China's Banking Reform: A Corporate Governance Perspective

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The candidate confirms that the work submitted is his own and that appropriate credit has been given where reference has been made to the work of others.

To my mother Jin Xiuying

and

in memory of my father Sun Chuansheng

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Abstract

This study investigates the process of the construction of a system of corporate governance in China's banking sector, with particular reference to the reforms of the SOBs since the late 1990s. The study provides a comprehensive analysis of both external and internal governance mechanisms of the banks.

The study shows that the Chinese SOBs have been undergoing a profound transformation since 1998 from a qualitative point of view. A new governance structure of the SOBs has been established through institutional reforms, which have mainly focused on three aspects aiming at addressing the ownership, asset quality and governance issues of the banks.

The study demonstrates that the Chinese government has emerged as still in control of the SOBs, which has seen little change throughout the reforms process. The reform efforts, however, have made significant changes in the ways that the government conducts its control over the SOBs. This has seen shifting from a system of direct influence and control of management to control through indirect forms.

The study shows that corporate governance reforms of the SOBs have all been a strategic choice in the whole process of the Chinese economic reform. The forms, approaches and pace are all subject to the country's dynamic political and economic institutions. The major steps of the reform have been motivated by the improvement of the efficiency of state ownership and interference.

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Abbreviations

ABC	Agriculture Bank of China
AMCs	Asset management companies
BIS	Bank for International Settlements
BOC	Bank of China
CARs	Capital adequacy ratios
CBRC	China Banking Regulatory Commission
CCB	China Construction bank
CCP	Chinese Communist Party
CFWC	Communist Party Central Financial Work Commission
CIRC	China Insurance Regulatory Commission
CSRC	China Securities Regulatory Commission
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
HKEX	Hong Kong Stock Exchange
IAS	International Accounting Standard
ICBC	Industrial and Commercial bank of China
IMF	International Monetary Fund
IPOs	Initial public offerings
MBO	Management buy-out
MOF	Ministry of Finance
NPLs	Non-performing loans
NPEs	Non-performing assets
PBOC	People's Bank of China
PCA	Prompt Corrective Action
RMB	Renminbi, Chinese currency
RTC	U.S. Resolution Trust Company
SAFE	State Administration of Foreign Exchange
SASAC	State-owned Assets Supervision and Administration Commission
SHC	State holding companies
SMEs	Small and medium-sized enterprises
SOBs	State owned banks
SOEs	State owned enterprises
SSE	Shanghai Stock Exchange
WTO	World Trade Organisation

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Introduction

In the five years since 2001 the country's WTO entry, China's banking sector, the final frontier, regarded as the weakest part of the country's fast-growing economy despite its slow evolution over the past two decades, has seen undergoing dramatic reforms. One of the most, if not the most momentous targets is building better corporate governance through restructuring of the state-owned banks (SOB).

The SOBs, namely, the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), the China Construction Bank (CCB), and the Agricultural Bank of China (ABC) (together, the 'Big Four'), are the most important players of the Chinese banking system. They have traditionally dominated China's banking industry. Although there has been marginal decline, the Big Four still remain a main force in China's financial market and are playing a decisive role in allocating financial resources in China. At and end of December 2006, according to the PBOC, they accounted for 51 percent of total assets of financial institutions in the country; their deposits made up 54 percent and loans 52 percent; they undertook nearly 80 per cent of the gross payment and settlement volume. Because of the importance of the Big Four, the ways in which reforms of the banks are resolved could have systematic consequences. In particular, as one of the last and most fundamental aspects in China's economic reform, this reform would engender far-reaching effects in the success of the state-owned enterprise (SOE) reform and the country's further sustainable economic development as a whole.

The new round of reform, though not yet completed, has attracted increasing attention within the academic circle both in China and internationally. There have been, however, very little comprehensive studies on the corporate governance of the banking sector in China. And also the existing literature has mainly adopted theoretical frameworks and provided too little empirical evidence due to suffering from dearth of examples of actual banking firms and their practices.

This study, against this backdrop, seeks to examine the process of the construction of a system of corporate governance in China's banking sector, and explore its peculiar nature. The study provides a comprehensive analysis of both external and internal governance mechanisms of the banks. It embraces multiple facets of the reforms, but focuses on four major issues: the general evolution process; financial restructuring; regulation and supervision; internal governance systems. The four issues are addressed in four separate chapters, but share a common approach based on the theoretical framework. They are also intimately linked within the system of corporate governance, which look at both the external and internal governance systems. Since the big four SOBs are the focus of the study, major attention has been devoted to the reforms of the banks during the period 2000-2006. The study offers a firm-level perspective on corporate governance reforms by studying individual banks the BOC and the CCB, which is indeed essential to understanding the practical implications of the reform policy. Meanwhile, in order to enhance the analytical perspective, discussion of the reforms is dated back to the late 1980s, while it is kept as brief as possible.

