

Network and Corporate Governance

Joseph P.H. Fan

Institute of Economics & Finance
The Chinese University of Hong Kong

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on Corporate Governance, Tianjin, China, September
2009

Outline

- Why network?
- Enforcement of network
- Effects of network on governance and value
- Limitation of network

Business Group – Network by Ownership

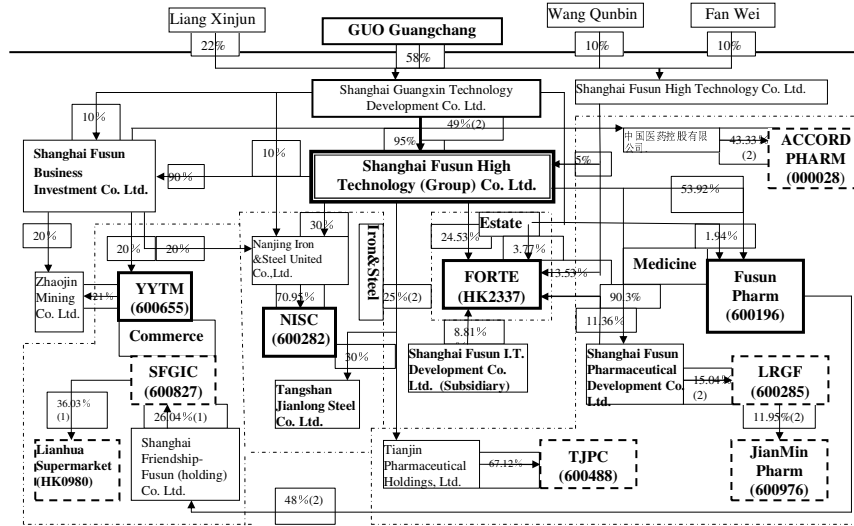


Figure 1: Organization Framework of Fusun Group

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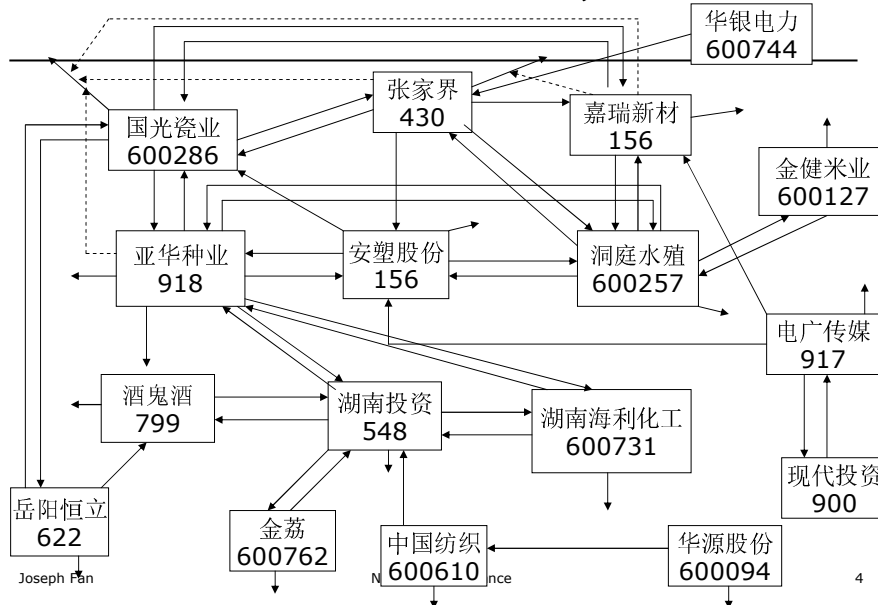
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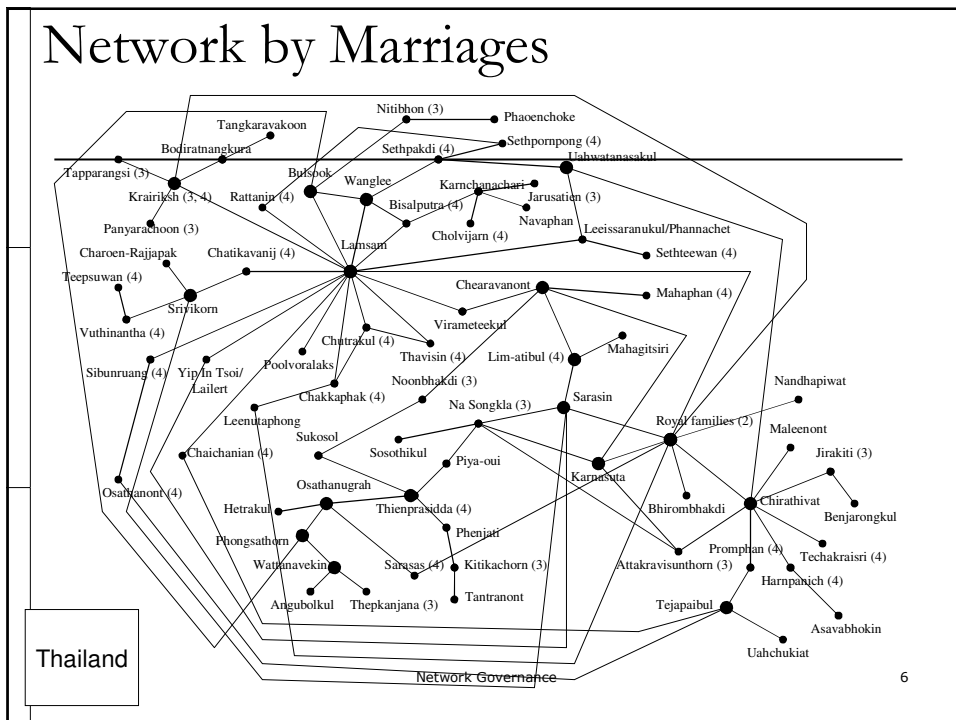
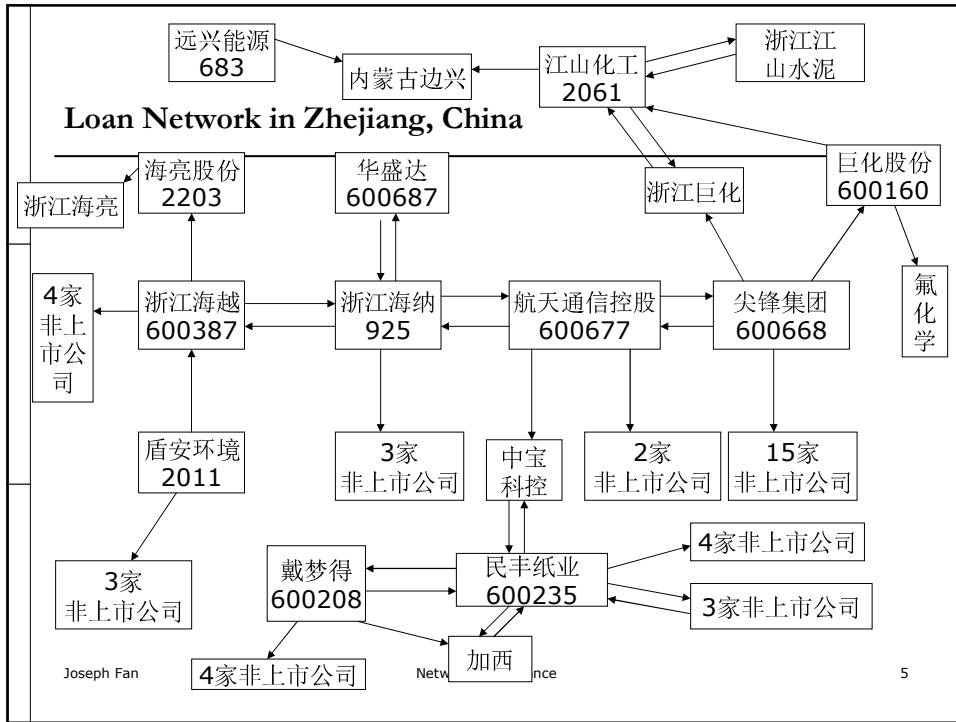
Loan Network in Hunan, China



