

Controlling Problematic Related Party Transactions of Banks in Asia

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Outline

- What are related party transactions?
- Disclosure of related party transactions
- Related party transactions in family controlled banks
- Related party transactions in state owned banks
- Controlling problematic related party transaction, what work?

What are related party transactions?

- Business dealings between a party and an entity that is controlled/influenced by the party
- How prevalent?
 - Almost all firms engage in RPT
 - Internal transactions are sometimes necessary for bypassing markets where business dealings are costly

Definition of Related Party (IAS 24)

- A party is related to an entity if it
 - Directly or indirectly controls, is controlled by, or is under common control with the entity
 - Has significant influence over the entity
 - Has joint control over the entity
 - Is a close member of the family of any individual who controls, or has significant influence or joint control over, the entity
 - Is an associate of the entity
 - Is a joint venture in which the entity is a venturer
 - Is a member of the key management personnel of the entity or its parent
 - Is a close member of the family of any of the aforementioned key management personnel
 - Is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, any of the key management personnel or their close family members
 - Is a post-employment benefit plan for the benefit of employees of the entity, or of any of its related parties

Disclosure requirements of RPT (IAS 24)

- Nature of relationships between parents and subsidiaries, even if there were no transactions
- Name of the entity's parent and, if different, the ultimate controlling party
- Compensation of key management personnel
- For transactions between related parties
 - The nature of the relationship and info. About the transactions and outstanding balances
 - Separate reporting categories: the parent, entities with joint control or significant influences over the entity, subsidiaries, associates, joint ventures in which the entity is a venturer, key management personnel, and other related parties

Disclosure requirements of RPT

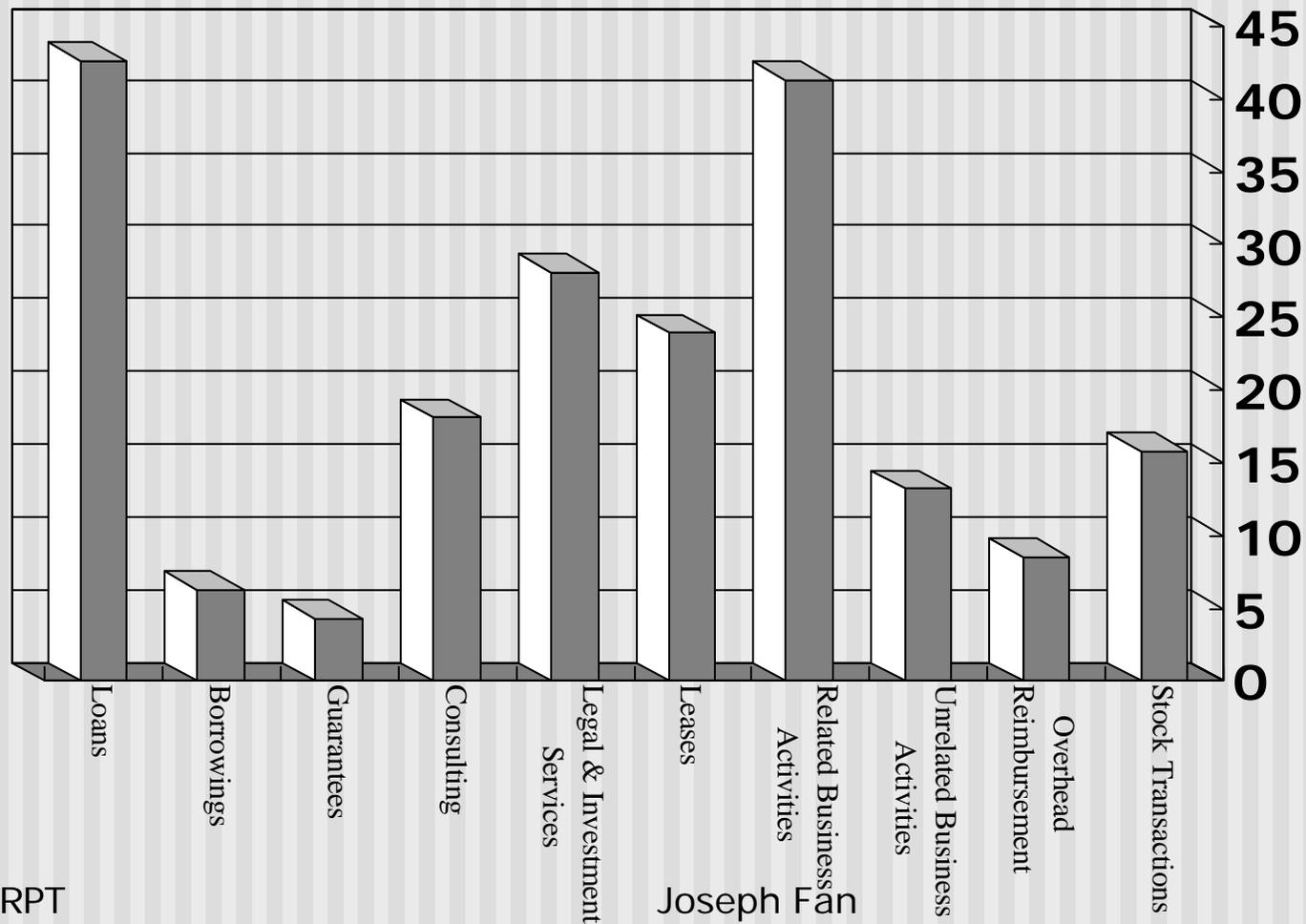
- Typically disclose material RPT in footnotes of corporate reports
 - Types and elements
 - Volume, amount
 - Pricing policy
- Transactions eliminated on consolidation are often exempted
- Although various Asian economies require detailed disclosure, in practice such disclosure is limited

Types of Related Party Transactions

- Loans/borrowings/guarantees
- Investment, M&As
- Purchases/sales
- Consulting
- Intercorporate dividends
- Executive/director compensation

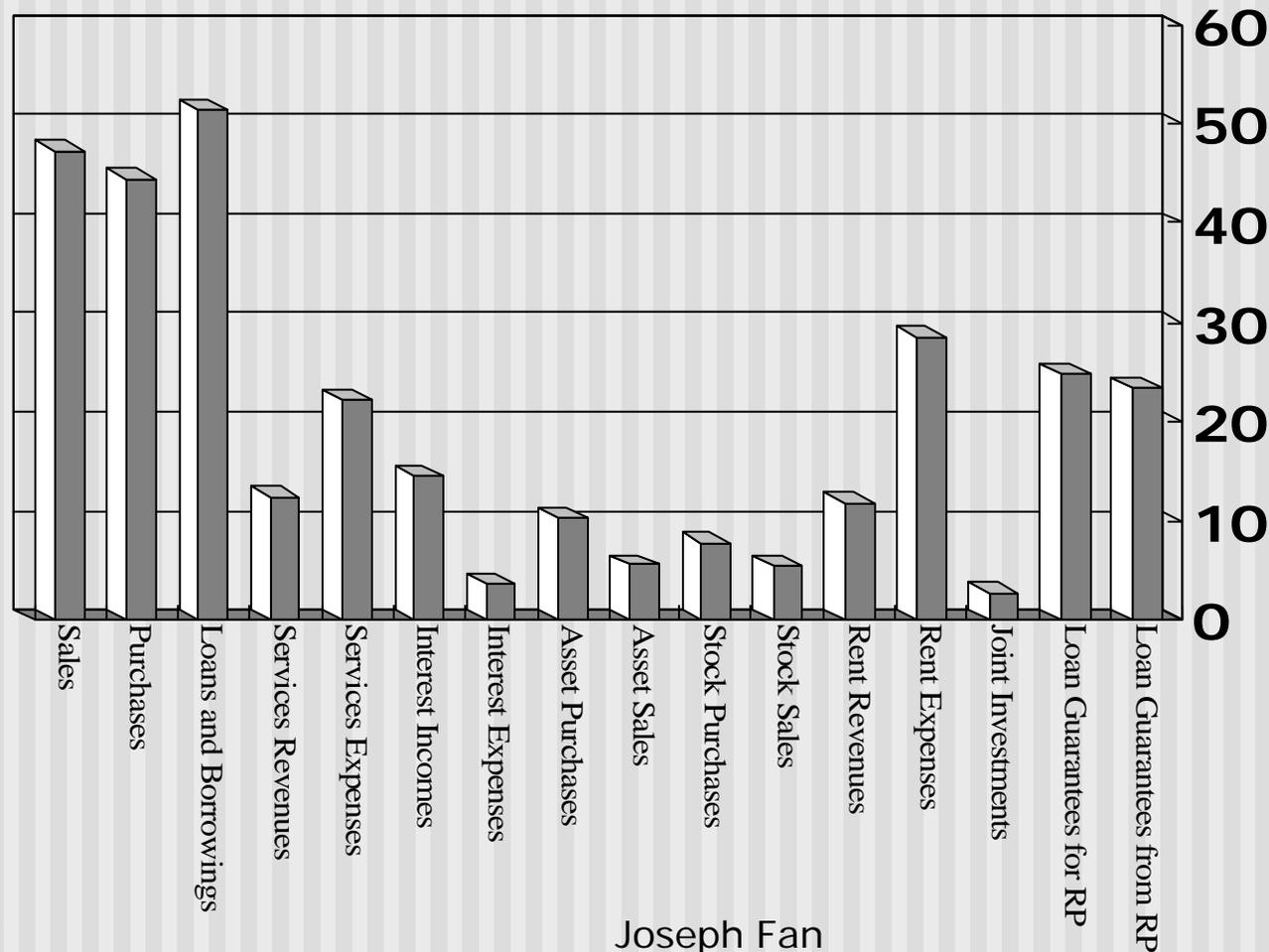
Types of Reported Related Party Transactions in U.S.

