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CEOs' power and perks: Evidence from Chinese banks

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ABSTRACT

In this paper, we investigate the relation between CEOs' power and their perks in Chinese banks over the period from 1999 to 2011 period. We find that banks with more powerful CEOs, as measured by the CEO as the only insider and the CEO's directorships, provide greater perks. This finding could be explained by social needs and monitoring difficulties but not by entrenchment. Powerful CEOs tend to maintain connections or "guanxi" by building political ties and attending more business entertainment activities. They also have lower pay-performance sensitivity. Only a gender-diverse board provides better monitoring to reduce perks.

1. Introduction

This paper studies the relation between the power and perks of CEOs in Chinese banks. We define a perk (short for perquisite) as any form of non-monetary compensation offered to employees at all levels. The research focuses mainly on the US market and shows the effects of perks for top executives on the firms' values (Edgerton, 2012; Rajan & Wulf, 2006; Yermack, 2006). The provision of non-cash subsidies and perks is a traditional compensation treatment under Chinese corporate culture (Luo, Zhang, & Zhu, 2011). Until now, firms have provided perks, such as resident subsidies, company cars, and club memberships, to compensate outstanding executives. However, the fiscal waste of "three public expenditures" or "san gong jingfei"[1]; is common, because Chinese leaders misuse their power. Many bank CEOs make use of their power to extract public funds in the name of welfare funds, education and training expenses, or medical expenses. The executive perks, such as cars, club memberships, travel, entertainment, yachts, or jets, are indicated in the annual reports in the United States (Rajan & Wulf, 2006; Yermack, 2006). However, the disclosure of perks is optional in China. The amount of perks may conceal in the income statements of the annual report. Recent finance literature (Gul, Cheng, & Leung, 2011; Luo et al., 2011; Xu, Li, Yuan, & Chan, 2014) that investigated the role of perks in the Chinese economy focuses only on nonfinancial firms. We determine that the mean (median) value of perks in banks is 21 (40) times higher than that in nonfinancial firms. Given that bank managers have discretion over large funds that mainly come from the public, the issue of perks in the banking sector is more important than that in the nonfinancial sector. Bank managers who misuse public funds can be prosecuted

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[1] This term refers to public money spent on official receptions, vehicles, and overseas travel. Taxpayers have long viewed this type of spending as a source of corruption and waste, allowing officials to misuse public funds for private purposes.

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and imprisoned. In fact, government courts have sentenced several subbranch chief managers of the Agricultural Bank of China and China Guangfa Bank to prison for corruption.[2]

To fill this gap in the literature, we investigate the relation between CEOs' power and their perks. Perks can be in the form of status or a positional good (Hirsch, 1976) that reinforces an executive's standing in the organization. In China, regulation directly or indirectly affects the monetary compensation of top managers. Therefore, perks can be a substitute for their relatively low monetary compensation (Chen, Li, & Liang, 2010). The more powerful CEOs have higher discretion. They also tend to be more confident or even overconfident, naturally believing that executives deserve greater perks. Therefore, CEOs with more power might more easily extract value from a firm through perks.

We manually collect the CEO power and perk data from annual reports over the period from 1999 to 2011. We focus on power as the restriction of the information by the CEO to the other directors and to receive timely information that the CEO would not otherwise be privy to. Thus, we adopt two proxies: the CEO as the only insider and the CEO's number of directorships. Following the literature on Chinese perks (Gul et al., 2011; Luo et al., 2011; Xu et al., 2014), perks comprise six possible items: traveling expenses, business entertainment expenses, overseas training expenses, board meeting expenses, company car expenses, and meeting expenses. The results show that banks with powerful CEOs provide more perks.

We argue that the association between power and perks might be due to social needs and monitoring difficulties. Powerful CEOs maintain "guanxi" by building political connections and attending more business entertainment activities. They receive higher compensation relative to other top executives and reduce pay-performance sensitivity. The monitoring function of a board to reduce perks is limited. Only gender-diverse boards effectively reduce perks.