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Network versus Market Based Governance

- Market based model
 - Anonymous trading counter parties
 - Explicit contract enforced by the court
 - Dispute resolution resorting to contract or third-party assistance
- Network based model
 - Trading among parties within a web of relationships
 - Long-term, recursive
 - Implicit contract enforced by loss due to non-salvaged investments (Klein, Crawford, Alchian, 1978)
 - Dispute resolution depends on whether to maintain the relationships (Williamson, 1979)

Why Network?

- By passing weak institutions and enforcement that fail to protect contracts
- Relationship help self-enforcement
 - Reputation and relationship are costly to build and break
- Emerging markets, including those in China, are typically relationship based

Enforcement of Networks

- Informal forces that do not depend on laws and third parties
- Key is investment in non-recoverable assets specialized to the relationship
 - Reputation from repeated transactions
 - Kinship (a relationship between any entities that share a genealogical origin, through either biological, cultural, or historical descent)
 - Marriage
 - Society membership
 - Specialized payment (gift, kickback, and bribery)

Evidence of Network and Value Impacts

- Business groups
- Marriages
- Family firm succession
- Loan network
- Corruption network

Why Do Shareholders Value Marriages?

Bunkanwanicha
Fan
Wiwattanakantang

Marriage as a method of building relationship
network (Bunkanwanicha, Fan, Wiwattanakantang, 2008)



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Marriage Sample from Thailand

Year	Number	Percentage
1991	12	5.9%
1992	14	6.9%
1993	8	3.9%
1994	15	7.4%
1995	12	5.9%
1996	15	7.4%
1997	7	3.5%
1998	13	6.4%
1999	12	5.9%
2000	11	5.4%
2001	18	8.9%
2002	13	6.4%
2003	11	5.4%
2004	9	4.4%
2005	23	11.3%
2006	10	4.9%
Total	203	100.0%

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Note: The sample includes 91 families (2 marriages/family on average)

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Marriages & Networks

	Number	Percentage
A. Family background		
Top business (i)	42	20.7%
Business, Professional (ii)	52	25.6%
Royal, Noble (iii)	17	8.4%
Politician, Military, Civil servant (iv)	50	24.6%
Foreigner (v)	11	5.4%
Others (vi)	31	15.3%
B. By type of network		
Business network (i)+(ii)	94	46.3%
Political network (iii)+(iv)	67	33.0%
Others (v)+(vi)	42	20.7%
C. By type of marriage		
Business & Political networks	161	79.3%
Others	42	20.7%

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Stock Price Effects of Marriages

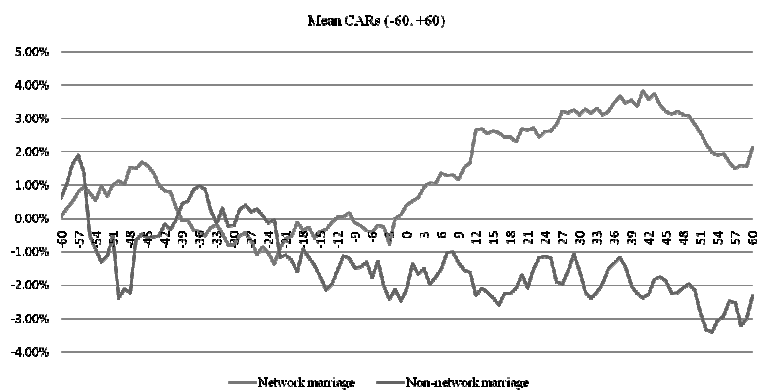
	Event: Announcement Date	
	CAR (-1,+1)	CAR (-2,+2)
A. Total sample (N=140)		
Mean (<i>clustering</i>)	0.85%***	1.22%***
Median (<i>sign-test</i>)	0.54%***	0.81%***
Positive CAR(%)	67%	69%
B. By type of marriage		
- Network marriage (N=110)		
Mean (<i>clustering</i>)	1.08%***	1.54%***
Median (<i>sign-test</i>)	0.71%***	0.91%***
Positive CAR(%)	72%	71%
- Other marriage (N=30)		
Mean (<i>clustering</i>)	-0.02%	0.03%
Median (<i>sign-test</i>)	0.00%	0.21%
Positive CAR(%)	50%	63%