This study attempts to answer two questions: how does the change in systems of corporate governance in the banking sector occur? Why is China engaged in such a process? This task involves investigations in four areas and a number of questions. The first is to examine the general background of the corporate governance reforms in the banking sector, in particular, how does China's overall corporate governance approach to enterprise shape the new arrangement of governance mechanism? The second area is the financial restructuring of the SOBs. How the banks' health has been restored? What approaches has China adopted? Why has China adopted such approaches? The next area of investigation is the banking regulation and supervision. What are the characteristics of China's banking regulation? How has institutional structure of banking regulation and supervision evolved? How has China introduced the prudential regulation and supervision? The final area is the internal governance system of the banks. How have the banks been partly privatised? What are the features of the restructuring? How have the banks changed the risk control and management systems? In the most general sense, it is not the intention of this study to make value judgment for the reforms or identify best practices, rather the focus of overall discussions and analyses have been placed on the issues that how the Chinese government deals with the issues of corporate governance in the banking sector, and how to understand it.

In light of the research questions, this study adopts descriptive (what is happening) rather than normative approach (what should be). It rests on a broadening theoretical framework, which consist of two tiers of theories. The first tier relates to the theory of corporate governance. The second tier of theories includes those that focus more on the specific issues of banking governance. The theories are proceeded with evolutionary and comparative perspectives, incorporating critical evaluation of other theoretical approaches, including the economic reforms in transitional economy.

This thesis is comprised of eight chapters. Chapter 1 reviews the literature on theories and practices of corporate governance. The chapter focuses on the evolving nature of corporate governance. It discusses how the evolution of the theory of the firm has underpinned the development of the theories of corporate governance, and how the diversity of practices around the world has derived from different institutional environment. Chapter 2 narrows the spotlight on the literature on corporate governance of banks. The chapter discusses the special features of banks and addresses why banking firms are different from other non financial firms in terms of corporate governance. The chapter also reviews the prevailing practices of bank governance, including both external and internal mechanisms. Chapter 3 focuses on the methodological issues of the research. The chapter discusses the research strategy employed and explains why the chosen methodology is considered the most suitable for addressing the research questions. The chapter also presents the information about how the research carried out, including the data collection and data analysis, as well as its reliability and validity.

The next four chapters examine the different facets of the corporate governance reforms in China's banking sector. Chapter 4 provides an overview on the development of corporate governance in the banking sector, in order to provide the context for the arguments which follow later in the thesis. The chapter critically analysis the issues in relation to the reform of SOE, and places the evolution of the banking sector in the context of China's overall corporate governance approach to enterprise reform. It identifies a two-stage evolutionary process. A detailed discussion of each stage is presented, including the causes, the nature and the process. Chapter 5 examines how the Chinese government rehabilitates the SOBs. The chapter discusses the process of financial restructuring, analyses the banks' unique set of problems, and evaluates the ways in which the problems of asset quality and capital adequacy have been tackled. Chapter 6 focuses on one important aspect of the banking reform, which is related to the banking regulation and supervision. The chapter explores how the set of policy evolves. It analyses the characteristics of the banking regulation in China, and examines the changing process of the institutional structure. The chapter also evaluates the standards and practices of prudential regulation and supervision. Chapter 7 investigates how the Chinese SOBs establish internal governance systems through a case study of the BOC and the CCB. In particular, the chapter focuses on three major aspects of the reforms, namely the ownership restructuring, the organisational restructuring, and the reforms on internal risk management systems. The features of the ownership reforms and management accountability under the new system are discussed.

The final chapter draws together the findings, and discusses the implications for future research and understanding of corporate governance in China's banking sector.

This study intends to make contributions to the ongoing debates of the evolution of corporate governance in China in two aspects. Firstly, it provides greater insights into China's practices in corporate control, by employing a new analytical approach which reflects the country's complex and dynamic context. Secondly, it addresses the deficiencies of existing literature concerning the corporate governance arrangements in China, which mostly adopted normative approach and included sparse firm-level perspective.

Chapter 1 Corporate governance: theory and practice

1.1 Introduction

Literature on corporate governance has developed mainly in the U.S. during the early 1990s, and dominated policy agendas in developed market economies for over a decade, lately in continental Europe (in particular Germany) and Japan. There has been a wealth of written literature focusing on the major economies. In the emerging markets and transition economies corporate governance took some time to rise the top of the policy agenda, but since the mid-1990s it has been among the most hotly debated issues. The rapidly evolving corporate governance both in policy and practice in the new century has become an international phenomenon, as a consequence of expediting ongoing processes of globalisation.

