG quality

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- Joseph P.H. Fan, Jun Huang, Randall Morck, and Bernard Yeung, "Vertical Integration, Institutional Determinants and Impact: Evidence from China"
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- Joseph P.H. Fan, T.J. Wong, and Tianyu Zhang, "Founder Succession and Accounting Properties"
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