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Figure 1C: Long-term Cumulative Abnormal Returns before the Marriage News Date (-60,+60)

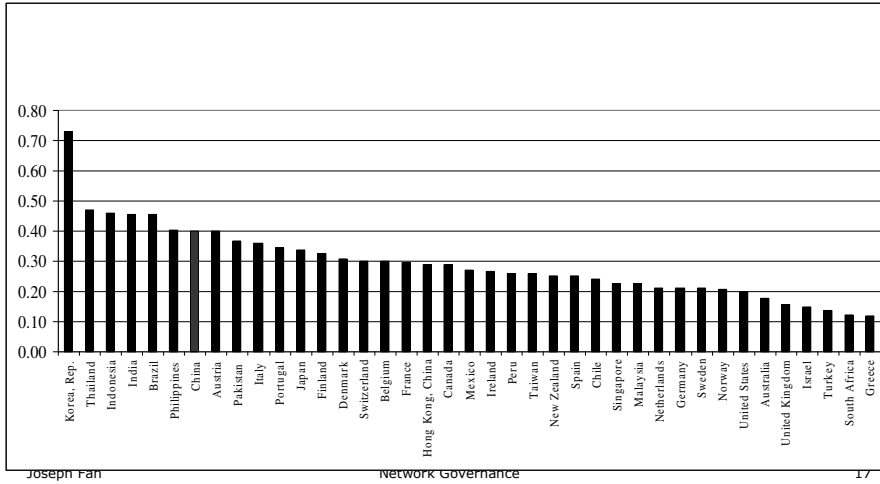


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Cross country pattern of corporate leverage (Fan, Titman, Twite, 2009)

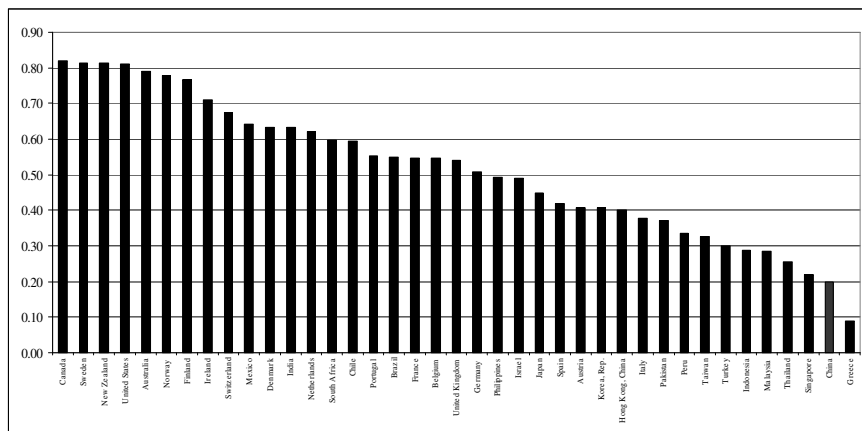


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Cross country pattern of corporate debt maturity (Fan, Titman, Twite, 2009)



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Corruption Networks and Access to Financial Capital

- ❑ Emerging markets are featured by high leverage and lack of long-term financing instruments. Why?
- ❑ In weak institution countries debt (bank loans) provide better private enforcement than equity
- ❑ Bureaucrats/politicians channel funds to their favored firms through banks they control
- ❑ Only well connected firms have access to long-term loans

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Public Governance and Corporate Finance: Evidence from Corruption Cases