This chapter provides an overview on the most prominent theories and practices of corporate governance, introduces the mainstream debate up to the present day, and highlights its evolving nature. The purpose is to provide a general theoretical background for the whole studies. This chapter is structured as follows: It starts by defining the meaning of corporate governance, it presents diverse views on how corporate governance can be defined. The next section discusses the theoretical foundations of corporate governance. Debate over the main theories of corporate governance is also reviewed. Section 4 reviews the practice of corporate governance in both major market and transition economies. Section 5 discusses the issues in relation to the evolution of corporate governance. Conclusions are presented in the final section.

1.2 Defining corporate governance

Corporate governance has attracted a good deal of public interest, due to its importance for the economic health of corporations and society in general. However, the concept of corporate governance appears to be poorly defined, it is viewed in many different ways, a single precise or universally accepted definition does not exist.

In its narrowest sense, corporate governance is often applied to questions about the structure and functioning of boards of directors (Blair 1995). Donaldson (1990) defined corporate governance as 'the structure whereby managers at the organisational apex are controlled through the board of directors, its associated structures, executive incentive, and other schemes of monitoring and bonding'. Tricker (1994) extended the scope of the board room to include 'owners and others interested in the affairs of the company, including creditors, debt financiers, analysts, auditors and corporate regulators'.

Corporate governance is also viewed as a set of arrangements internal to the corporation that define the relationship between shareholders and managers of the corporation. According to Shleifer and Vishny (1997), 'Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment'. Monks and Minow (1995) wrote that: 'corporate governance is the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management, and (3) the board of directors'.

Corporate governance, however, has wider implications and is crucial to economic and social well-being. Such significance is captured by broader definitions, which is stretched to include 'the structure, process, cultures and systems that engender the successful operation of the organisations' (Keasey and Wright 1993). Adrian Cadbury (1992) defined corporate governance as 'holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society'.

The OECD (1999) offered the following definition, which has gained wide acceptance: Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

The World Bank (1999) defined corporate governance from two different perspectives: from the standpoint of a corporation, the emphasis is put on the relationships between the owners, management board and other stakeholders (the employees, customers, suppliers, investors and communities). Major significance in corporate governance is given to the board of directors and its ability to attain long term sustained value by balancing these interests. From a public policy perspective, corporate governance refers to providing for survival, growth and development of the company and at the same time its accountability in the exercise of power and control over companies.

Corporate governance potentially covers a large number of distinct economic and societal phenomena, and the borders of the subject are perpetually expanding. As a result, The various views on corporate governance draw the boundaries of various disciplines, including economics, organisational theory, law, finance, management, sociology and politics, which basically reflect those scholars' and practitioners' special interest in the field. However, at the core is a fundamental question about corporate power and wealth and how this should be controlled. The contests implied in the definitions are more fully elaborated in the theories of corporate governance that follow.

1.3 Theories relevant to corporate governance

The development of corporate governance is essentially bound with the evolution of the theory of the firm. The issues on the rationale for existence and control of the firm have remained subjects of interest and of controversy. Adam Smith (1776) noted in the eighteenth century the 'negligence and profusion' to be expected when managers of joint-stock companies handle 'other people's money'. Much later, but in like vein, the work of

Berle and Means (1932) provided one of the fundamental explanations of investors and corporate relationships. They contended that as countries industrialised and developed their markets, the ownership and control of public corporations became separated. The separation of ownership and control has since become the underlying problem of corporate governance, many of the theories relating to corporate control are set in this context. The three clashing schools of thought which have been the most influential for the development of corporate governance are discussed in detail below.

1.3.1 Agency theory

Agency theory emerged from the seminal papers of Alchian and Demsetz (1972) and Jensen and Meckling (1976) explaining the firm as a nexus of contract among individual factors of production. Previously classical economics conceived the firm as a single-product entity with a commitment to the maximisation of profits, and what went on within the firm was considered to be of subordinate interest to what went on in markets. Agency theory argued that economics was able to analyse the working of the firm by explaining it as a constantly re-negotiated contract, contrived by an aggregation of individuals each with the aim of maximising their own profit (Learmount 2004).

