



The 2005 Asian Roundtable on Corporate Governance
Task Force on Corporate Governance of Banks in Asia

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Session 1

Corporate Governance of Banks in Asia

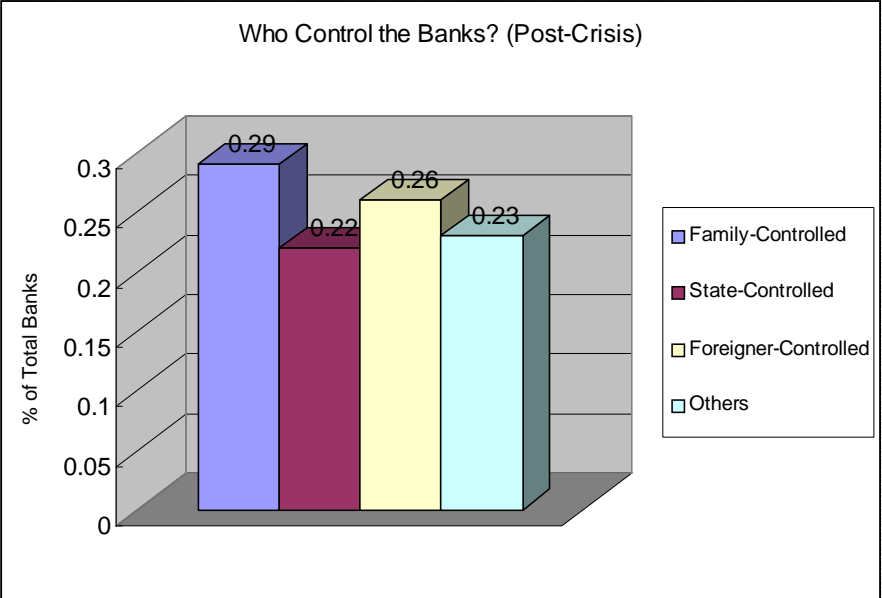
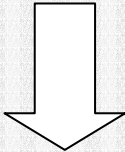
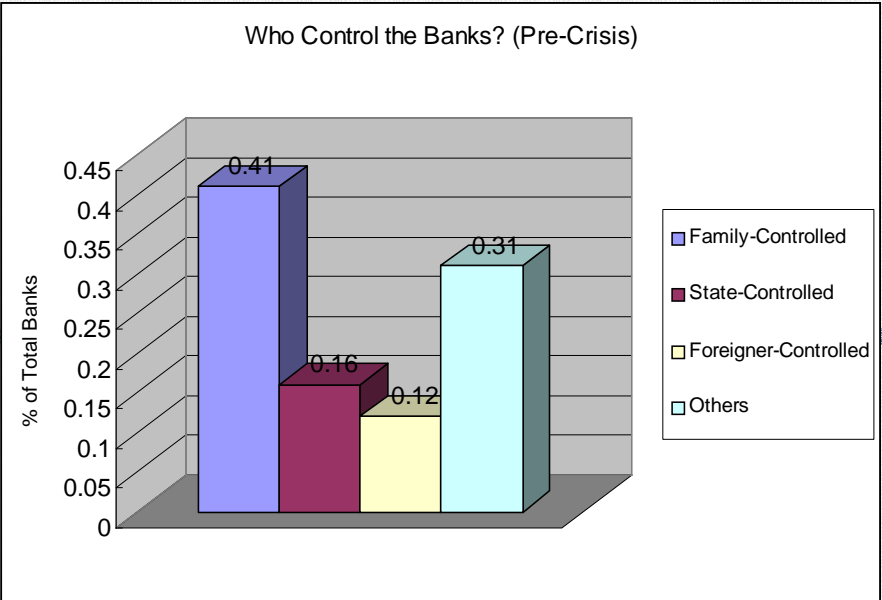
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Outline

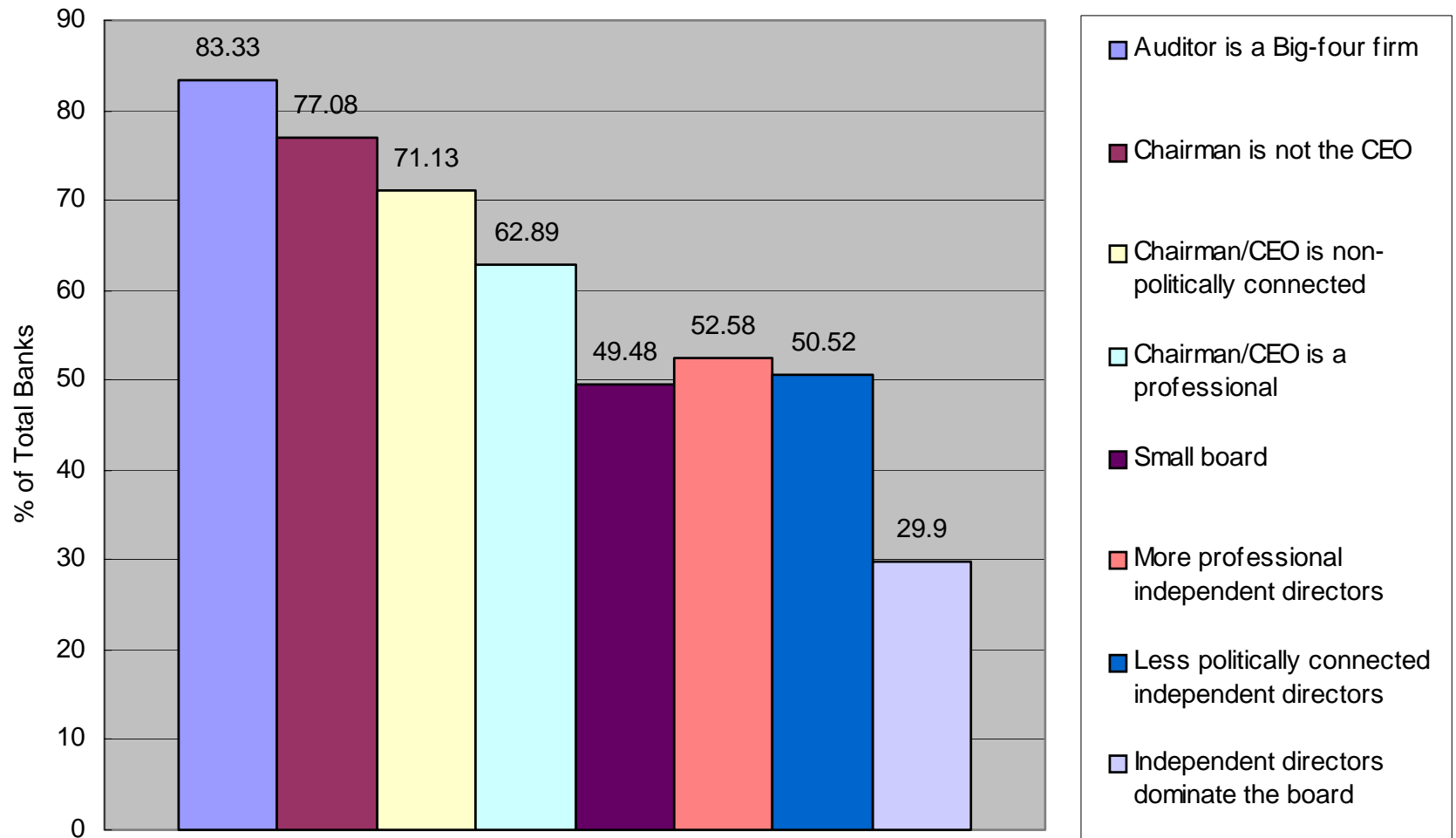
- The landscape of Asian bank ownership
- The governance traits of Asian banks
 - Family controlled banks
 - State controlled banks
- Public governance and bank governance
- Bank governance and corporate finance
- Conclusions