Joseph P.H. Fan*

Oliver M. Rui*

Mengxin Zhao**

*Chinese University of Hong Kong

**University of Alberta

Journal of Comparative Economics (2008)

A Corrupt Bureaucrat and His Publicly Listed Allies

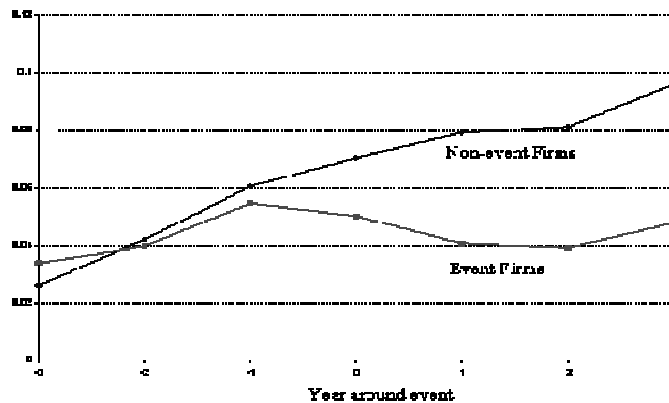
	Firm Name	Listed Market	Connection Type	Note	
	Beijing Development	HK	Colleague & Briber	Gao Qiming (chairman) was an ex-secretary of Chen Xitong. Besides, there were other three officials from the Beijing government sat on the company's board.	
	Shougang Concord Century	HK	Briber	Zhou Beifang, chairman 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.	
Joseph Fan	Beijing Tianqiao	Shanghai	unconnected firm	N/A	
	Beijing Tianlong	Shanghai	unconnected firm	N/A	
	Wangfujing Store	Shanghai	unconnected firm	N/A	21

The Scandal List

Province	Name	Position	Event Day	Sentence Day	Sentence	Number of firms in the province	The Bribing Firms	The Connecte d Firms	The Non-eve nt Firms
Anhui	Wang Huizhong	Vice-Province Governor	20010407	20031229	Death Penalty	25	1	1	23
Bank	Liu Jingbo	Vice-Chairman & CEO of Bank Of China (HK)	20030525	N/A	N/A (Still under investigation)	10	2	1	7
Bank	Wang Yuebin	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 Pengshang	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 Qingli	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 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
Jiangsu	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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Effects of Network on Corporate Governance

□ Insider based governance

- Concentrated ownership and control
- Managers and boards dominated by insiders and connected personnel
- Accounting opacity due to difficulty of measuring network cost and value
- Managerial incentive aligned by controlling ownership rather than explicit compensation

□ Is this bad?

- No, network and insider based governance are optimal responses to weak institutions

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Succession: The Roles of Specialized Assets and Transfer Costs

Joseph P.H. Fan (CUHK)
Ming Jian (NTU, Singapore)
Li Jin (HBS)
Yin-Hua Yeh (Fu-Jen Catholic University,
Taiwan)

Relationship/network based business dictate family successions (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%

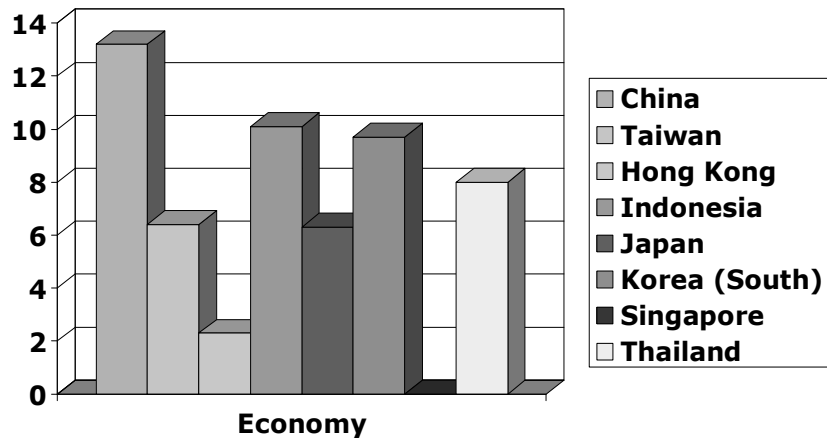
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Poor Corporate Transparency