Agency theory rests upon the contractual view of the firm. The essence of the agency problem is the separation of management and finance. In this view, the pre-eminent position of shareholder in a firm is not based on an idea that they are the firm's owners. Instead, the primacy of the shareholder is legitimised by the idea that they are the residual risk takers of the firm[1] (Alchian and Demsetz 1972). In an ideal world, when managers raise funds from investors to put them to productive use, managers would sign a complete contract that specifies exactly what they could do under all states of the world and how profits would be allocated between them and the investors. The problem is that most future contingencies are too hard to describe and foresee, and as a result, complete contracts are technologically unfeasible (Shleifer and Vishny 1997).

As a consequence, managers obtain the right to make decisions which are not defined or anticipated in the contract under which debt or equity finance is contributed (Grossman and

Hart 1986). Given the assumption of self-interested motivation of actors, it is assumed that managers will act to maximise their own self-interest. This raises the 'principal's problem' (Ross 1973) and 'agency problem' (Fama and Jensen 1983 a,b).

Agency theory casts management as 'agents' for shareholders (principals), it suggests that in the absence of either appropriate incentives, or sufficient monitoring, the value of a firm can not be maximised, because managers possess discretions which allow them to expropriate value to themselves. There are two dimensions to this including. First, the interests of principals and agents will not coincide, in particular the principal and the agent may prefer different actions because of their different attitudes toward risk. Second, it is difficult or expensive for the principal to verify that the agent has behaved appropriately, due to information asymmetry whereby the principal and the agent have access to different levels of information. Jensen and Meckling (1976) showed how investors in publicly traded corporations incur costs in monitoring and binding managers in best serving shareholders. They identified agency costs as being the sum of the cost of: monitoring management (the agent); binding the agent to the principal (shareholder/residual claimant); and residual losses.

How are the owners of the capital able to protect their investments? For agency theory, this constitutes the corporate governance issues. The solution is hinged on three main governance mechanisms. Firstly, agency theory focuses on determining the most efficient contract governing the principal-agent relationship. A complete contact should contain specifications of the agent duties, rewards and the rights of the principal to monitor their performances (Fligstein and Freeland 1995). Adopting appropriate incentive systems to reward managers is viewed as a key solution to the agency problem. An optimal choice between a behaviour-oriented contract (e.g. salaries) and an outcome-oriented contract (e.g. commissions, stock options and transfer of property rights) becomes crucial. The second mechanism is governance structure. A three-tier hierarchical structure of checks and balances was designed, which includes the general shareholders' meeting, the board of directors and the executive managers. The board of directors is an essential monitoring device by conducting performance evaluation of the management and communicating shareholders' interests to managers. Market approach is the third solution to corporate governance problems. These include a market for corporate control [2] and management labour.[3] Agency theory especially emphasises the facilitation of the efficiency of the market. Corporate governance failure can be best addressed by removing restrictions on factor markets (Fama 1980). Any external interventions and additional obligations imposed on corporations may distort free market mechanisms and should be avoided (Hart 1995).

Agency theory became the dominant approach in the theoretical understanding of corporate governance in the last decades of the twentieth century. It has provided significant insights into the workings of firms. Agency theory re-establishes the importance of incentives and self-interest in organisational thinking (Perrow 1986). It makes specific contributions in the treatment of information and risk implications (Eisenhardt 1989). However, agency theory has its limits. There are many critiques over the simplistic assumptions that it makes. The underlying premise of the theory is based upon an 'individualistic', 'self-interested' human nature. Whereas labelling all motivation as self-serving does not explain the complexity of human action (Doucouliagos 1994), and it also does not suit the demands of social existence (Frank 1994). Moran and Ghoshal (1996) strongly criticised the fact that the pessimistic assumptions of the theory create the conditions which encourage the type of behaviour it assumes.

In addition, agency theory simplifies a firm by confining the participants to managers and shareholders. Whilst it is clear that firms can not operate in isolation without having regard to the effect of their actions on the various stakeholder groups. Firms need to be accountable to their shareholders in order to attract and retain equity investment, at the same time they also need to give real consideration to the interests of their wider stakeholder constituencies (as discussed below). Even the supporters of agency theory concede that the theory presents a partial view of the world, it ignores a good bit of the complexity of organisations. Additional perspectives can help capture the greater complexity (Eisenhardt 1989).

1.3.2 Stakeholder theory

Stakeholder theory is a competing theory of the firm. The intellectual lineage of the stakeholder concept can be traced back to the work of Clark (1916), Dodd (1932) and Berle and Means (1932). Freeman (1984) in his work, *Strategic Management: A Stakeholder approach*, laid the groundwork for developing stakeholder theory as a theory. He initiated a new way of thinking about business organisation by explaining the relationship of the firm to its external environment, and its behaviour within this environment. Clarkson (1994) further defined Stakeholder theory as that the firm is a system of stakeholders operating within the large system of the host society that provides the necessary legal and market infrastructure for the firm's activities. The purpose of the firm is to create wealth or value for its stakeholders by converting their stakes into goods and services.