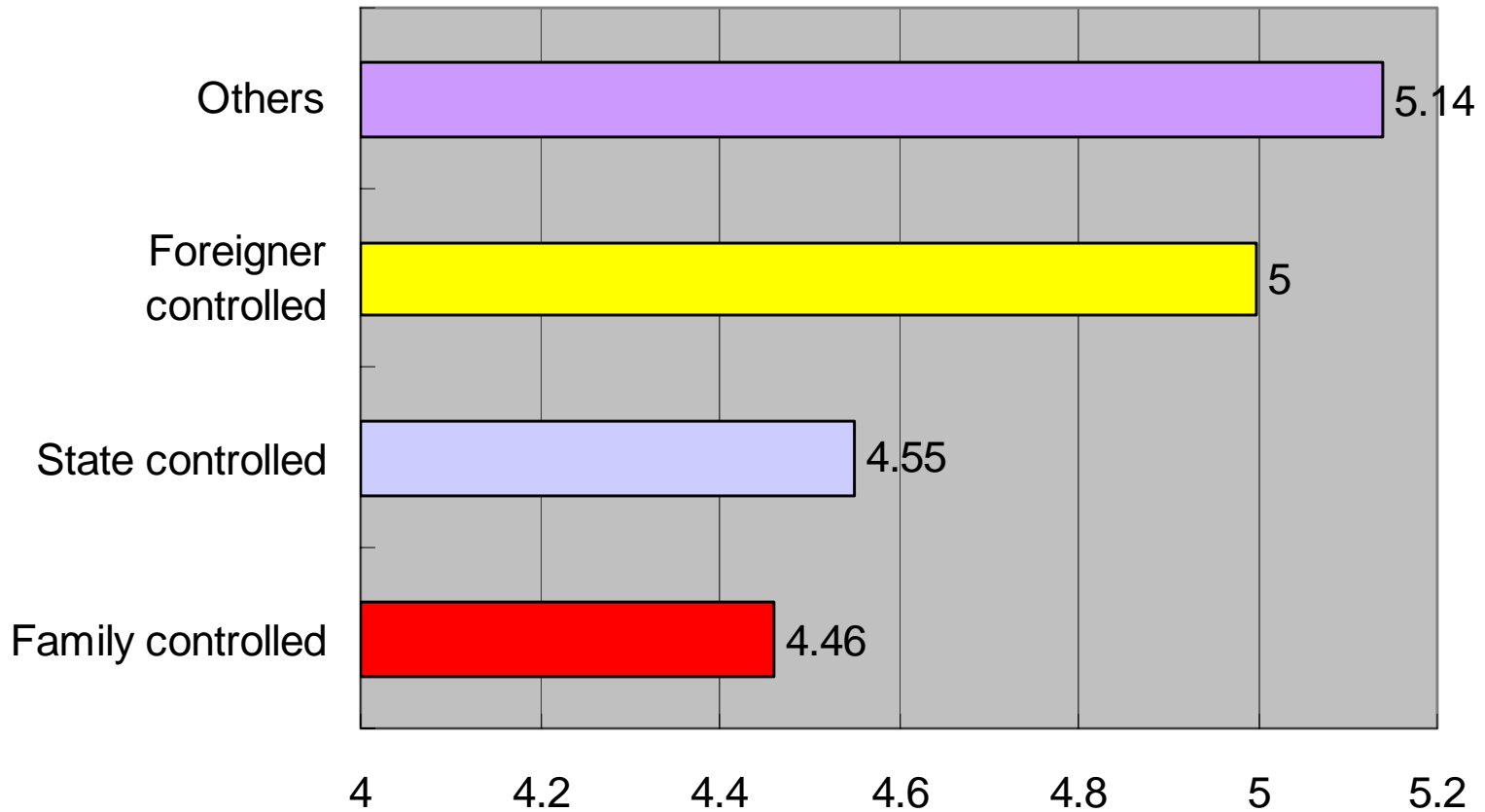
Corporate Governance characteristics of Asian Banks

- Below we report basic corporate governance characteristics of banks in 7 Asian economies (Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand)
- Be warned: a few other important factors that influence governance quality are not included
 - Reputation
 - Regulatory oversight of the industry (substitute or complement?)
 - Competition
 - Takeovers and product market competition

Governance Characteristic (Pooled Samples)



Governance Score (By Ownership Type)



Bank Ownership and Governance Characteristics

- The banks' corporate governance characteristics are in line with their ownership and control structures
 - Diffusely owned banks and foreigner controlled banks adopt outside investor friendly governance structures:
 - more independent boards,
 - smaller boards,
 - fewer politicians on boards,
 - more separating function between chairman and CEO
 - More professional bank leadership
 - The reverse is true for state or family controlled banks

Bank Ownership and Governance Characteristics

- Banks with different types of ownership and control structures are likely to have different business and financing models:
 - Family and state banks – more relationship based banking and less dependent on equity financing
 - Foreigner controlled and widely-held banks – more arm's-length banking and more dependent on outside capital
- Because of the differences in business and financing models between the two classes of banks, the governance structures of the two types of banks are likely different

Bank Governance and Performance

- No strong evidence that Asian bank efficiency and performance is related to poor corporate governance
 - Assuming that the banks' governance structures are chosen to adapt to their business environments, the lack of relation is what we should find
- However, significant relations between bank performance and governance exist in a few sub-samples.
 - More analysis is needed to find out the explanations for the relations.

Bank Governance and Performance

- No strong evidence that Asian bank efficiency and performance is related to the corporate governance score
- Assuming that the banks' governance models are chosen to adapt to their business environments, the lack of relation is what we should find
- In the following, we discuss the governance models of Asian banks, focusing on family and state owned banks

Family Owned Banks

- Trait
 - Relationship based banking
 - Focusing on a region or a community
- Advantages
 - High incentive to maximize profit and manage risk
 - Strong social network and local knowledge