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:
Network/relationship-based business post
difficulty of measuring benefits and costs

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Founder Succession and Accounting Properties

Joseph Fan, TJ Wong, and Tianyu Zhang

Forthcoming, Contemporary Accounting Review

Table 2: Level of discretionary accruals

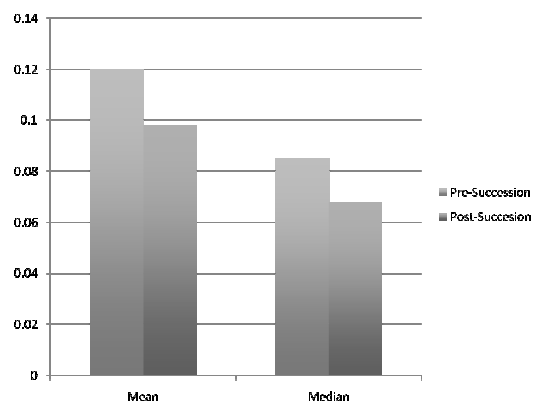
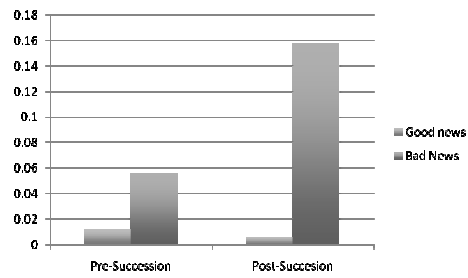


Table 3 Timely loss Recognition

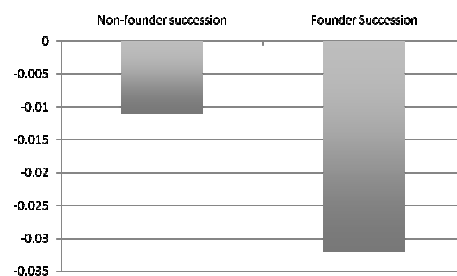


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Table 4: Change in Accruals

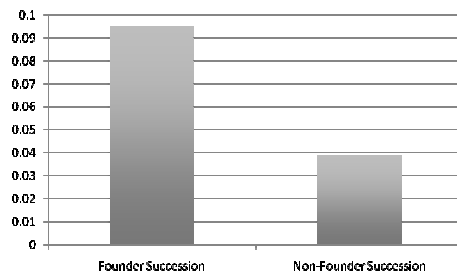


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Table 5 Panel A: Change in TLR



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Relationship Networks and Earnings Informativeness: Evidence from Corruption Cases

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Zengquan LI /SUFU
Yong George Yang /CUHK