Stakeholder theory focuses on the entire network of informal and formal relations which determines how control is exercised within the firms and how the risks and returns are distributed among the various stakeholders. The principle of this theory is that companies should be required to serve a number of groups, rather than treat the interests of shareholders overriding all others. Stakeholders are defined broadly, ranging from the highly specific and legal to the general and social by referring to individuals and entities that can be influenced by, or can impact on the achievement of a firm's objectives (Freeman 1984). Those that are immediately and directly impacted by a company's activities are regarded as primary stakeholders, which include shareholders, creditors, customers, suppliers, managers, employees, the state and local communities. The secondary stakeholders include those that can be less obviously or directly affected by a company's success or failure, such as regulators, competitors, media and civic institutions.

Stakeholder theory has been categorised into three types: descriptive, instrumental and normative (Donaldson and Preston 1995). According to Donaldson and Preston, firstly, stakeholder theory is descriptive when it is used to describe and sometimes to explain specific corporate characteristics and behaviours. Secondly, the theory is instrumental in that it identifies the connections, or lack of connections, between stakeholder management and the achievement of traditional corporate objectives. Finally, the theory also can be used normatively, which involves interpretation of the function of the corporation and identifying the moral and philosophical guidelines of the corporate operations.

Although the three perspectives of stakeholder theory share the same core proposition of the stakeholder approach, they differ in an important aspect. For instance, as main theories of stakeholder theory, the instrumental theory legitimises the value of stakeholders on the grounds of stakeholding as an effective means to improve efficiency, profitability, competition and economic success. While the normative theory emphasises the intrinsic value of the interests of stakeholders, managerial relationships with stakeholders are based on normative, moral commitments, rather than on a desire to use those stakeholders solely to maximise profits. A firm established certain moral principles to guide how it does business, in particular with respect to how it treats stakeholders. The justification of the 'intrinsic value' as good or morally right and ideal depends on an emotional faith and social belief rather than necessarily on factual reasons (Campbell 1997).

Stakeholder theory has mainly been covered from a normative perspective. This probably, at least partly, relates to Donaldson and Preston's framing of normative stakeholder theory as the core and most central interpretation of the theory (Berman, Wicks et al. 1999). From a practical perspective, Jones (1995) argued that the instrumental benefits of stakeholder paradoxically result only from a genuine commitment to ethical principles. Firms which create and sustain stakeholder relationships based on mutual trust and cooperation will have a competitive advantage over other firms that do not act in this way. More importantly, the normative theory provides a basis on which concepts such as corporate social responsibility, corporate social responsiveness and corporate social performance which 'carry no clear meaning and remain elusive constructs' can be 'analysed and evaluated more effectively by using a framework based on the management of a corporation's relationships with its stakeholders' (Clarkson 1995). These may provide a strong argument for the phenomenon that stakeholder theory has gained considerable ground in the recent years not only in the fields of corporate strategy, economics and public policy, but also establishing itself especially in business ethics.

In spite of the rising of the stakeholder approach, the development of stakeholder theory has appeared to rely highly on adapting economics theories, rather than constructing a systematic theory to describe more adequately contemporary organisational practices. Stakeholder theory fundamentally shares a common feature with agency theory that the firm is regarded as a nexus of contact,[4] and concludes that managers are agents. In this respect, Stakeholder theory is not in conflict with agency theory. Hill and Jones (1992) noted both the implicit and explicit contractual relationships in a firm and developed a stakeholder–agency theory.

In addition to the above limit, more inadequacies remain within stakeholder theory. For example, it fails to provide adequate guidance to decision making by management. Friedman and Miles (2002) contended that the stakeholder theory presumes a clear-cut, stable and homogeneous boundary among stakeholding groups, between stakeholder legitimacy and illegitimacy, and in managerial perception of stakeholder-corporation relationships. However, in practice stakeholders' interests are so diverse and conflicting that not only may it be incompatible between stakeholder groups, but also within a single group. In insisting that the management has many responsibilities toward its various stakeholders, the theory does not provide a suitably precise formula with which the weighing and balancing of competing considerations are to be made.

1.3.3 Stewardship theory

Stewardship theory was initially established as alternative perspective to agency theory, which proposes that a manager is the steward of a firm's assets, not an agent of the shareholders (Donaldson and Davis 1991; Davis, Schoorman and Donaldson 1997). Proponents of this theory argued that a manager whose behaviour is pro-organisational and collectivistic has higher utility than individualistic, self-serving behaviours. Thus, even where the interests of the manager and the principal are not aligned, the manager places higher value on cooperation than defection. Since the manager perceives greater utility in co-operative behaviour and behaves accordingly, his or her behaviour can be considered rational.