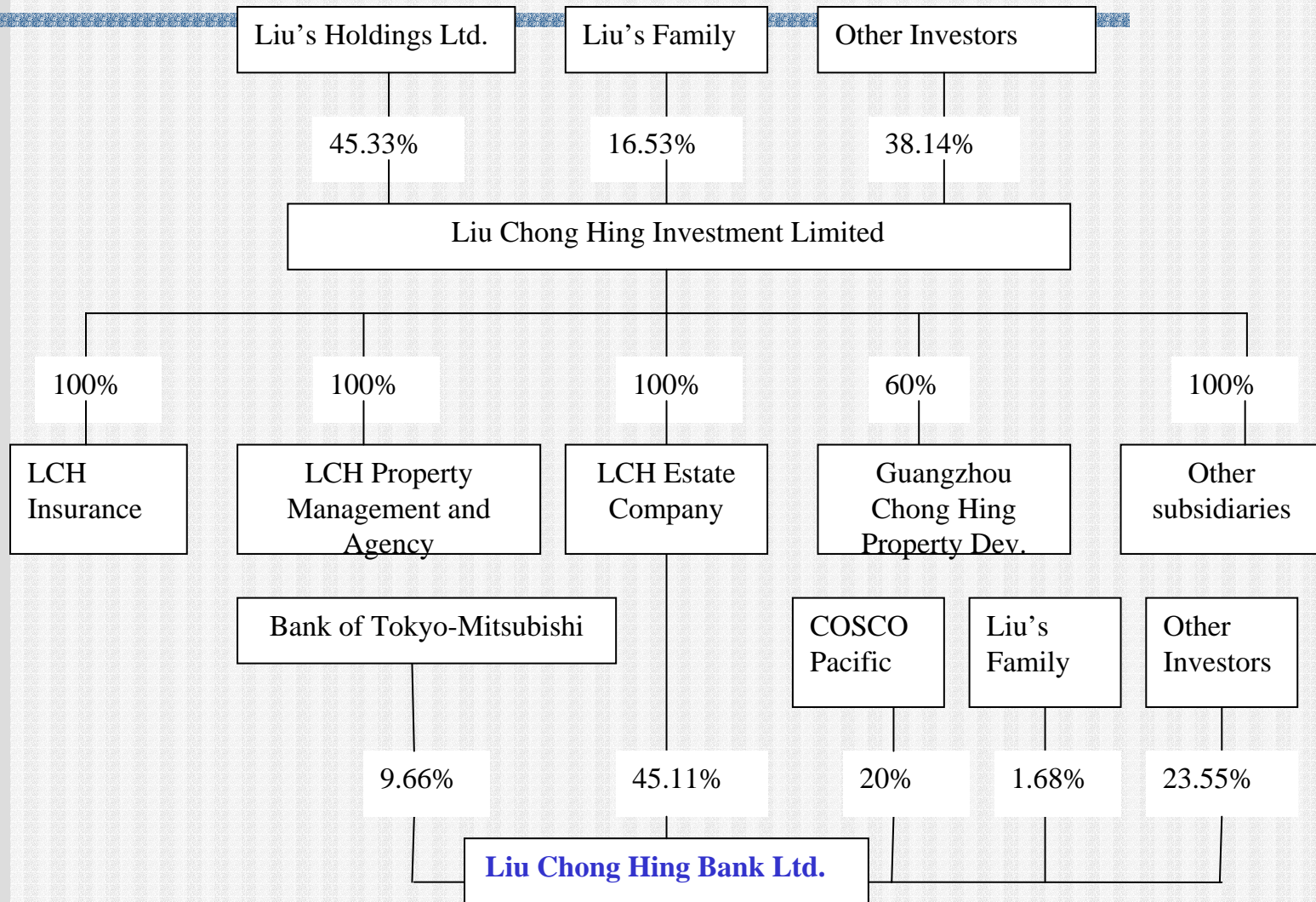
Governance Advantages of Family Owned Banks

- Strong internal governance (through **family codes** and **back-end loaded compensation** structure) and external governance of contractual relationships through family **reputation**, both provide **private enforcement** that is particularly important in weak legal environment where public enforcement is weak

Governance problems of family-owned banks

- Concentrated ownership exacerbate **financial leverage** and the associated agency problems with depositors, creditors, and minority shareholders
- Lower professionalism
- Uncertainty in family **succession**
- Intensive **related party transactions** associated with group and diversified business structures

A Case in Point: Liu Chong Hing Bank (HK)



A Case in Point: Liu Chong Hing Bank (HK)

- Most of the service of LCHB is provided for the group!
 - 88% of the revenue in banking segment is from internal-segment sales
 - 70% of the assets in banking segment are investments in associates.
- The bank has been performing quite well
- Note that related party lending is not limited to banks and certainly not family banks. It is generally popular among non-bank conglomerates

Family Owned Banks

- Related party transactions (loans and investment)
 - Normal as the business is relationship based
 - Side effect – can be abused by controlling owners
- How do family firms mitigate the conflict?
 - Family reputation
 - Reputation may not contain holdup problem in crisis or ownership transition (succession)
- What regulation is needed?
 - Not much as family firms have incentives to deal with most of the issues during normal time
 - **Firewall** between bank and other non-bank family businesses to prevent conflicts in abnormal situations

Government Owned Banks

- Trait
 - Multiple objectives, not just profit maximization
 - Bureaucratic, low efficiency
 - Corruption and bank scandals
- Advantage
 - Social interests (?)
 - Deep pocket

The governance issues of state owned banks

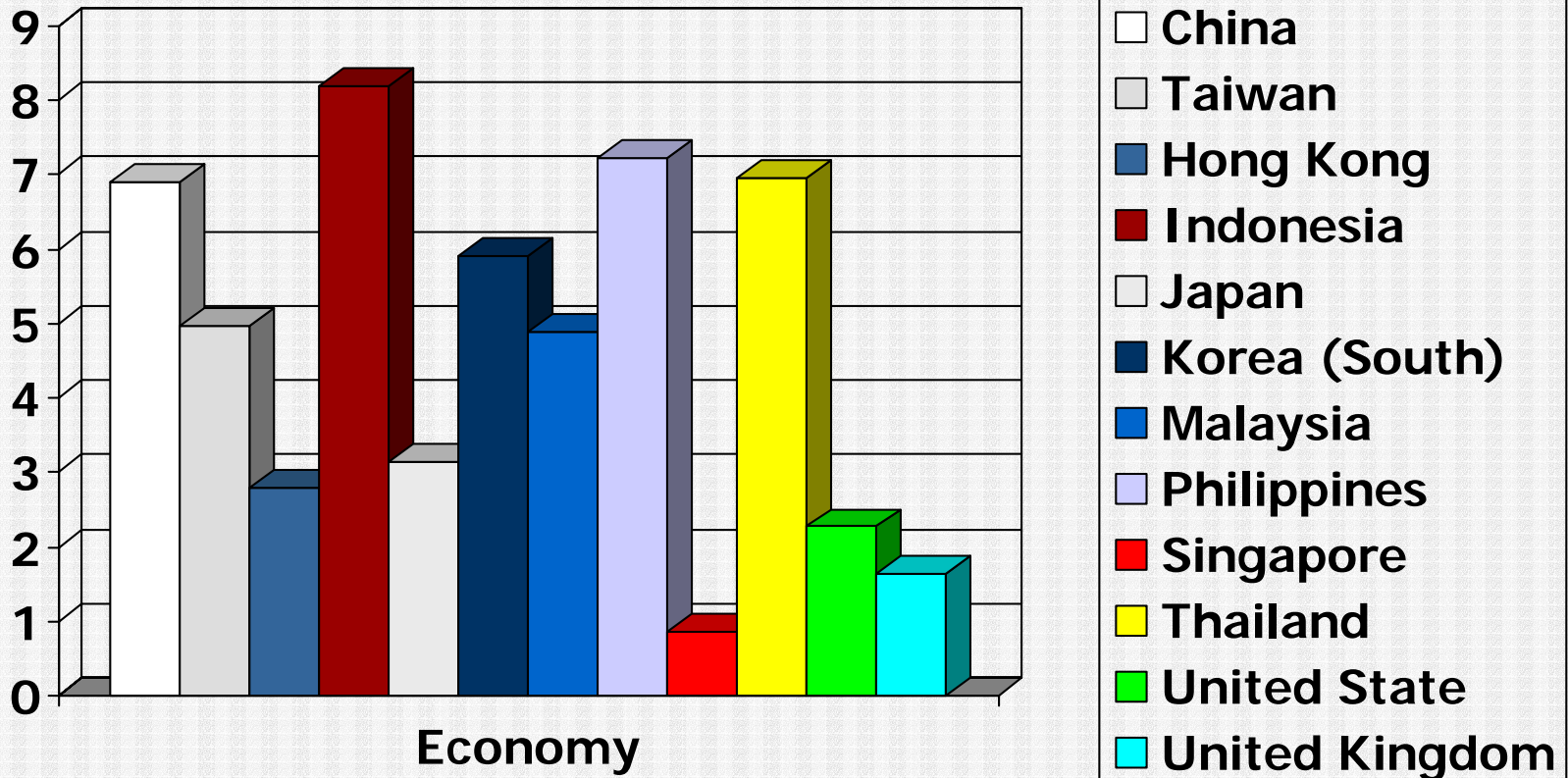
- Weak incentives of bank managers
 - Lack of ownership
 - Rigid compensation structures
- Methods of mitigating conflicts
 - Bureaucratic rules
 - Monitoring and supervision
- The state's incentive of monitoring is weakened by their own conflicts of interest
 - Politicians and bureaucrats are not the true owners of the banks
 - Dual role of bank regulator and operator
 - Vulnerable to weak public governance