(S&P1500 firms, 2001, Kohlbeck and Mayhew, 2004)



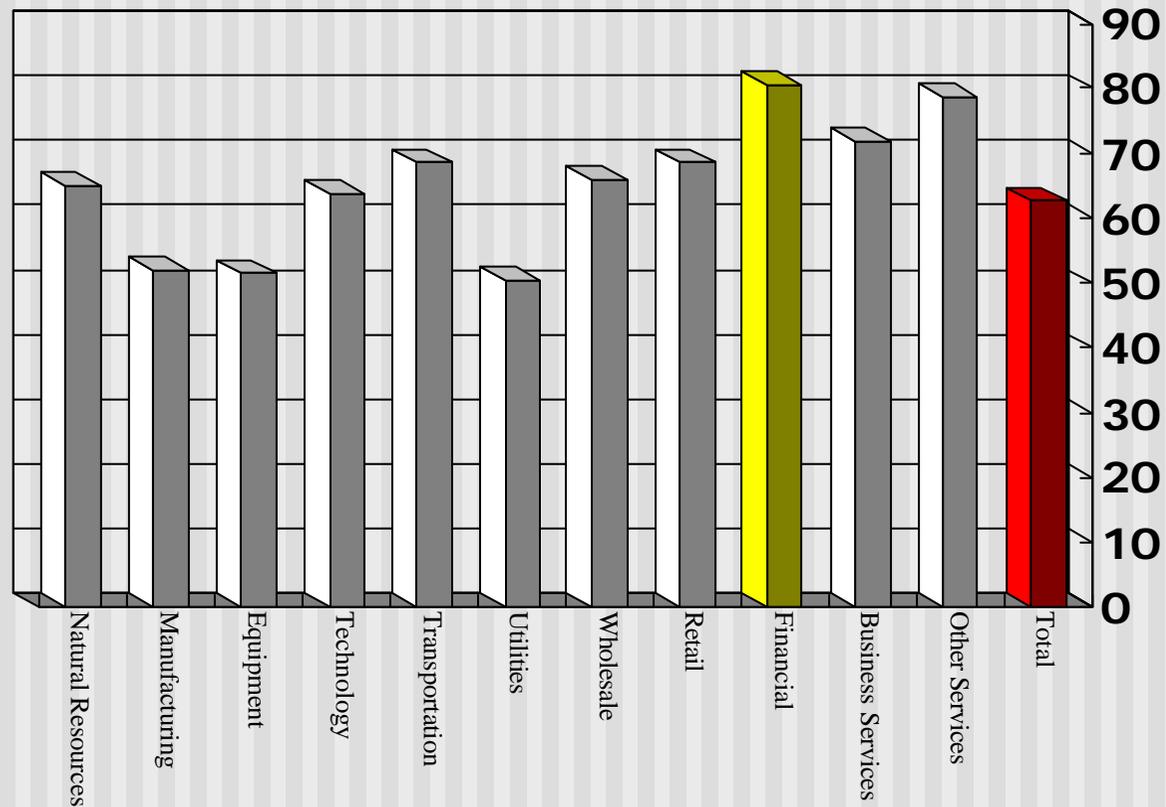
Types of Reported Related Party Transactions in China

(1200 listed firms in China 1998-2002, Jian and Wong, 2006)



Extents of Reported Related Party Transactions by Industry

(S&P1500 firms, 2001, Kohlbeck and Mayhew, 2004)



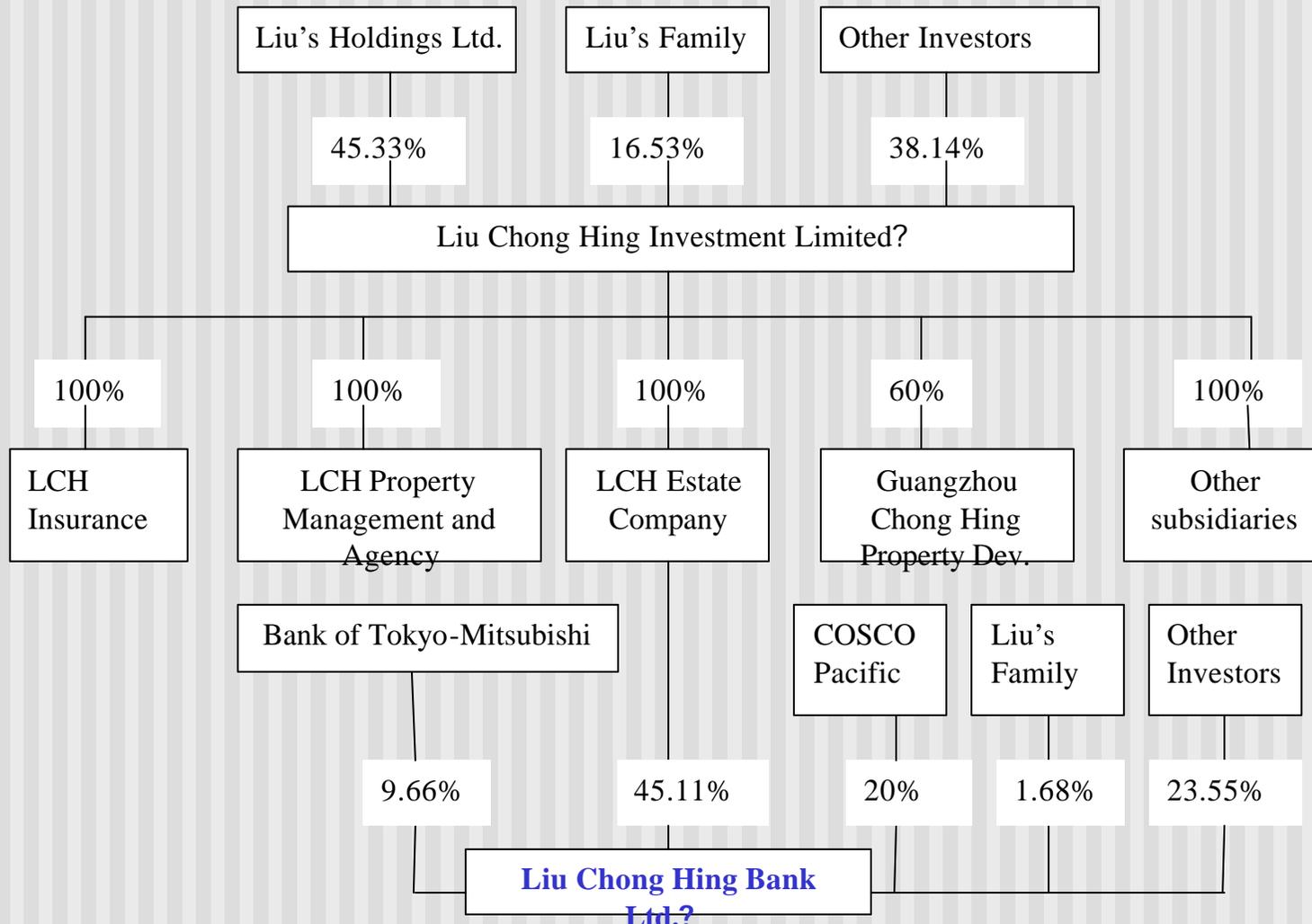
Which RPT are problematic?