Stewardship theory suggests that depth of knowledge, commitment, access to current operating information and technical expertise are important requirements enabling a firm to be run effectively. As a result of this view, it is argued that directors should empower governance structures and mechanisms to maximise the benefits of a steward. For CEOs who are stewards, their pro-organisational actions are best facilitated when the corporate governance structures give them high authority and discretion (Donaldson and Davis 1991). Structurally, this situation is attained more readily if the CEO is also chair of the board of directors. The CEO-chair who is unambiguously responsible for the fate of the corporation will have the power to determine strategy without fear of being countermanded by an outside chair of the board.[5]

Thus, stewardship theorists asserted that directors should play a greater role in facilitating and empowering managers instead of monitoring and control. Donaldson and Davis further argued that the non-executive board of directors is, by its design, an ineffective control device and the whole rationale for having a board becomes suspect. Therefore, the logical extension of stewardship theory is either towards an executive-dominated board or towards no board at all (Hawley and Williams 1996).

With regard to the linkage between directors' role and firm performance under the stewardship theory, according to the theory, the behaviour of the manager is collective who seeks to attain the objectives of the organisation (e.g. sales growth or profitability) himself. This behaviour in turn will benefit principals such as outside owners (through positive effects of profits on dividends and share prices) and also principals who are managerial super-ordinates, because their objectives are furthered by the manager. Stewardship theory assumes a strong relationship between the success of the organisation and the principal's satisfaction. A manager protects and maximises shareholders' wealth through firm performance, because, by doing so, the manager's utility functions are maximised. Thus, the directors will play a more indirect function, they empower the managers, who will directly be responsible for the performance of the company.

Empirical studies however have presented mixed results for the claims of stewardship theory. Some researchers (e.g. Donaldson and Davis 1991; Finkelstein and D'Aveni 1994) found that stewardship's executive-chaired boards have significantly higher corporate performance. While others contended that there is no significant difference in firm performance between executive-chaired and outsider-chaired boards (e.g. Chaganti et al. 1985; Molz 1988). It is important to note that while stewardship theory is seen as a promising approach for research into manager and director motivations, it is a relatively new theory and needs to be validated by further research (Davis et al. 1997).

In sum, the mainstream theories of corporate governance rest their ideas and assumptions on the theory of the firm.[6] The competing/alternative approaches have different purposes and different implications. They all tend to acknowledge the complexities of organisational life, and therefore have made tremendous contributions to the understanding of corporate governance. However they also have different validity criteria and different limits either being narrow or poorly developed theoretically.

1.4 Corporate governance in practice

Corporate governance practices vary across countries, whereas similarities in some major corporate governance dimensions have been identified between certain sets of countries. For instance, the role of the firm and accountability, the ownership structure, the board system, the role of the banking system in the economy, an efficient functioning capital market and the level of product market and capital market competition. Consequently the governance literature (Franks and Mayer 1992; Weimer and Pape 1999; De Jong 1989; Moerland 1995a, b; Khan 2003) has identified a variety of corporate governance regimes.[7] This section reviews two generic systems, namely the Anglo-American system and the German-Japanese system, as well as corporate governance mechanisms in the transition economies of Central and Eastern Europe,[8] with a focus on the solutions to the corporate governance problems faced and its tradeoffs.

1.4.1 Anglo-American system

The Anglo-American system mainly groups the models found in the US and the UK, as well as other countries such as Canada and Australia. The agency problem is particularly acute in this system with very dispersed ownership. Roe (1994) characterised this system as ‘strong managers, weak owners’. Because ownership dispersion typically creates passive shareholders, It is not rational for any investor who owns small minority interests spending time and incurring cost to monitor management as this provides a ‘free ride’ for other investors. The growth in shareholding by institutional investors (e.g. pension and mutual funds) may overcome the free-rider problem, while it is sceptical that institutional shareholders could pose a credible threat to management in terms of the conflicting interests of fund managers, information asymmetry, willingness and capabilities (Romano 1993; Short and Keasey 1997). In any event, small shareholders may lack the power and influence to extract information which could reveal expropriation or mismanagement. The only disciplinary mechanism available to small investors is selling their shares. Exit is more practical than voice (voting). Thus the de facto control rights over corporate assets and strategies fall into the hands of the incumbent management. This potentially engenders conflicts of interests between entrenched managers and dispersed shareholders.