Public Sector Governance and Bank Governance

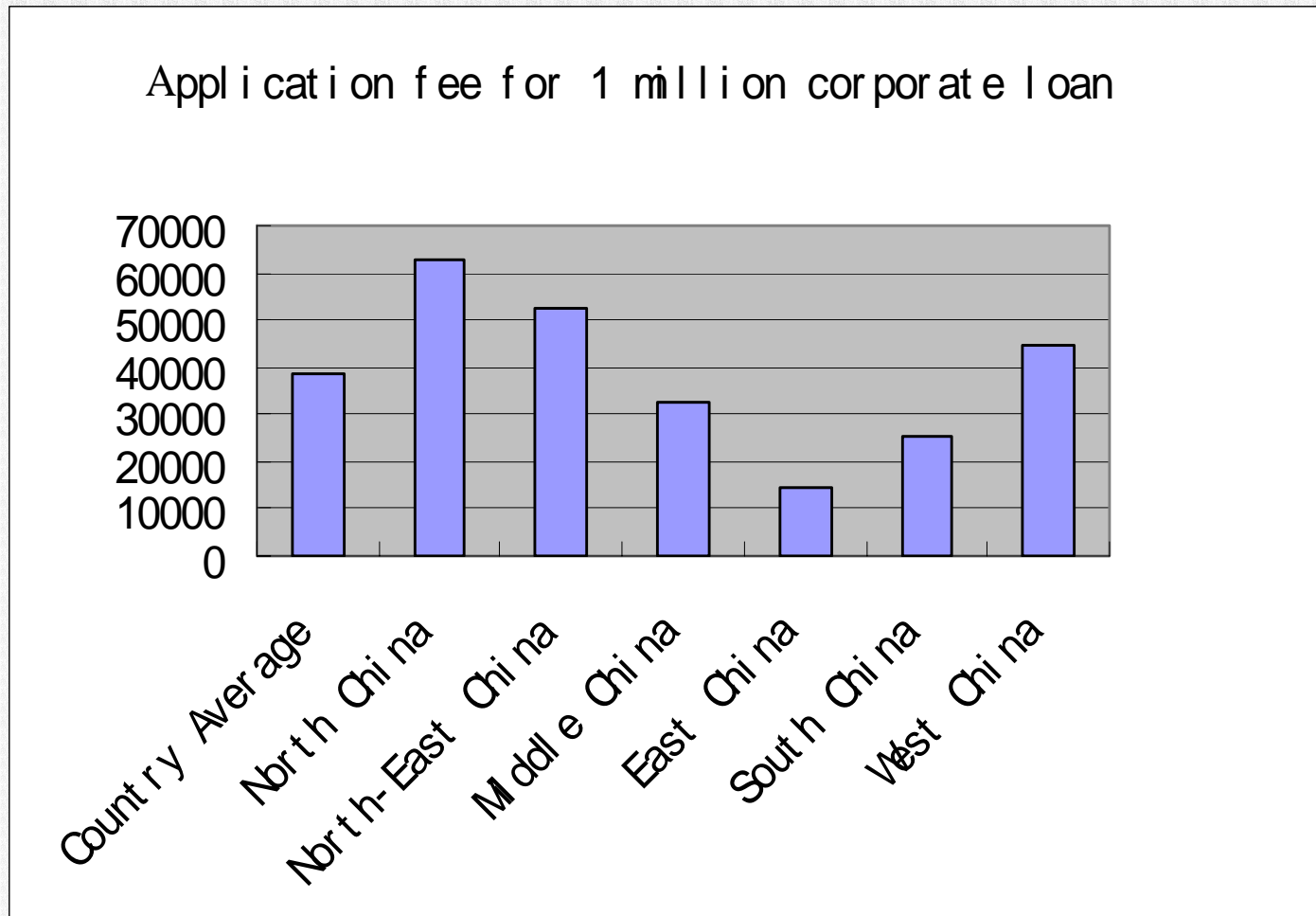
- Social or private interest?
 - Academic research show little support for the view that government banks facilitate economic development
 - Abundant evidence that politicians use banks to channel funds to their favored firms or supporters
 - Non-preferred borrowers need additional payment to establish banking relationships
 - Excessive crony and policy lending may have explained why corporate sector debt is high in a few Asian economies