- Transactions that transfer out cash or assets from an entity without immediate or future reciprocal compensation of cash or assets at fair prices
- It is often difficult to determine whether an RPT is problematic or not
 - Difficulty of establishing a fair price
 - due to lack of a liquid market, or
 - during a period of high uncertainty
 - Relationship based transactions
 - Discrepancy in the time and/or form of payment
- Accounting disclosure has limitation in dealing with RPT

Factors conducive to problematic RPT

- Separation of ownership and control in complex organizations
 - Intra-group dealings, insider dealings
- Powerful/entrenched stakeholders
 - Unionized labor
 - State and political influence
 - Transaction made under the influence of a politician/bureaucrat or his allies (supporters, family members, colleagues, friends, bribers)
 - More common among state owned enterprises/banks
- More fundamentally weak institutions
- In the following, we separately examine RPT issues of family and state banks

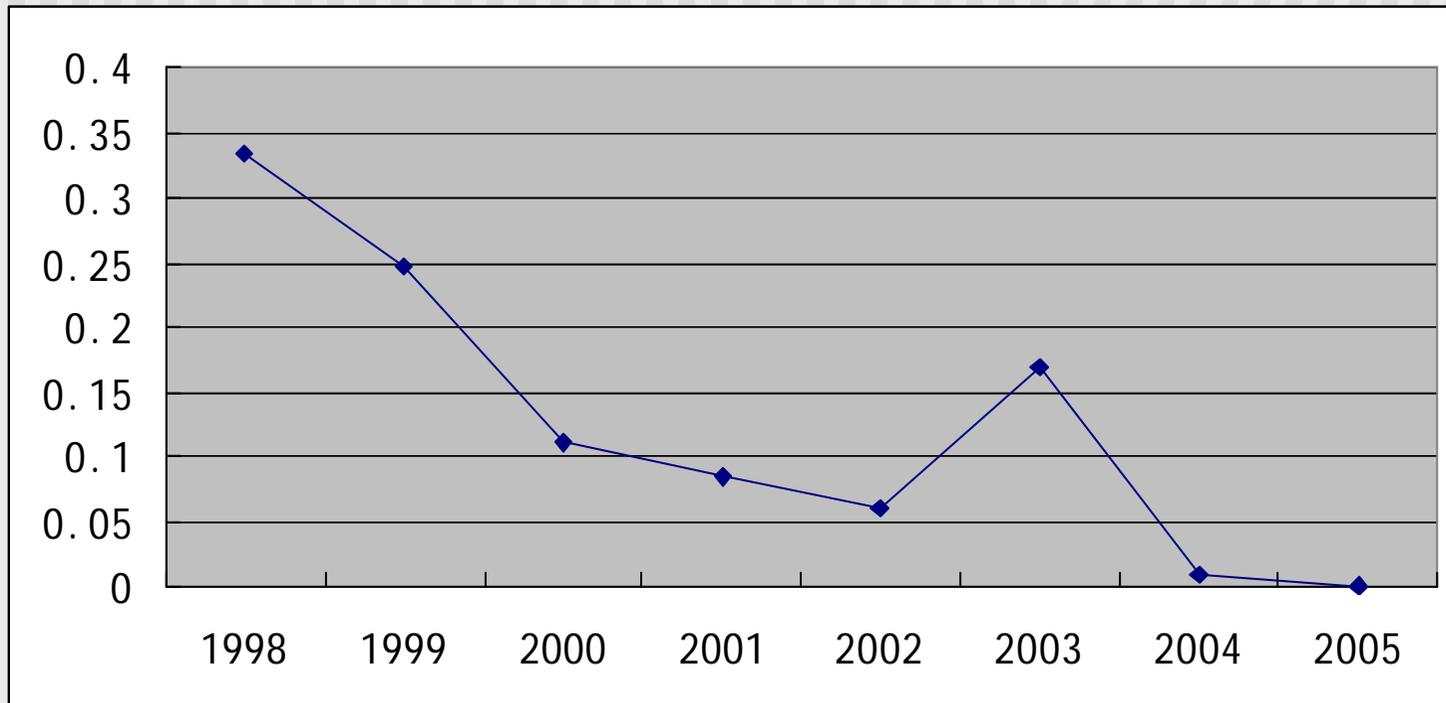
Separation of Ownership and Control of Bank in Family Group – LCH Group and Liu Chong Hing Bank (HK)



Separation of Ownership and Control of Bank in Family Group – LCH Group and Liu Chong Hing Bank (HK)

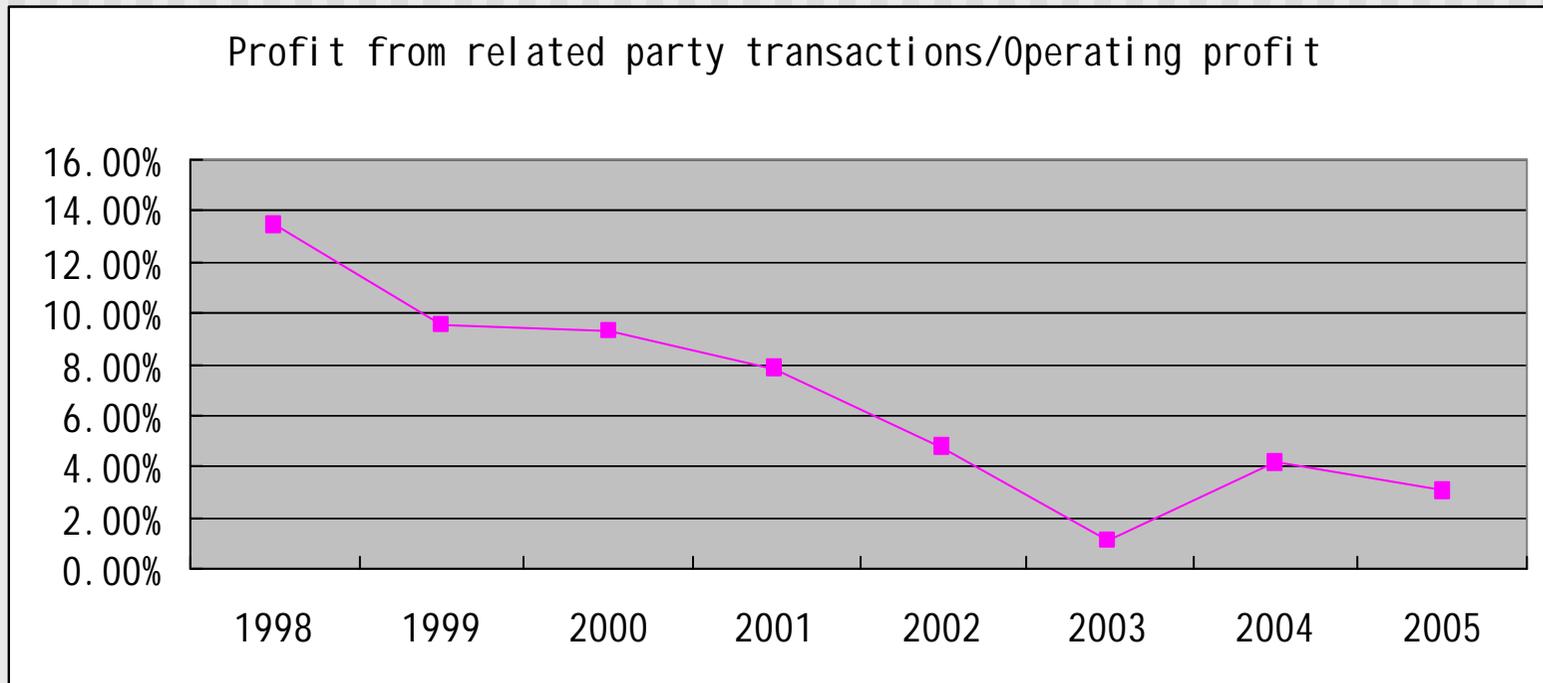
- Liu family is the largest shareholder of LCH Bank
- The family has at least 45% of voting rights of the Bank, while its ownership of the Bank is only 28% $((45.33\% + 16.53\%) * 100\% * 45.11\%)$
- Potential conflict of interest
 - A decision maker benefits from a transaction but does not bear the full cost of his/her decision
 - For every dollar taken away from the Bank, the family lost only 28 cent
- Significant RPT between the Bank and its affiliates during and shortly after the Asian Financial Crisis, but RPT declined substantially more recently

The Group borrows less from the Bank



Interest expenses paid to associates/total interest expenses to bank loans
(LCHI)

A decreasing trend in LCH Bank's profit from RPT



Data resources: annual reports of Liu Chong Hing Bank (1111)

Why fewer RPT?

- New laws or stronger enforcement?
Unlikely
- Most likely due to the Bank's strategy change
 - Expanding into arm's length businesses rather than depending on the family group
 - More professional, less family-influence
 - Chong Hing Bank--Erasing the family surname from the name of the Bank in the new headquarters building

Controlling Problematic RPT in Family Controlled Banks

- Family may have conflicts of interest with minority shareholders and/or depositors
- Reputation concern is typically sufficient to mitigate these conflicts during normal time
- But during turbulent time, such as a deregulating market or a large negative profit shock, reputation and self-governance alone might not be sufficient to contain conflicts of interest of desperate controlling owners

Controlling Problematic RPT in Family Controlled Banks

- Mechanisms that separate the banking and non-banking businesses (such as real estate investment)
 - Simplifying and disclosing organizational/ownership structure
 - Independent board committee that monitor material RPT
 - Board (independent of owners, managers, and bureaucrats) that monitor material RPT
 - Material RPT subject to regulatory approval during turbulent times
- Liberalizing the banking market to allow competition
 - Let the market monitor the banks and the regulator monitor the market

RPT in state owned banks are more serious problems

- Practically, state banks and SOEs are related parties, transactions between them are therefore always RPT
- Politicians and their allies have incentives to intervene state banks' lending decisions
 - Social welfare, votes, corruption
- Internal monitoring is typically weak – other people's money
- Regulators often fail to monitor problematic RPT of SOB, because of obvious conflicts of interest
- Need an enforcement system independent of political influences, but this is hard to come by