The Anglo-American system provides flexibility to address this issue by employing some internal, external and market techniques. Given the domination of public traded companies, this system is characterised by competitive managerial capitalism, where arm’s-length, low-trust contracts have a short-term financial focus and shareholder value reigns.

At the macro level, the advanced legal and regulatory frameworks protect shareholders and promote securities markets by establishing an environment of equal access to information and especially protect small investors. Capital markets present high Liquidity with widely held nature and lack of significant intercorporate relationships. Firms seek long term financing through equity and corporate bond markets. Financial institutions such as commercial banks have a limited role as a potential monitor of listed companies. Whereas with deep and liquid markets, the share price at any point in time provides an unbiased signal to management performance and therefore monitors the firms. An active market for corporate control, often referred to as the takeover market, is also a very important means to impose discipline on management. The takeover process through mergers, or tender offers, or leveraged buy-outs, allows control to be transferred from inefficient to efficient management teams and encourages a convergence of interests between the corporate management and the shareholders (Franks and Mayer 1990).[9]

At the micro level, the board of directors are legally and practically charged with directing and monitoring the business management on behalf of shareholders. The one-tier board structure consisting of executive as well as non-executive directors relies on both board committees and an internal control system, overseeing the management's actions. From a legal point of view, executive directors are responsible for the operation of the company. From a practical point of view, non-executive directors provide executive directors with advice on major strategic decisions. Both executive and non-executive directors are primarily accountable to shareholders. On the incentive side, there is the presence of senior management compensation, which is related to the performance of the firm. The prevalent forms of this remuneration are stock-option plans and multiyear plans. By using compensation tied to share price, such reward system is regarded as an important device capable of aligning more closely the interests of management and shareholders.

Whilst countries in the Anglo-American system have striking similarities, it is noted that corporate governance arrangements are not identical in those countries. For example, there are large differences in the practice between the UK and the US models.[10] First, the independent outside directors make up a majority of the board in the US, while the notion that the board is there to oversee executive management is constantly challenged in the UK. The board is seen as a genuine unitary body with responsibility for driving the company forward. Executive and non-executive directors are not accorded different roles and oversight function remains secondary. Moreover, powers to enforce fiduciary duties are weak in the UK. In practice, enforcement is almost non-exist. The higher fiduciary duties of directors in the litigious US has resulted in numerous lawsuits against directors (Rickford 2003). In addition, the chairman and chief executive positions are almost always separated in the UK, the exact opposite of US practice. Furthermore, although the US is often cited as the example of governance monitoring by an active market for take-overs, US companies bristle with 'poison pills' [11] and other obstacles such as extensive state legislation, which discourages takeovers. This is completely different in the UK, where none are legal.

The market solution of the Anglo-American system to corporate governance problem is often criticised for its fundamental flaw in short-termism (Jacobs 1991; Charkham 1994; Sykes 1994; Macey and Miller 1995; Blair 1995). According to the myopic market argument,[12] the institutional arrangement of the Anglo-American system encourages management to focus on the short term strategies speculatively by sacrificing the firm's long term competitive capability. This is due in part to the system's reliance on takeovers, proxy fights, and boardroom coups to control agency costs (Roe 2001). This problem becomes more severe as the takeover deterrent becomes more vigorous, causing managers to look for quick fixes to keep the shareholders satisfied (Porter 1997). It is also argued that the market is not a reliable indicator of the corporate performance, because it often misprices assets. The change of share prices may simply result from speculation about the behaviours and psychology of market participants and prejudices of investors rather than corporate fundamental values (Shiller 1989). The market for corporate control therefore loses its credibility as an efficient disciplinary mechanism. The threat of hostile takeover may distort and distract from the true target of value creation. The stock option plans, as part of the executive compensation package, also induces short-term behaviour of management.[13]

1.4.2 German-Japanese system

Stakeholders, in particular creditors and employees, play an important role in a number of countries in influencing how corporate governance systems work in practice. It is prominent particularly in Germany and Japan, and can also be found in other continental European Countries, including France, Italy, and Netherlands. The governance spectrum that stems from these countries is classified as the German-Japanese system.

This system, in contrast to the Anglo-American system, is characterised by relational high-trust, long-term contracting with stakeholder and community orientations, it is also referred to as 'cooperative capitalism' (Windolf and Beyer 1996). A concentrated ownership structure and cross-shareholding are pervasive in this system. The capital market and the market for corporate control do not function well as external control mechanisms. Banks have significant monitoring and disciplining role on firms' behaviour through close intercorporate relationships, ownership of large equity holdings and active boardroom participation.[14] While internal governance system plays a more pronounced role. The management is monitored by a board, and by large companies (controlling blockholders). In this system, the interests of employees are salient and can exert substantial influence on managerial decision making. The role of employees is long term which reflects in the long employment tenures and high investment in firm-specific skills. Meanwhile, senior managers tend to be internally promoted. Management compensation is much closer to that of average employees' schemes and lack strong shareholder-oriented incentives such as stock options.