Corruption in Asian Economies

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

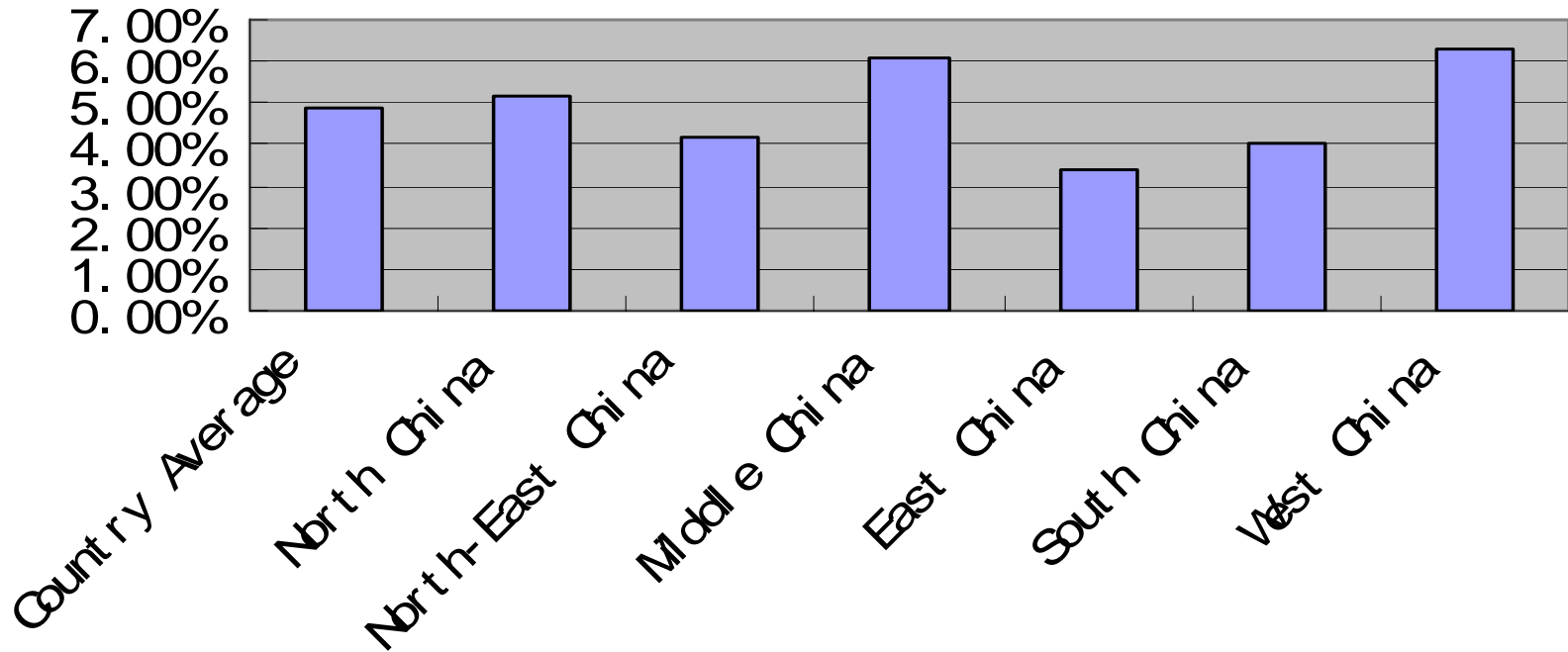


How much side payment is needed for firms to get 1 million bank loan in China?



Cost of maintaining relationship with banks in China

The cost needed to maintain the loan relationship with bank represented by interest rate



A case in point – China Construction Bank



Wang Xuebing



Zhang Enzhao

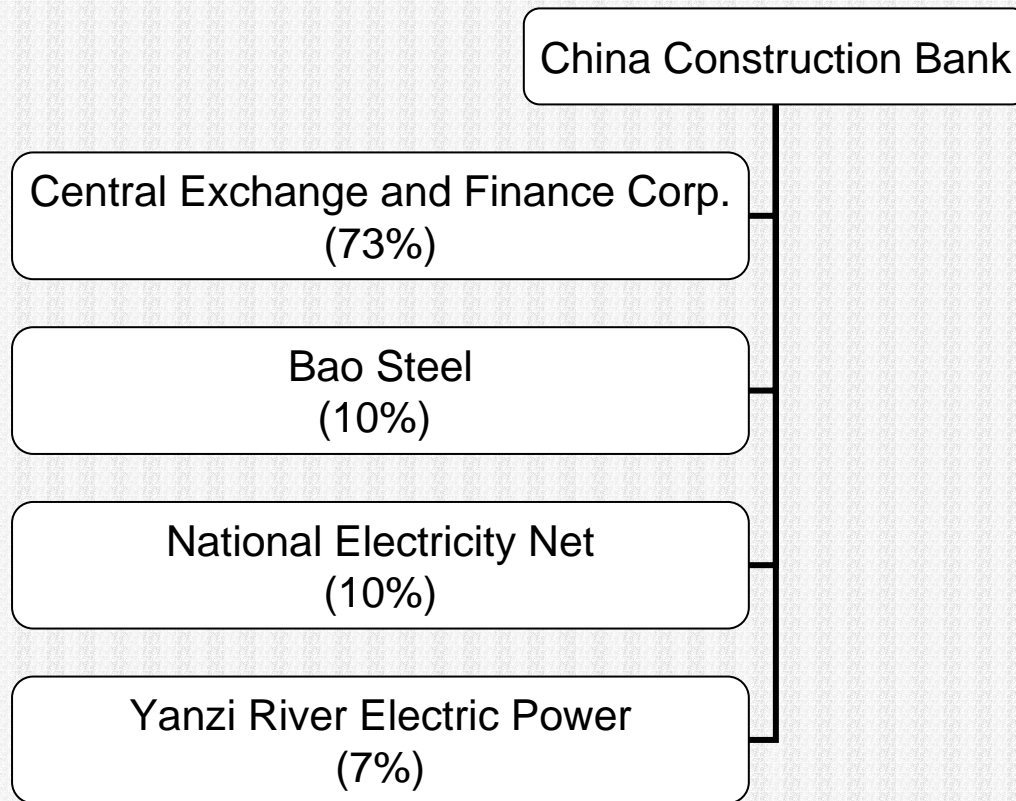
A case in point – China Construction Bank

- China's third-biggest lender
- On the verge of initial public offering in Hong Kong., chairman Zhang Enzhao resigned on March 16, 2005, for "personal" reasons
- It was revealed that Zhang was involved in a corruption scandal in which he took bribe of \$1 million in the U.S. He is being investigated by the communist party
- Wang Xuebing , the former chairman of the bank was also removed due to corruption a few years back
- Directors and other senior managers of the bank were uninformed about Zhang's problem until rumor spread around March 14
- What went wrong?

Corporate Governance of Banks in China

- All government owned
- Government appoints senior management (not just chairman and CEO)
- Few senior management appointed externally from markets
- Executive compensation is inflexible
- Communist party committee dominates the board of directors
 - Party committee members serve as key members of other boards (director, supervisory, management)

Ownership Structure of China Construction Bank



Governance Structure of China Construction Bank



Entrenchment Problem at the China Construction Bank

- Both corrupted chairmen were long-timer of the bank and were approaching retirement age
- The chairman's decisions were uncontestable by other directors and managers.
- The chairman is also the party secretary who controls the party committee.
- Once a decision is passed in the party committee, it won't be challenged by other boards as these other boards are controlled by the party board members