A case in point – China Construction Bank

- CCB is one of four wholly government controlled specialized banks before 2004
- China's third-largest lender, focusing on lending to infrastructure investment projects
- *The Banker* magazine ranked CCB the 35th largest bank in the world based on total assets as of 2004
- Since 2003, went through a series of restructurings: recapitalization, disposal and write-off non-performing loans, issuances of subordinate bonds, etc.
- 2004.9, became joint-stock commercial bank
- 2005.10, listed in Hong Kong exchange, from a wholly state to a state-controlled public bank

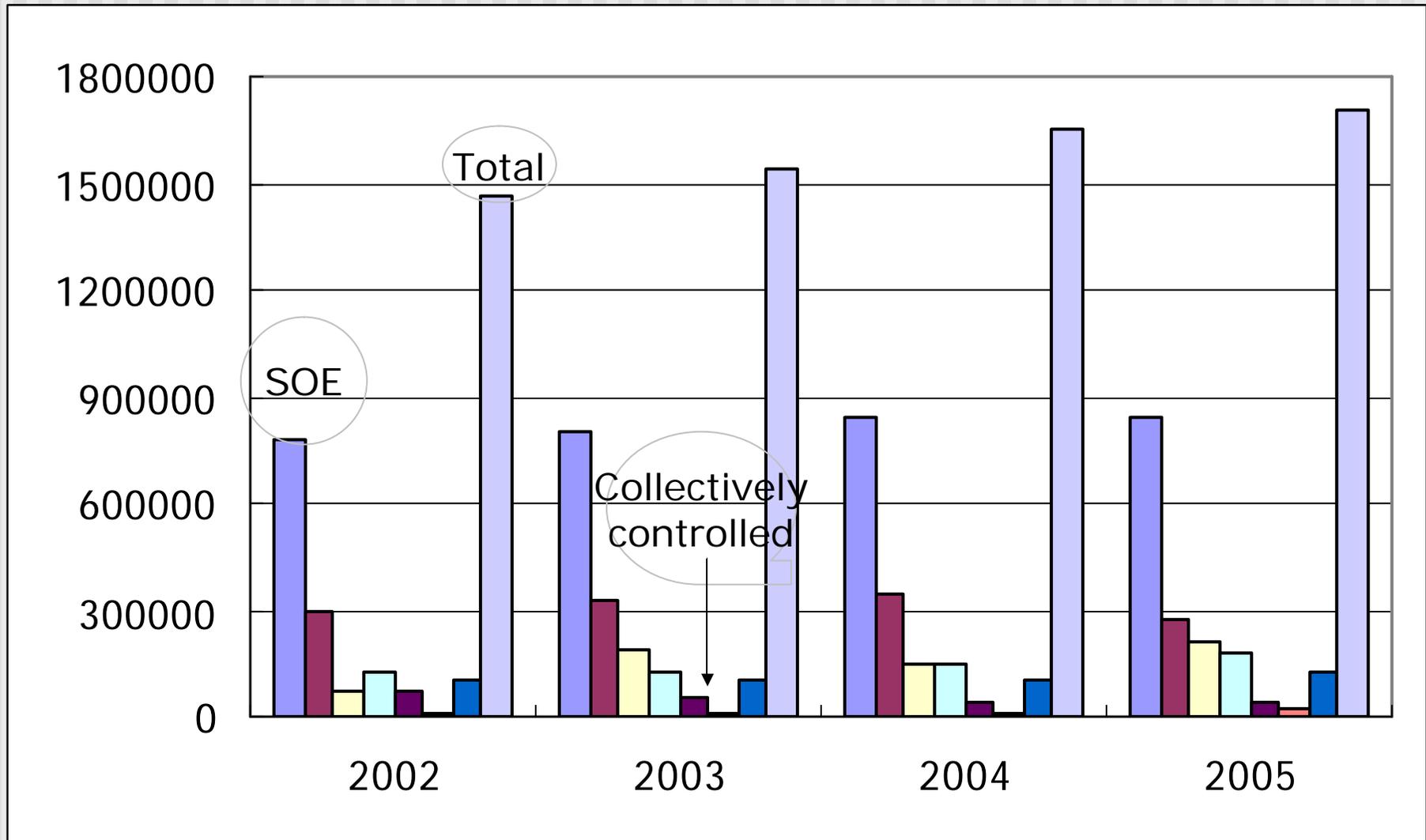
As December, 2004

	Branch	Total Assets (Billion RMB)		Deposit (Billion RMB)		Loans (Billion RMB)	
		Amount	% of total	Amount	% of total	Amount	% of total
Industrial and Commercial Bank of China	21223	5589.9	32.9%	5000	34.2%	3635.2	35.5%
Agriculture Bank of China	31004	4013.8	23.6%	3491.5	23.9%	2590.1	25.3%
China Construction Bank	14458	3904.8	23%	3489.4	23.9%	2225.6	21.7%
Bank of China	11307	3489.6	20.5%	2637.2	18%	1797.1	17.5%
Total	77992	16998.1	100%	14618.1	100%	10248.1	100%

Lending Bias toward Related Parties

- An important but ignored fact: state banks and SOEs are related parties
- CCB's has been offering most of its loans to SOEs
- By contrast, performance and growth of SOEs have been lagging behind the private sector
- Most of its impaired loans resulted from the bank's local branches' lending to local government controlled entities

Most loans go to SOEs



Output and investment growth of SOEs have been lagging behind the private sector

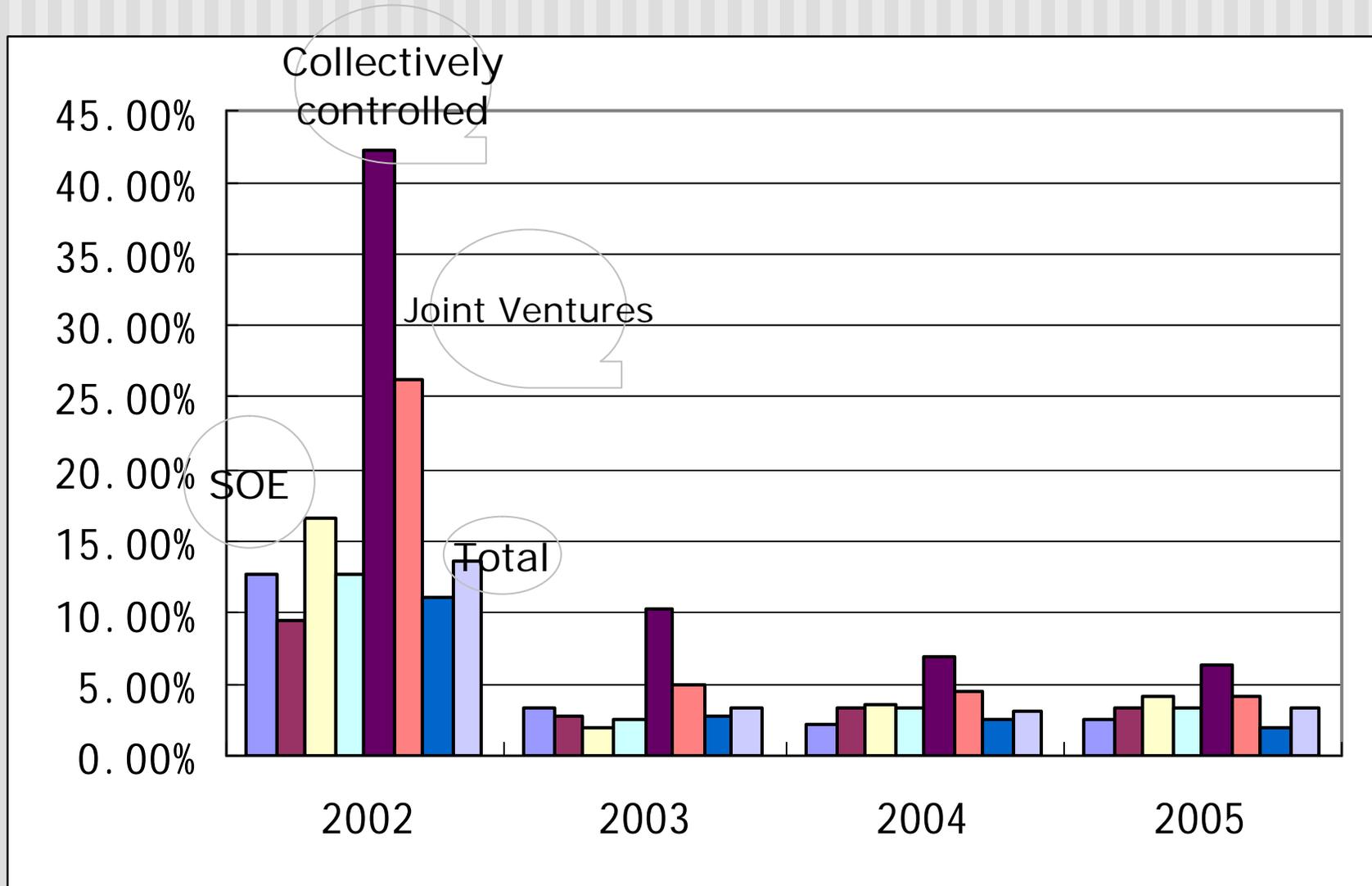
THE AVERAGE GROWTH RATE OF INVESTMENT IN FIXED ASSETS FOR THE TWO SECTORS.

