Value of Politically Connected Independent Directors: Evidence from the Anti-Corruption Campaign in China - Commentary

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Objective of the Paper

- To investigate the effect of introducing Regulation/Decree 18 (an anti-corruption law) in Oct 19, 2013 on PCID's resignation from corporate boards in SH and SZ listed firms which in turns affect firm performance and corporate governance.
- Using event study with data extracted at three points in time:
  - (1) when Reg 18 was released
  - (2) announcement of PCID's resignation
  - (3) when PCID actually resigned
- The regression results show that firms with PCID have negative CAR when Reg 18 was introduced but positive CAR when the ID's resignation was announced – non-SOEs were more affected by the regulation.
  - The author explained that this is due to the decrease in political risk rather than the loss of future cash flow. Non-SOEs were more affected as unlike non-SOEs where PCID might be their main source of political risks, SOEs have other political connections and political risk is not reduced by the announcement of PCID's resignation.
- Also, operating performance is not affected when the PCID left the company
- In addition, the results also showed that on 4 aspects of corporate governance
  - Board monitoring efficiency – using ID's busyness as proxy (in turn measured by average number of board positions held)
  - Management entrenchment – using executive pay as proxy
  - Related-party transaction
  - Entertainment & Transport Cost

  The respective figure decreases more significantly for SOEs than for non-SOEs, suggesting better corporate governance improvement for SOEs after the departure of PCID.

Contribution of the Paper

- Neat, clear and easy to read. Well-written paper.
- Quite a number of literature surrounding President Xi's anti-corruption reforms, e.g. on shareholder valuation (Lin, Morck, Yeung and Zhao 2016), equilibrium effect on firm performance (Ding, Fang, Lin and Shi 2017).
- But few went further to look at the effect of the campaign at firm level, e.g. departure of so-called "politically connected independent directors" or PCID.
    - Liu, Lin and Wu's 2018 paper in *Journal of Business Ethics*. Looked at only one point in time, i.e. when Regulation 18 was released
- The paper looks at 3 time points and offers alternative explanation by introducing the idea of political risk. It argues that political connections can increase firm risks and need not be helpful to the firm – the helping hand theory is debunked. In addition, it argues that PCIDs' departure in SOEs helped in improving the corporate governance of SOEs.

Comments - Definition

- Interesting paper, but may be trying to achieve too much and link everything to the departure of PCID
- “Politically-connected” need to be defined properly
  - politics/political parties and government generally mean separate things in most jurisdictions. Even in China, only the top government officials have political ties. But Reg 18 affects all government official – so the idea of anti-corruption has wider scope than just politically driven – this was also the assertion of Griffin, Liu and Shu in their 2018 working paper.
  - In addition, Griffin etc. found that “politically connection” depends on which fraction in the central party leadership the person has affiliation to. Right affiliation means that the company would less likely be investigated.
- Identifying PCID’s reason for resignation – through their resignation reason (stated to be as a result of Reg 18) or whether they were govt officials or party members (any database?). Are there any ID who fell within your definition but continued to stay on the board? What about other IDs? Based on the resignation reports, 2217 ID resigned from 1433 firms after the release of Reg 18. This means that there were quite a number of non-PCIDs who resigned during the time of the study period as well. Any idea why they resigned?

Comments – Political Risk Theory

- Fascinating argument, as it shows that there can be more than meets the eye. It casts doubts on the cash flow explanation, ie losing political connection can mean the company loses benefits and can lead to worse operating performance.
- However, I have a few comments and suggestions:
  - The paper compares the performance of companies with PCIDs leaving after the release of Reg 18 to control group of companies. The treatment group actually suffered 2 shocks – released of Reg 18 and the departure of ID. A more direct and better comparison would be to use a treatment group with non-PCIDs leaving during the same period, i.e. departure of independent director that are not politically connected.
  - It is not clear how close the three dates are. The positive CAR observed at points 2 and 3 might have been just a “correction” or reversal by the market and not due to the resignation. Also, for Hypotheses 2 and 3, the paper compares companies whose stock returns have dropped significantly recently after the release of Reg 18 with those in control groups that did not have the experience. So at points 2 and 3, the treatment companies are actually starting from lowered base as compared to the control group.

Comments – Political Risk Theory

- The paper is not very clear as to how the political risk came about. The paper says “since the PCIDs do not necessarily resign right after the release of the regulation, firms with PCIDs may have higher politcal risk than other firms before their PCIDs actually leave”. If the grace period for resignation is permitted by the authorities, then why should there be political risk before the actual resignation? If the PCID had committed crime or breached his fiduciary duty before the regulation, then it should not increase the risk between the release of the regulation and the actual leaving. After the release of the regulation, it would be even inconceivable to think that the PCID, even if he continued to stay on board, would do anything illegal or anything to increase the political risk.
- Finally, using stock return volatility risk to capture political risk can be difficult. Stock return volatility captures total volatility and the return can be volatile due to a wide range of issues not necessarily linked to politics. The leaving of the directors itself may cause uncertainty or disruption and hence increase volatility.

Comments – Corporate Governance

- 4 facets of corporate governance are explored in this portion:
  - Board monitoring efficiency
  - Management entrenchment
  - Expropriation by controlling shareholders
  - Entertainment and travel costs
- Monitoring efficiency - using ID’s busyness as proxy (in turn measured by average number of board positions held). The results shows that the overall number of directorships held by directors in treated companies were fewer than those in control group. First, there was no departure of directors from control group and therefore naturally the treatment group’s overall directorship held would be lower. Also, non-PCID need not be ‘less busy’ than PCID. Finally, fewer directorship does not mean that the board is more efficient – still depend on many other factors such as board composition, frequency of board meeting, tenure of directors etc.

Comments – Corporate Governance

- Decrease in executive compensation in SOEs - the paper argues that this is due to the fact that executives in SOEs are more likely to capture the PCIDs and so the departure of the latter led to greater decrease in management entrenchment. However, I am doubtful as to the causal effect of the departure of PCIDs and would attribute this to the overall anti-corruption measures taken by the Chinese governments, esp. on SOEs.
- Similarly, related party transactions include not only transactions which majority shareholders are interested but also when the senior management is involved. Therefore, decrease in RPT in SOEs is more likely due to the effect of the anti-corruption measures on management rather than that the “non-connected directors replacing the PCIDs are less likely to protect the interest of the State and thus better protect minority shareholders”. I don’t think that for SOEs where the Chinese government is the majority shareholder, the directors can disregard the government’s interest, whether they are politically connected or not. Same explanation goes with the decrease in ETC.
- The fact that only SOEs are affected but not the non-SOEs in all the four aspects may also show that these PCIDs are just “tokens” on board and their absence/presence has no effect on the operating performance nor on corporate governance.