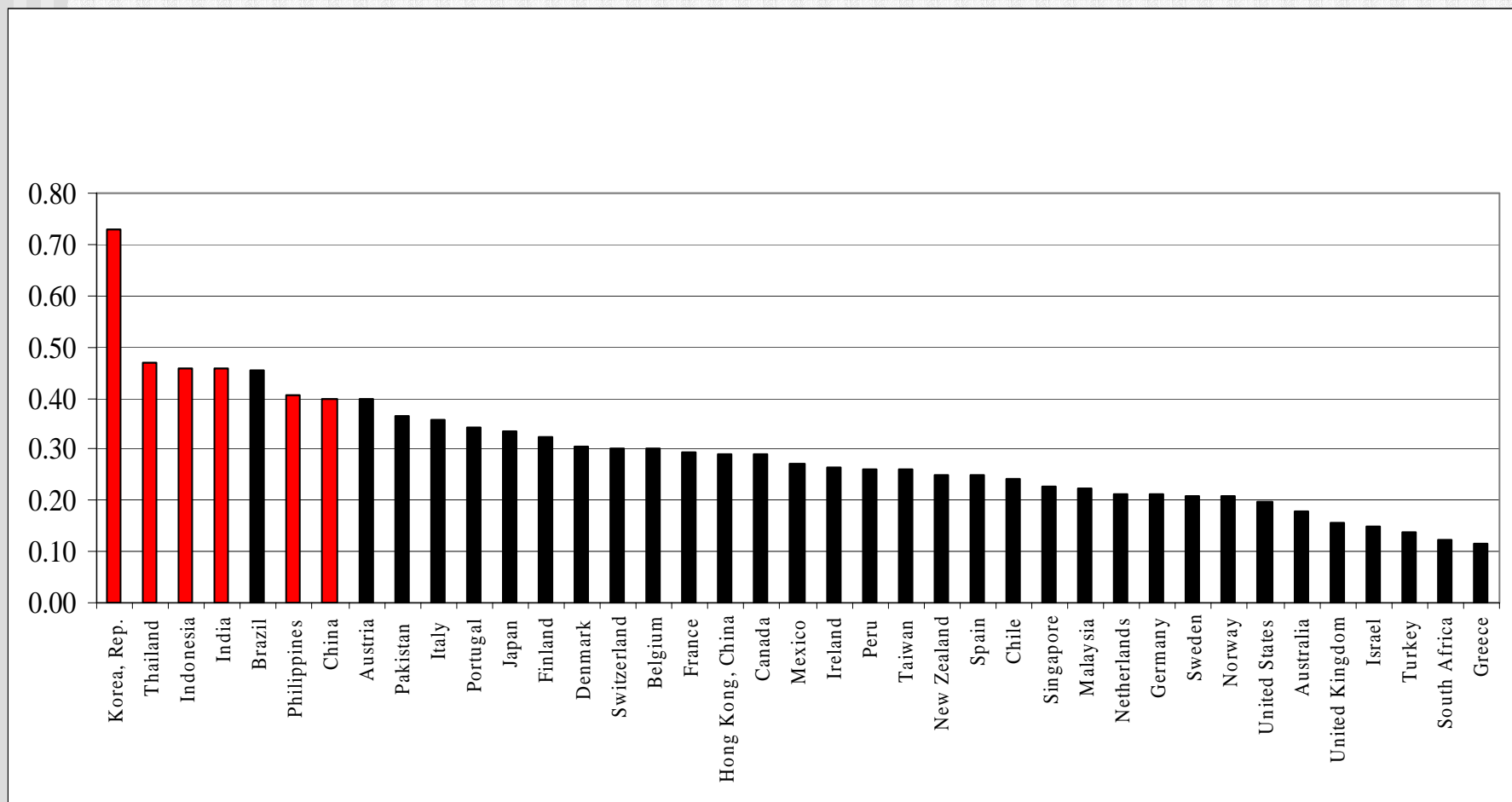
What are needed for improving the governance of government banks?

- Making bank ownership transferable. This is usually done through privatization
- **Firewall** that prevents politicians from intervening banking decisions based on self-interests
- Mechanisms that prevent managerial entrenchment

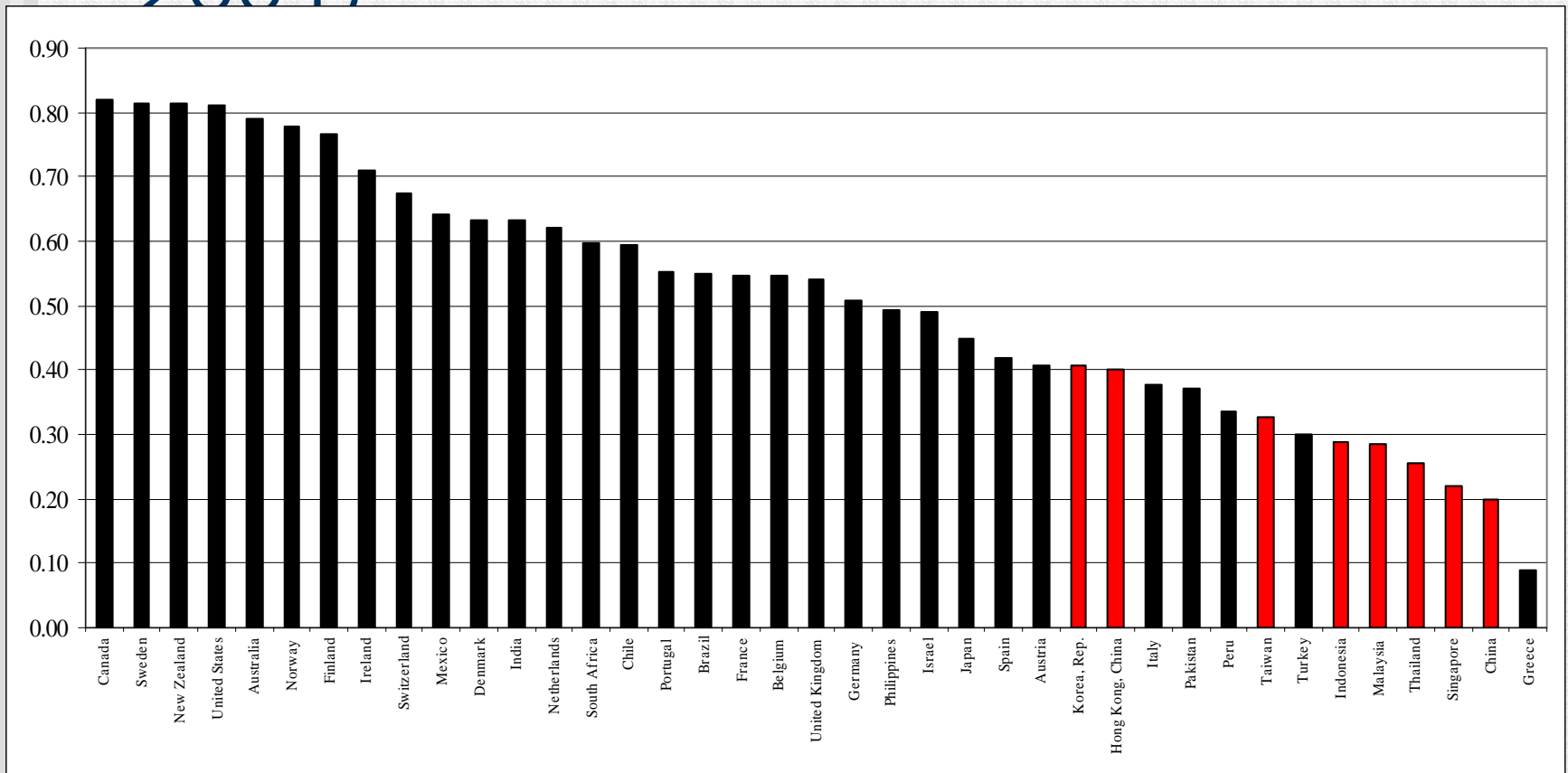
Effects of weak bank governance: High Corporate Financial Leverage

- 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?