Growth rate (%)	Panel A: industrial output		Panel B: investment in fixed assets	
	State & Listed sectors	Private Sector	State & Listed sectors	Private Sector*
1996	15.9	17.4	10.2	17.3
1997	-0.6	18.9	9.0	6.1
1998	-6.5	10.2	17.4	9.0
1999	5.8	6.8	3.8	7.5
2000	14.0	24.2	3.5	11.4
2001	4.6	9.9	6.7	12.6
2002	6.5	12.5	7.2	16.8
Ave. Annual rate (95-02)	5.4	14.3	8.2	11.5

Sources: China Statistic Yearbooks 2000-2003.

*Includes foreign-owned companies, companies owned by investors from Taiwan and Hong Kong, and

Most impaired loans resulted from lending to local government controlled entities



Two former chairmen and CEOs were caught in corruption scandals



Wang Xuebing

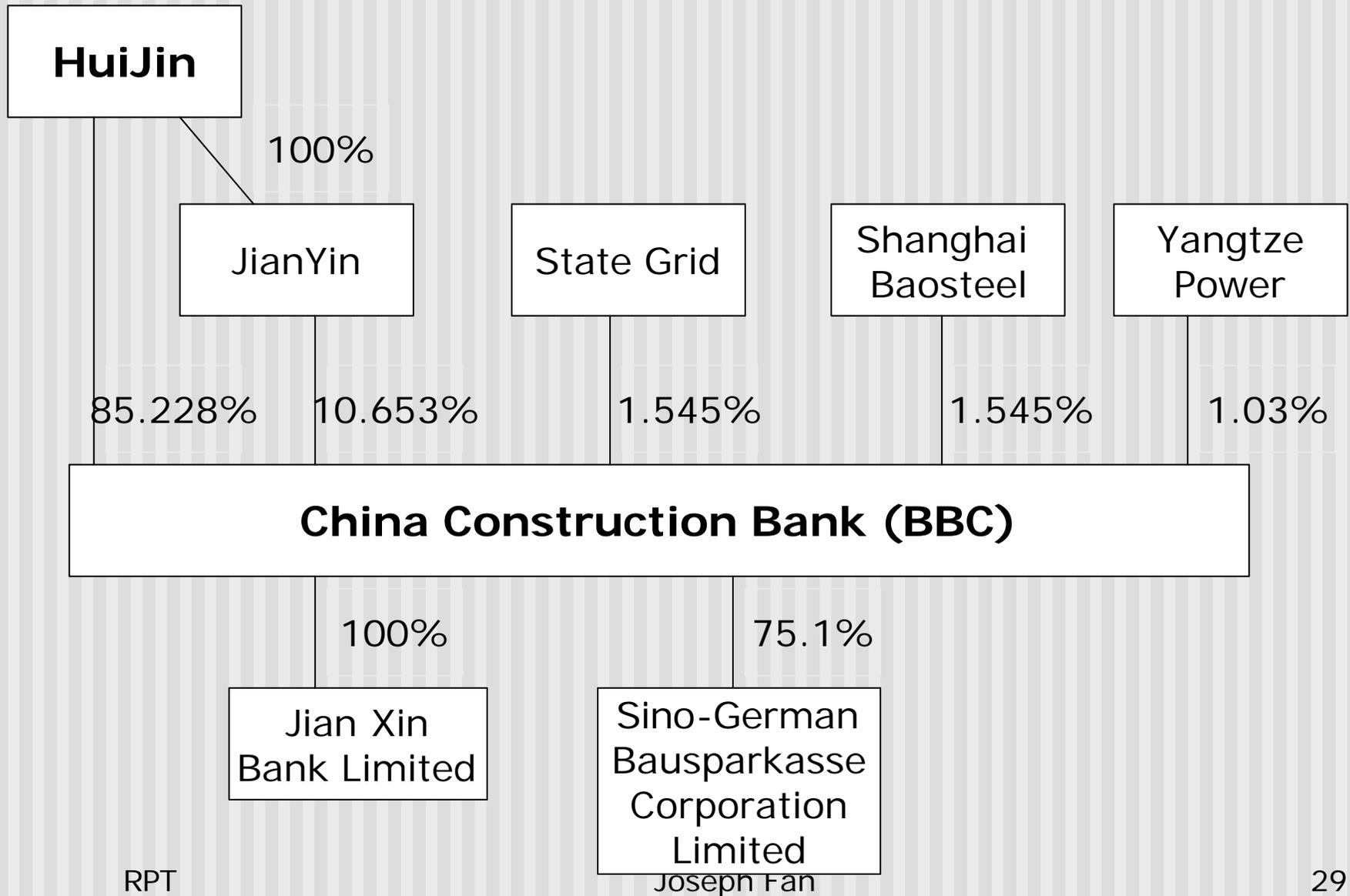


Zhang Enzhao

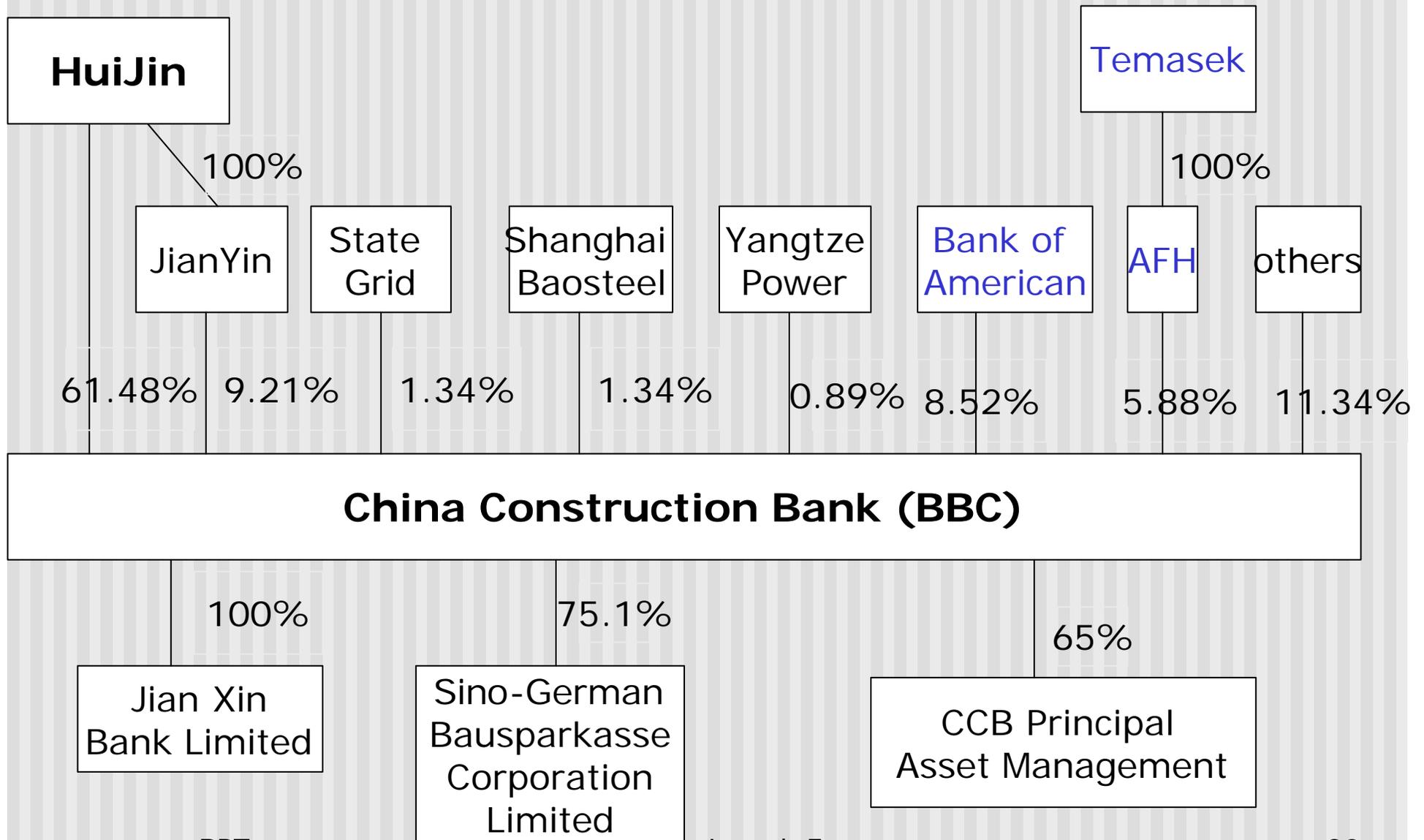
Can public listing mitigate unsound related party lendings?