This study provides new insights and contributes to several different research streams. First, we highlight the problem of perks in Chinese banks. Second, we contribute to the literature on the CEOs' power. While previous studies focus on the firms' performance and risk-taking (Adams, Almeida, & Ferreira, 2005; Daily & Johnson, 1997; Pathan, 2009), we address the link between power and the agency problem. Third, we complement the studies on gender-diverse boards (Adams & Ferreira, 2009; Berger, Kick, & Schaeck, 2014) and find that diversity provides better monitoring of perks.

The remainder of the paper proceeds as follows. In Section 2 we discuss the institutional background and literature review. Section 3 describes the data. Section 4 presents the relation between the CEOs' power and perks and investigates the possible explanations for it. Section 5 concludes.

2. Institutional background and literature review

In 1997 the Chinese government initiated a comprehensive reform with the objective of transforming banks into market-oriented and profitable institutions. The reform focused mainly on the restructuring of the largest banks, the state-owned commercial banks (SOCBs), which had long served as lending arms to state-owned enterprises. The rest of the country's banking system has a much more diversified structure. First, state-owned development banks (so-called policy banks) are mainly in charge of financing long-term projects, such as infrastructure. Second, the so-called joint-stock commercial banks (JSCBs) are generally the most market-oriented and are, to a larger or lesser extent, privately owned. Third, city commercial banks (CCBs), created by restructuring and consolidating urban credit cooperatives, generally operate at the provincial level although some are much larger. Fourth, rural commercial banks (RCBs), which serve rural enterprises and individuals, are still not immune to government requests for policy loans.[3] Fifth, trust and investment corporations (TICs) play an intermediary role with foreign funds to finance local government companies and infrastructure and construction projects. The levels of perks could be different among these bank types because of their different historical backgrounds and functions.

Mainly there are two strands of theory that are related to perks. One strand argues that perks are a way for executives to misappropriate the surplus funds of the firm, because such actions are hard for outsiders to observe (Grossman & Hart, 1980; Jensen & Meckling, 1976; Jensen, 1986; Yermack, 2006). The other strand argues that firms offer perks to incentivize executives to enhance managerial productivity and hence lead to optimal incentive contracts (Fama, 1980; Marino & Zabojnik, 2008; Rajan & Wulf, 2006). The studies on perks in China (Cai, Fang, & Xu, 2011; Gul et al., 2011; Luo et al., 2011)[4] generally echo the aforementioned literature.

Perks can be a form of status or a positional good (Hirsch, 1976) that reinforces an executive's standing in the organization. Rajan and Wulf (2006)[5] indicate that perks are meant to enhance status; thus they are likely to be used in organizations that emphasize status by carefully delineating positions. They find that steeper firms, or firms with narrower spans[6] of control, are more likely to signal status and give CEOs access to a company plane. Bank CEOs have enormous resources, and their power plays a key role in a

[2] China Guangfa Bank, 2012 http://news.sina.com.tw/article/20121216/8565812.html. Agricultural bank of China, 2007 http://news.xinhuanet.com/legal/2007-04/24/content_6020808.htm

[3] These loans are issued for political reasons, such as the desire to support certain politically important industries or firms, not because the firm is an attractive candidate for a loan.

[4] Cai et al. (2011) find that entertainment and travel costs, overall, have a significantly negative effect on firms' productivity. Gul et al. (2011) note higher perks are more likely to be associated with a lower quality of financial reporting. Luo et al. (2011) suggest that higher levels of executive perks hurt firms' operating efficiency. However, Chen et al. (2010) and Adithipyangkul et al. (2011) provide evidence that suggests firms provide perks as incentives to executives that result in improved performance and higher value.

[5] They argue that treating perks purely as a managerial excess is not appropriate. They present evidence that, in certain situations, perks can enhance managerial productivity. For example, CEOs that work in headquarters located in close proximity to larger airports are less likely to have access to a company plane. More geographically dispersed firms are more likely to offer a company plane. Larger firms and firms headquartered in more populated counties are more likely to offer chauffer services to their CEOs. The implication of the productivity hypothesis is that more time-saving perks should be offered to managers who are more productive.

[6] Span represents the breadth of hierarchy or the span of control and is defined as the number of positions that report directly to the CEO.