Cross country pattern of corporate leverage (Fan, Titman, Twite, 2004)



Cross country pattern of corporate debt maturity (Fan, Titman, Twite, 2004)



Rent seeking and Corporate Finance

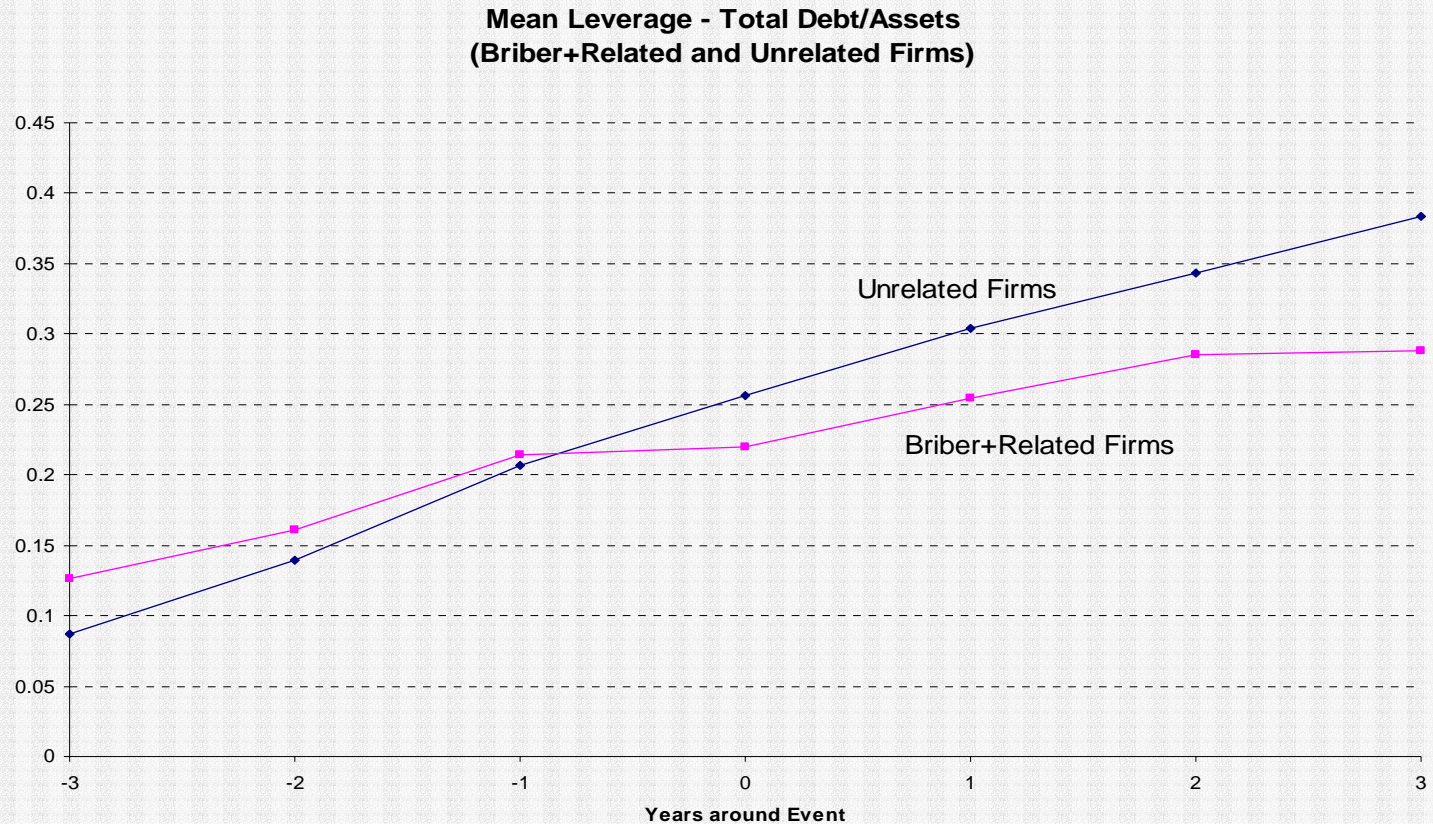
- In a country plagued by weak public governance, the government is a weak enforcer (or even a violator) of property rights, and debt (bank loans) provide better protection than equity
- Politicians/bureaucrats channel funds to their favored firms through banks they control
- See below research evidence from China

High-level Government Officers Corruption Cases in China, 1995-2004

Province	Name	Position	Event Day	Sentence Day	Sentence	Number of firms in the region	Briber	Related
Anhui	Wang Huizhong	Vice-Province Governor	20010407	20031229	Death Penalty	27	1	2
Bank	Liu Jingbao	Vice-Chairman & CEO of Bank Of China (HK)	20030525	N/A	N/A (Still under investigation)	5	5	0
Bank	Wang Xuebin	CEO of China Construction Bank	20020111	20031210	12 years of imprisonment	5	5	3
Beijing	Chen Xitong	CPC Secretary	19950426	19980731	16 years of imprisonment	12	5	5
Central	Xu Penghang	国防科工委副主任, 国家经贸委副主任	20001011	20001011	Dismissal from the service	1	1	0
Fujian	Shi Zhaobin	Vice-CPC Secretary	19990818	20010927	Dismissal from the service and CPC	34	5	5
Guangxi	Chen Kejie	Chairman of Municipality	20000111	20000731	Death Penalty	10	2	3
Guangxi	Liu Zhibin	Vice-Chairman of Municipality	20000319	20020624	15 years of imprisonment	10	2	3
Guangxi	Wang Qinglu	Vice-Chairman of PPCC	20010222	20010222	Dismissal from the service and CPC	13	0	1
Guangxi	Xu Binsong	Vice-Chairman of Municipality	19980523	19990827	Life imprisonment	6	0	1
Guizhou	Liu Changgui	Vice-Province Governor	20030417	20040430	11 years of imprisonment	12	1	3
Guizhou	Liu Fangren	CPC Secretary & PC Chairman	20030422	20040629	Life imprisonment	12	1	1
Hainan	Xin Yejiang	Vice-PC Chairman	19961227	19980526	5 years of imprisonment	10	2	0
Hebei	Chen Weigao	CPC Secretary & PC Chairman	20000301		Dismissal from CPC	25	1	3
Hebei	Cong Fukui	Vice-Province Governor	20000627		Dismissal from the service and CPC	24	0	2
Hebei	Jiang Dianwu	Vice-PC Chairman	19971101		10 years of imprisonment	13	0	0
Hubei	Li Daqiang	Vice-Province Governor	20000925		Dismissal from the service and CPC	2	2	1
Hubei	Meng QingPing	Vice-Province Governor	19980410		10 years of imprisonment	33	1	5
Jiangxi	Hu Changqing	Vice-Province Governor	19990808		Death Penalty	12	0	2
Liaoning	Mu TuoXing	Vice-Province Governor	20010321		Death Penalty	51	5	8
Xingjiang	Aman.Haji	Vice-Province Governor	20031015	N/A	N/A (Still under investigation)	25	1	2
Yunnan	Li Jiating	Vice CPC Secretary & Province Governor	20010620	20030509	Death Penalty	17	1	4
Zhejiang	Xu Yunhong	Vice-Province Governor	19990922	20001017	10 years of imprisonment	35	2	5
Total						394	43	59