- The challenges with CCB are representative of China's bank sector
- The government has been in process of listing its state banks, hoping problems will go away
- Not clear how it will work, in particular on lending bias toward related parties (SOEs)
- But let's look at how management and governance structures have changed

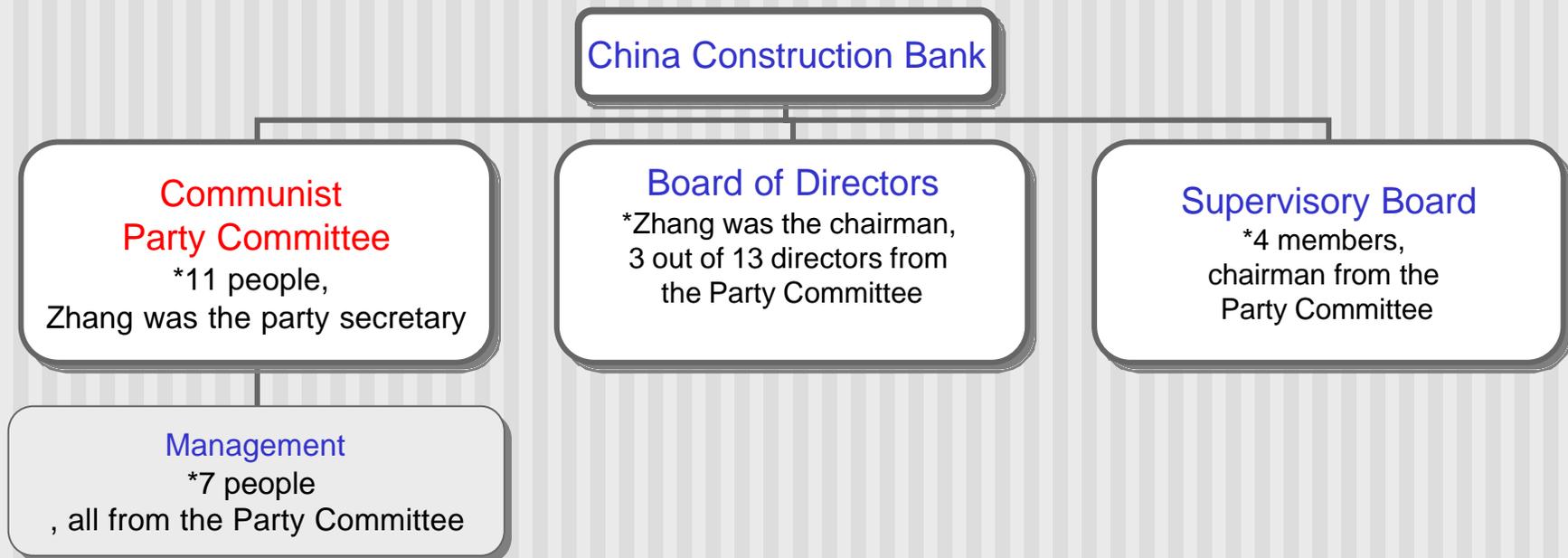
Ownership structure before IPO (as of 2004.12)



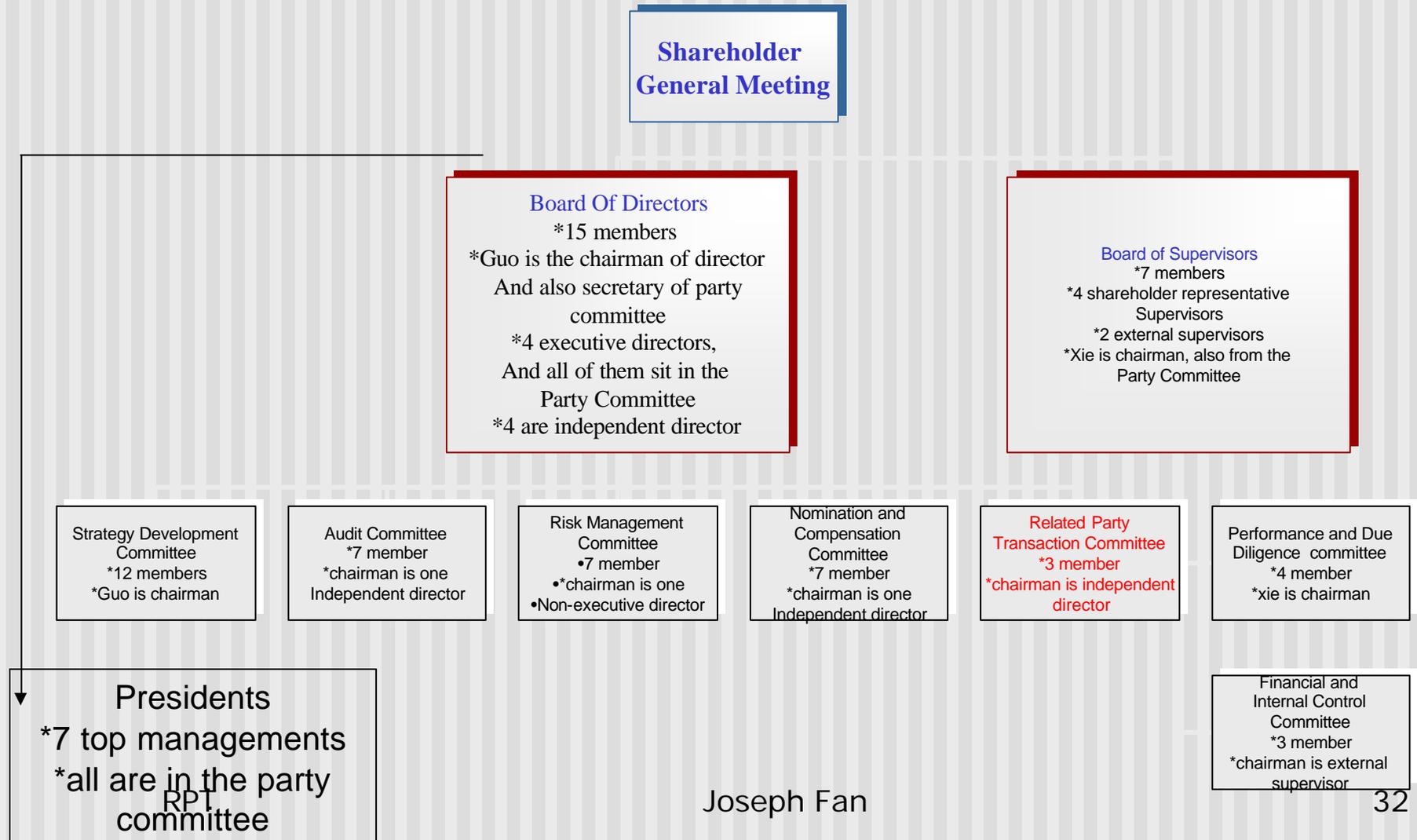
Ownership Structure on IPO (as of 2005.12)



Governance Structure of China Construction Bank before IPO (2004)



Governance Structure of China Construction Bank after IPO (2006)