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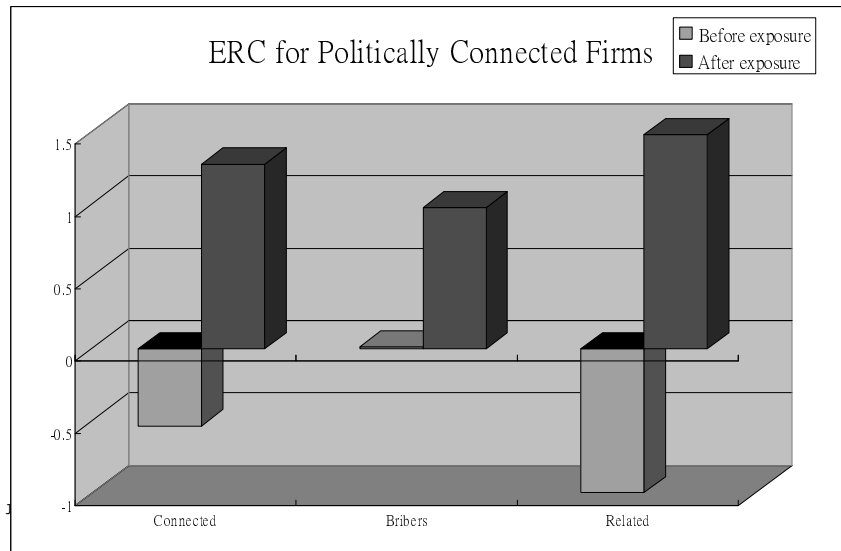
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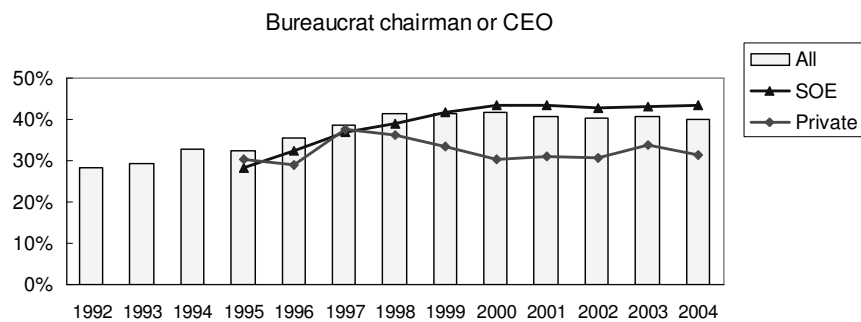
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Earnings informativeness of politically connected firms before and after corruption exposure

(Fan, Yang, Zhang, 2009)



Politically Connected Chairmen/CEOs in China's Publicly Listed Companies

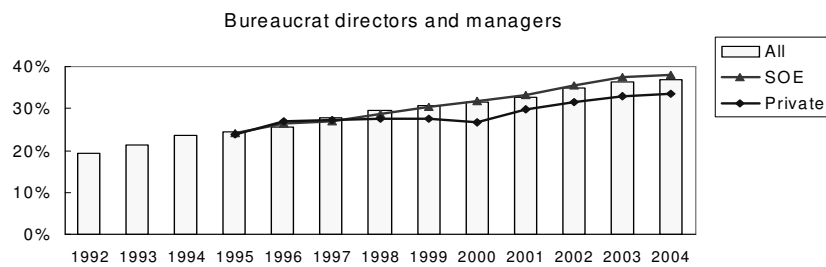


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Politically Connected Directors and Managers in China's Publicly Listed Companies



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Limitation of Network Based Governance

- ❑ Insiders dominate, conflict of interest costly to manage
- ❑ Specialized, difficulty of transfer
- ❑ Small scale, internal transactions not sufficient for large, sophisticated projects
- ❑ Low professionalism, not suitable for projects requiring high skills
- ❑ Localized, not suitable for the increasingly global business environment

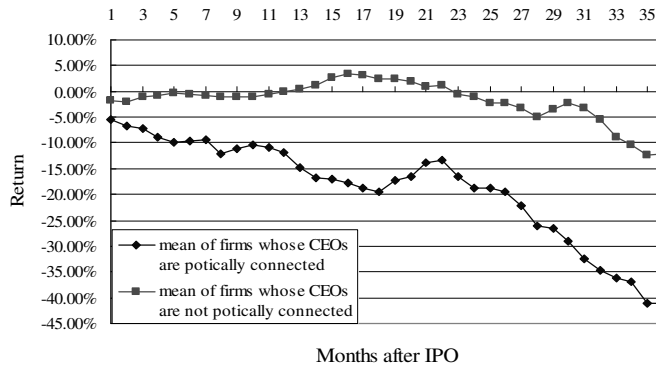
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Post-IPO stock return performance (CAR) distinguished by whether CEOs have been bureaucrats
(Fan, Wong, Zhang, JFE 2007)