Rent Seeking and Firm Leverage in China

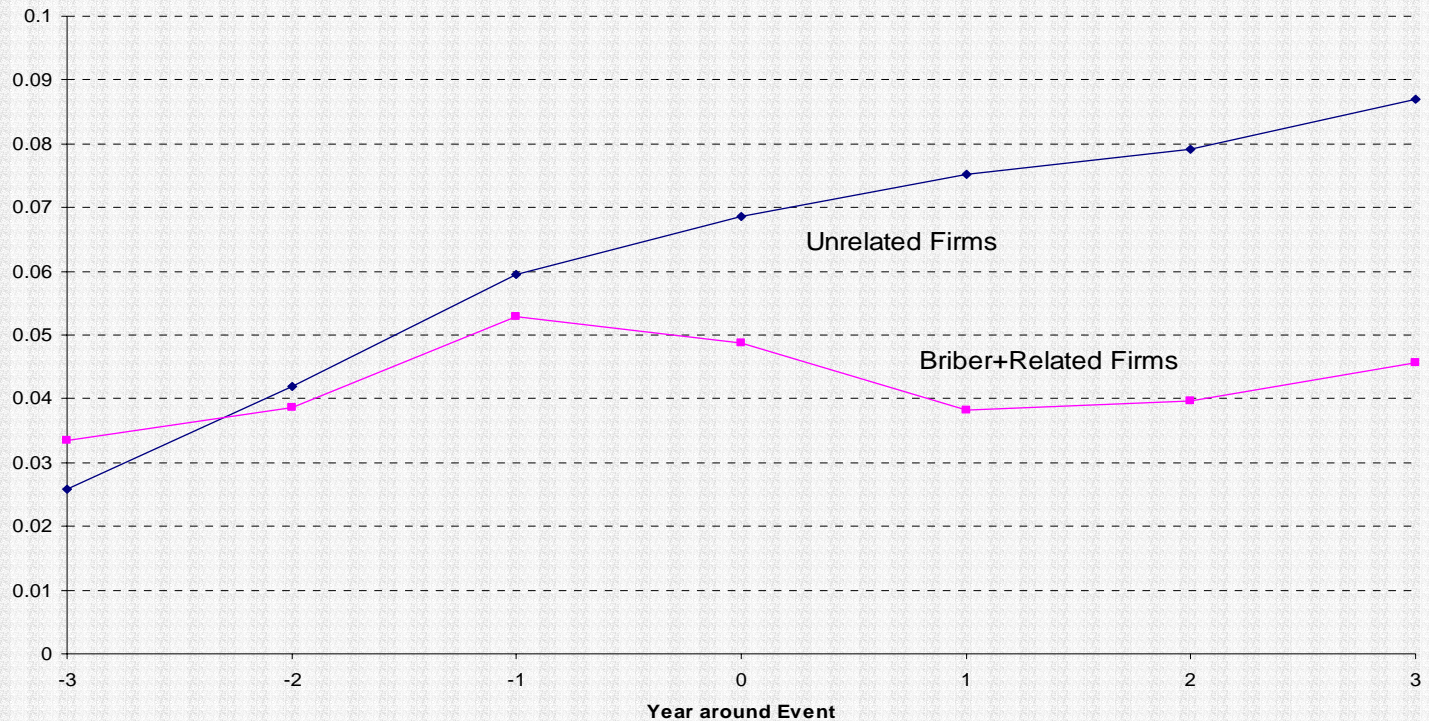
(Fan, Rui, Zhau)



Rent Seeking and Long-term Debt Financing in China

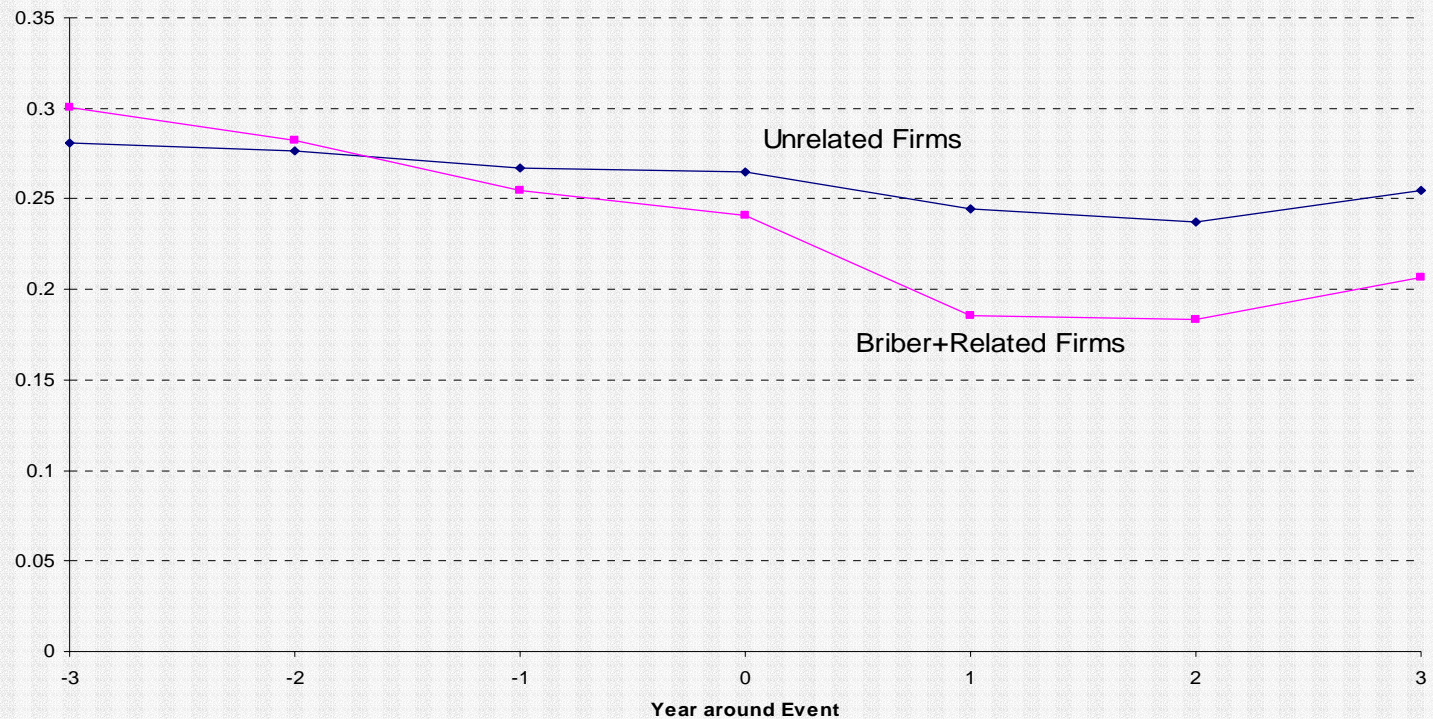
(Fan, Rui, Zhau)

Mean Long Term Debt/Assets
(Briber+Related and Unrelated Firms)



Rent Seeking and Corporate Debt Maturity in China (Fan, Rui, Zhau)

Mean Maturity - Long Term Debt/Total Debt
(Briber+Related and Unrelated Firms)



Conclusions

- Corporate governance of banks in Asia is fundamentally shaped by the banks' business **strategy, ownership**, and more fundamentally **public governance** and government regulations
- There is no strong evidence that deviation of western governance practices hurt bank performance
- Governance reforms merely at the bank level alone are unlikely to be effective
- Deeper reforms at the country level, such as fighting corruption, will result in changes in bank governance