Rent Seeking and Corporate Finance: Evidence from Corruption Cases

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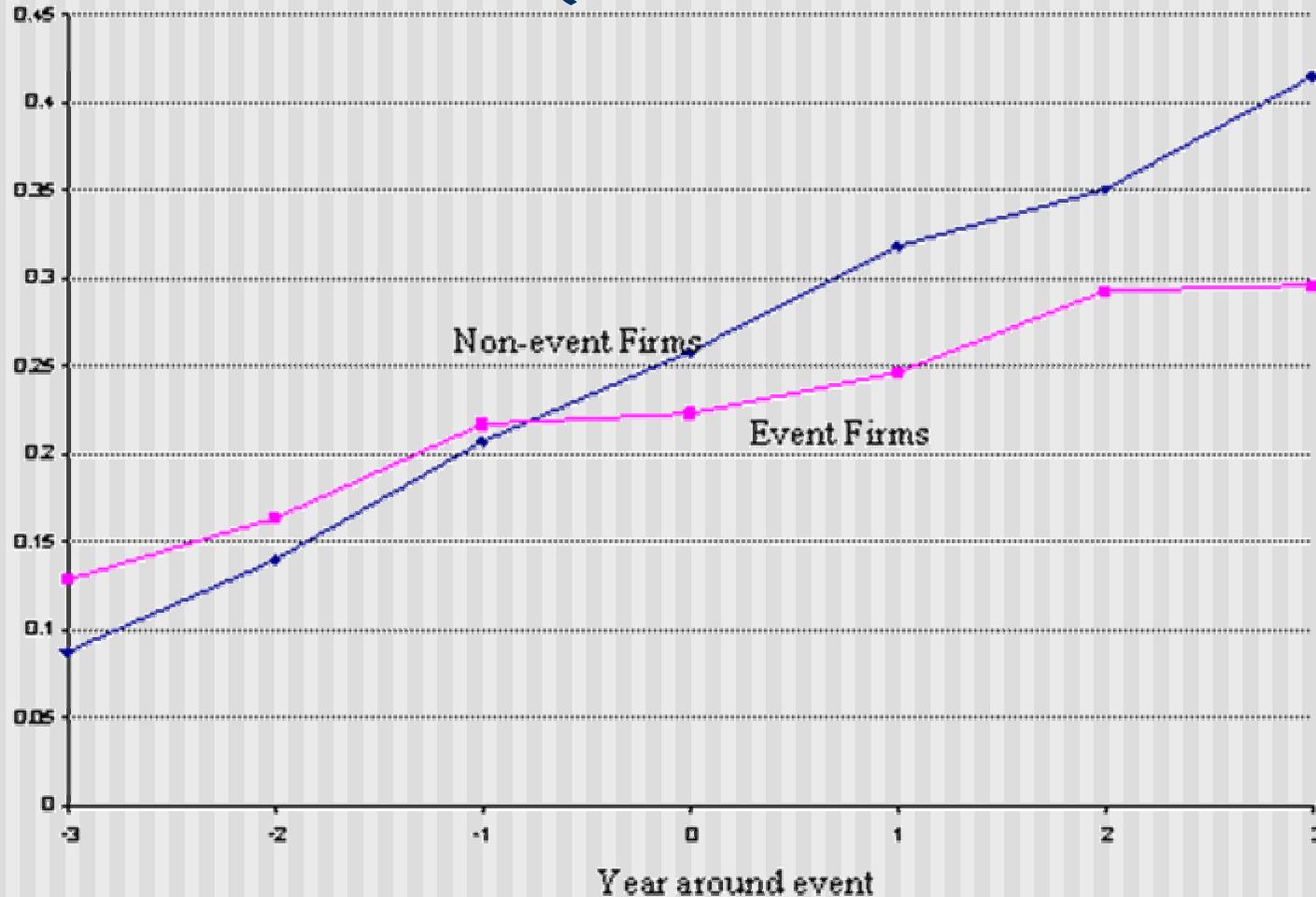
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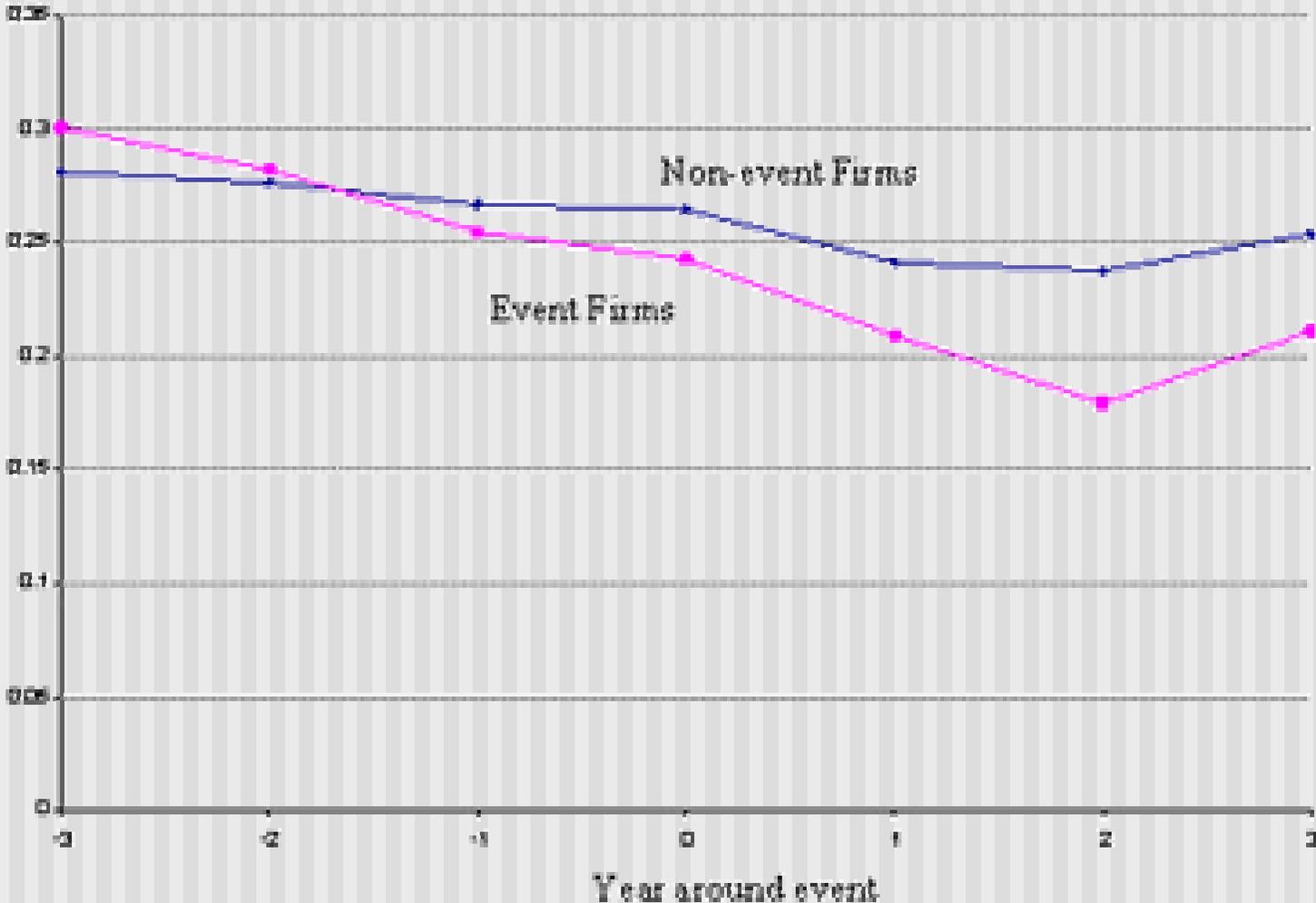
The Corruption List

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	27	1	2	24
Bank	Liu Jinbao	Vice-Chairman & CEO of Bank Of China (HK)	20030525	20050812	Suspended death penalty	5	5	0	0
Bank	Wang Xuebin	CEO of China Construction Bank	20020111	20031210	12 years of imprisonment	5	5	0	0
Beijing	Chen Xitong	CPC Secretary	19950426	19980731	16 years of imprisonment	11	5	3	3
Central	Li Daqiang	Vice-Province Governor	20000925	20000925	Dismissal from the service and CPC	2	2	0	0
Central	Xu Penghang	Vice chairman of national defense technology commission and national economics and trade commission	20001011	20001011	Dismissal from the service	1	1	0	0
Fujian	Shi Zhaobin	Vice-CPC Secretary	19990818	20010927	Dismissal from the service and CPC	34	5	3	26
Guangxi	Xu Binsong	Vice-Chairman of Municipality	19980523	19990827	Life imprisonment	6	0	1	5
Guangxi	Chen Kejie	Chairman of Municipality	20000111	20000731	Death penalty	10	2	1	7
Guangxi	Liu Zhibin	Vice-Chairman of Municipality	20000319	20020624	15 years of imprisonment	10	2	2	6
Guangxi	Wang Qinglu	Vice-Chairman of PPCC	20010222	20010222	Dismissal from the service and CPC	13	0	1	12
Guizhou	Liu Changgui	Vice-Province Governor	20030417	20040430	11 years of imprisonment	12	1	3	8
Guizhou	Liu Fangren	CPC Secretary & PC Chairman	20030422	20040629	Life imprisonment	12	1	1	10
Hainan	Xin Yejiang	Vice-PC Chairman	19961227	19980526	5 years of imprisonment	10	2	0	8
Hebei	Jiang Dianwu	Vice-PC Chairman	19971101	19981207	10 years of imprisonment	13	0	0	13
Hebei	Chen Weigao	CPC Secretary & PC Chairman	20000301	20030809	Dismissal from CPC	25	1	3	21
Hebei	Cong Fukui	Vice-Province Governor	20000627	20010518	Dismissal from the service and CPC	24	0	2	22
Hubei	Meng QingPing	Vice-Province Governor	19980410	19991201	10 years of imprisonment	33	1	4	28
Jiangxi	Hu Changqing	Vice-Province Governor	19990808	20000215	Death penalty	12	0	2	10
Liaoning	Mu TuoXing	Vice-Province Governor	20010321	20011113	Death penalty	51	5	6	40
Xingjiang	Aman.Haji	Vice-Province Governor	20031015	N/A	N/A (Still under investigation)	25	1	1	23
Yunnan	Li Jiating	Vice CPC Secretary & Province Governor	20010620	20030509	Death penalty	17	1	4	12
Zhejiang	Xu Yunhong	Vice-Province Governor	19990922	20001017	10 years of imprisonment	35	2	3	30
Total						393	43	42	308