Figure 3: Cumulative market-adjusted compound stock returns

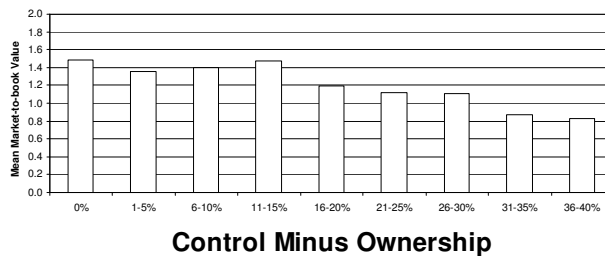


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Ownership Discount (Claessens, Djankov, Fan, Lang, JF 2002)

Company Valuation and the Difference between Control and Ownership



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Challenges of transferring network/relationship in 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

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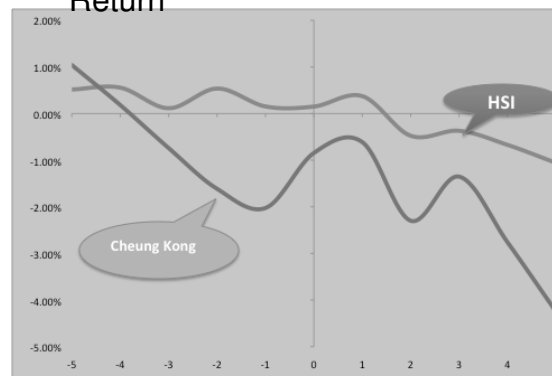
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Li Ka-shing (77) was sent to hospital on Sep. 6th, 2005.

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Cumulated Daily Stock Return



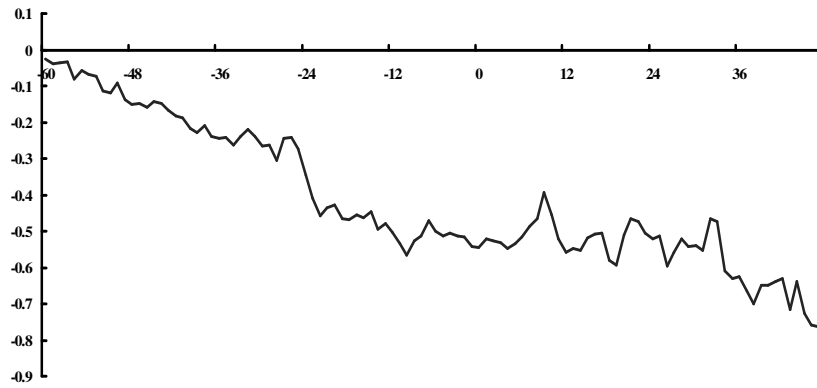
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Succession and firm value (Fan, Jian, Li, Yeh, 2009)

Monthly cumulative abnormal stock return (CAR) around succession



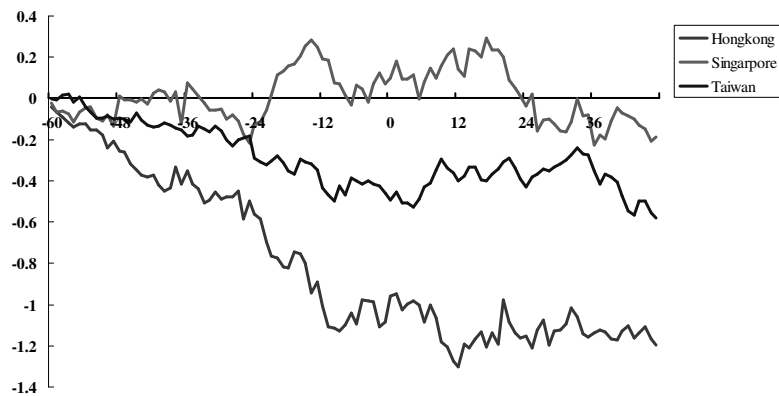
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Succession and firm value (Fan, Jian, Li, Yeh, 2009)

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



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Conclusions

- ❑ Emerging market corporate governance is relationship based
- ❑ Network governance is optimal response to weak institutions
- ❑ Government imposing Western arm's length based model will not work
- ❑ Firms evolve to arm's length governance when their business model change due to change of leadership, market, or institutional environment
- ❑ We know very little about these. More research is needed