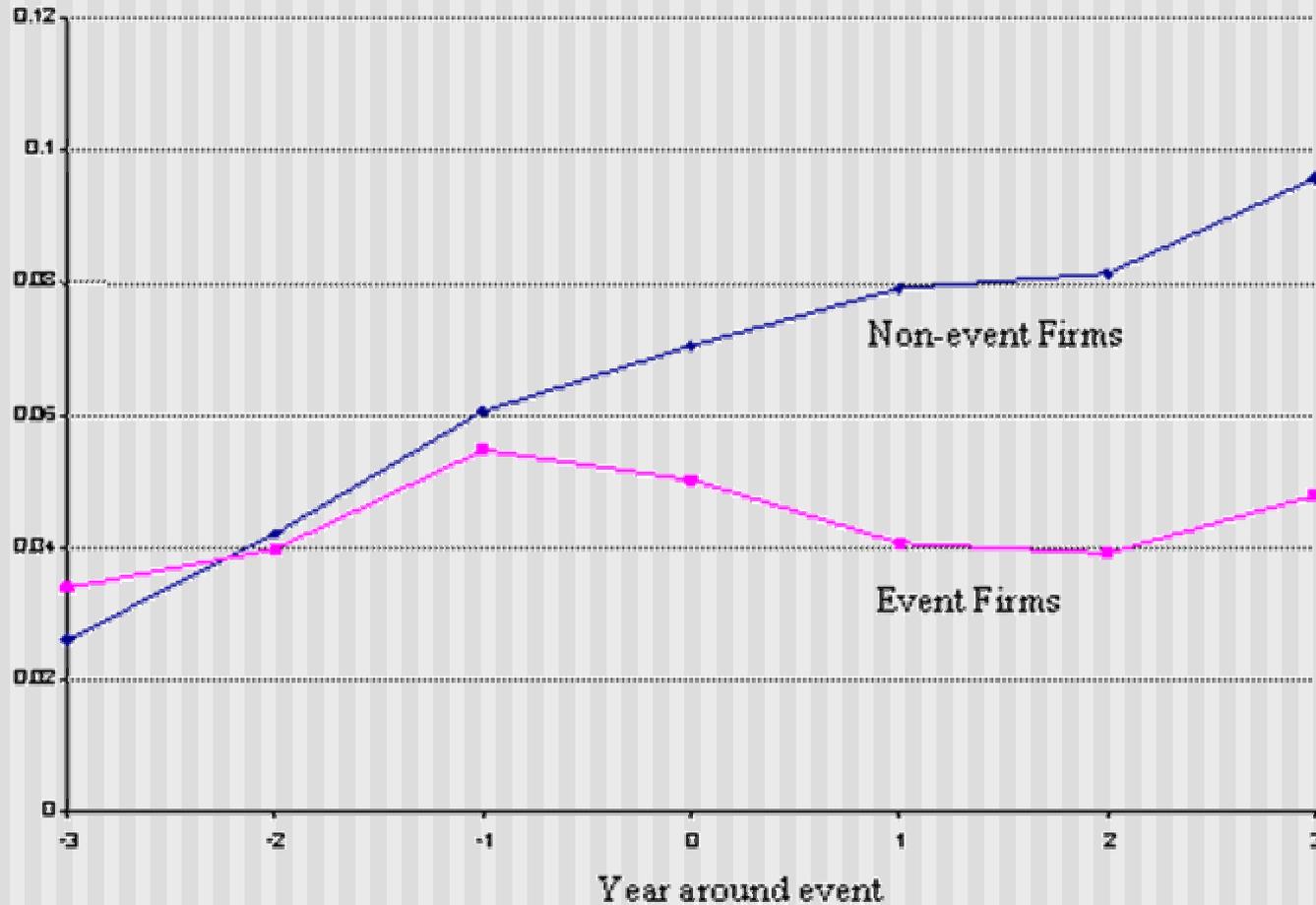
Borrowing Pattern of Listed Companies Connected with Corrupt Bureaucrats /bank officers (Mean Total Debt/Assets)



Debt Maturity Pattern of Listed Companies Connected with Corrupt Bureaucrats/Bank Officers (Mean Long Term Debt/Total Debt)



Long-term Borrowing Pattern of Listed Companies Connected with Corrupt Bureaucrats /Bank Officers (Mean Long Term Debt/Assets)

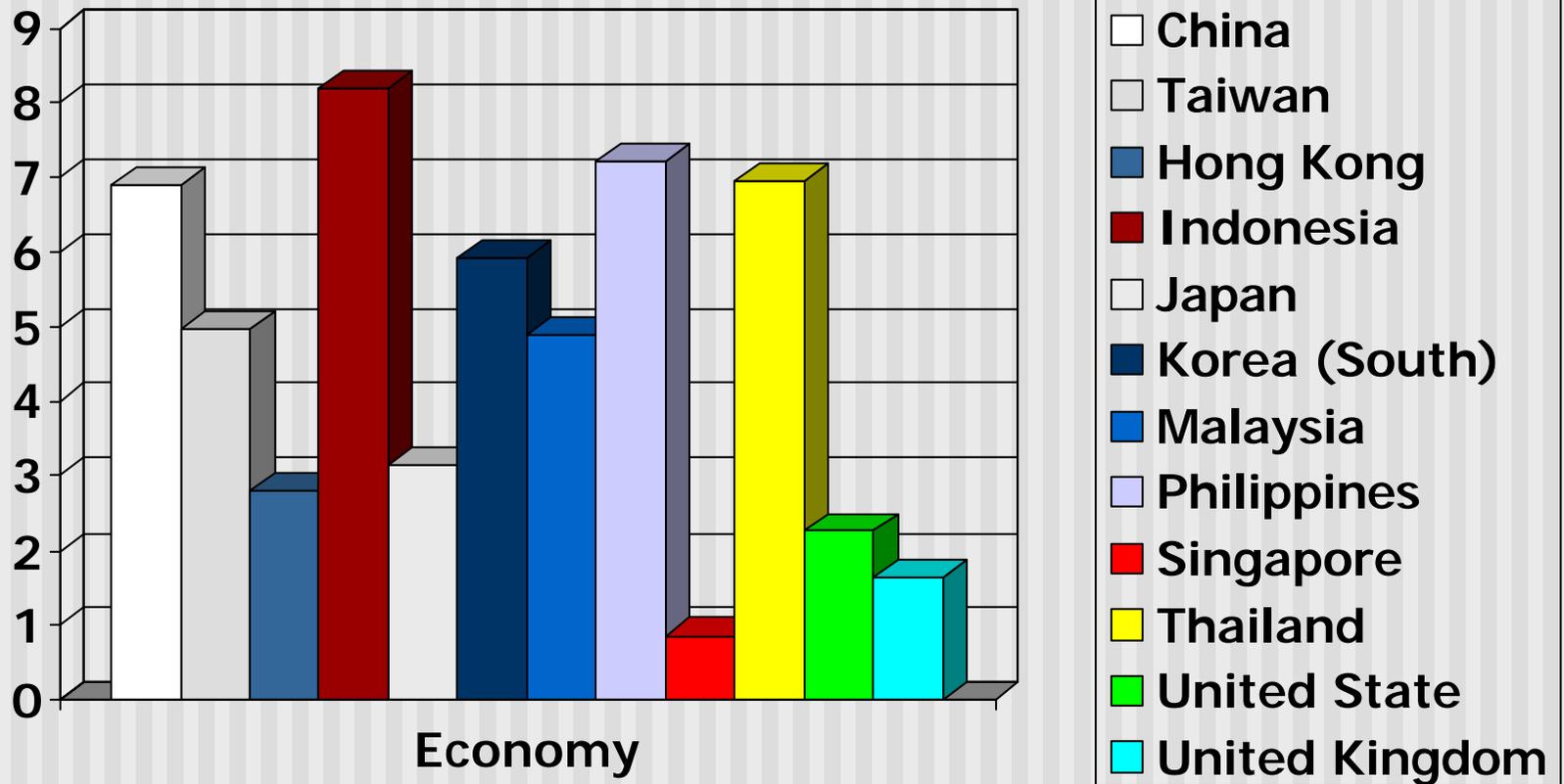


What do we find?

- An unhealthy trend of corporate finance
 - Increasing trend of corporate debt load, but decreasing trend of debt maturity
- Corrupt companies and/or companies connected with corrupt bureaucrats gain access to bank loans
- Does corruption grease the wheel of commerce?
 - NO. We find little evidence suggesting that rent seeking facilitates capital allocation in China
- Is corruption and crony lending unique to China?
 - On the contrary...

Corruption in Asian Economies

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



What do we push for?

- Not just about catching scandals
 - But, fundamental institutional improvements, i.e., transparent, merit based rather than connection based capital allocations
- Taiwan could become a role model if its legal system and citizen properly deal with the first family's corruption scandals which involve government controlled banks and financial institutions

Controlling problematic RPT in State Owned Banks, what work?

- Firewall between politicians/bureaucrats and banks
 - Away from bank key personnel (top managers and directors) decisions
 - Improving transparency
- Removing SOB's policy burdens
 - There is little evidence that SOB promote economic development, but abundant evidence that SOB slows it down
- Freeing up restrictions of bank executive compensation
- Privatization
 - Ultimate solution. But be careful: several Asian economies are privatizing their SOB, generating immense incentive of self-dealings through RPT

Conclusions

- RPT in Asia are prevalent
- The good news is that problematic transactions in private banks have largely been contained during normal time.
- During turbulent time, more intense monitoring of RPT by regulators are needed
- Problematic RPT can be further mitigated by market liberalization and improving legal institutions
- State owned banks however post a challenge
 - Laws and regulations are not effective, because of conflicts of interest
 - We need institutional reforms that improve government quality and reduce corruption