Despite the broad similarities, some differences arise within the system. In Germany, board structures are often more complex. In the sense of incorporated firms, a unique two-tier board regime, which comprises the supervisory (i.e. non-executive) board and the management (i.e. executive) board, is employed to govern and manage the company. The supervisory board possesses power to make strategic decisions, hire (or fire if necessary) and supervise members of the executive board. It consists equally of representatives of labour, appointed through the employees' trade union and representatives of capital, appointed by the shareholders. Such composition of the board is deemed as a consequence of German co-determination [15] policies which see large companies as informal partnerships between labour and capital.

In Japan, major companies tend to be closely related by an informal interlocked business network, the so-called *keiretsu*, which is based upon mutual shareholding and connected directors. Banks play a central role as major creditor of long-term and short-term capital of the firm as well as the shareholder. Intercorporate shareholdings serve to insulate the management of member companies from the threat of a takeover. The main bank closely monitors management of the company to reduce insolvency risk, and when a member company experiences a financial difficulty, the bank often take over the management until the company has been restructured and revived. The main bank system has been the main pillar of corporate monitoring and governance in post-war Japan (Aoki and Patrick 1994). In addition to the stake of shareholders, Japanese companies are organised and governed as a multi-stake sharing unit, representing the interests of its employees, creditors and suppliers. Although there is no formal representation of employee interests at board level, encouragement of communication throughout all levels of the organisation is ubiquitous in Japan.

Given the large shareholders controlling the board and having easy access to inside information, concentrated ownership of the German-Japanese system reduces the problem of monitoring management. Owners with substantial stakes can exercise considerable power and reduce the propensity of executives to act in a self-serving manner (Berle and Means 1932). It may also mitigate free rider problems of corporate control (Shleifer and Vishny 1986).

However, there are corresponding trade-offs. One of the major shortcomings of this system could be the potential costs to minority shareholders. La Porta et al. (2000) argue that in governance systems with emphasis on stakeholders, there is typically relatively low protection of minority investors and extensive expropriation of minority outside shareholders by controlling shareholders. The presence of controlling position gives blockholders the ability to pursue other benefits than market performance (e.g. higher share price). For instance, benefit from utility-maximisation goal, which includes engaging in costly investments in pet projects or activities associated with politics, diversion of assets to companies owned by the controlling shareholders, salary and bonus contracts unrelated to performance. If small investors do not have the legal rights to protect their stakes or due to the free rider problem and information asymmetry, they may have to bear more of the costs of such non-wealth maximising behaviour undertaken by the controlling shareholders. In addition, the preceding arguments suggest that significant ownership concentration is likely to reduce the need and motive for governance reform and thus limit the growth potential of companies, which may be attributed to the close link between concentration ownership and control ambitions (Lutgart Van den Berghe 2002).

1.4.3 Transition economies

The corporate governance mechanisms in the post-communist Central and Eastern European countries have seen formation and development in the transformation process towards a market economy.[16] The mass privatisation embarked on in these countries, has been regarded as a means to bring about the transition. Given the crucial role of privatisation, the nature of governance structure in the transitional economies is closely linked to the approaches of privatisation adopted, and in turn, essentially conditioned by the country's historical institutions and social environment.

Countries that are in the transitional process from central planning to a market economy all face the same problems. They all inherited an unsound legal system, with many having to construct basic institutions from scratch. Coupled with the lack of financial discipline (soft budget constraints), the system transition was initially placed on the ground with an absence of the necessary prerequisites of an institutional regime. They also have a large sector of formerly state-owned enterprises that need to be restructured and in many cases phased out. The overwhelming mass privatisation process in this context yielded a dominant corporate control pattern across the region — insider control (manager control). In the absence of well functioning laws, managers with or without shares can effectively expropriate minority investors.

The planning system is normally described as a common feature of all socialist economies,[17] but they also had great differences prior to reform in terms of the level of development, the degree of macroeconomic stability and the extent of microeconomic decentralisation. These generated major implications for the objectives of privatisation concerning pace, accountability and efficiency. Consequently, these transition economies each have their own approach to solving the problems they encounter. In general three approaches to privatisation have been observed: the first is a voucher scheme used in Russia and the Czech Republic, state assets are distributed free of charge (or almost free) to the general public through vouchers that can be traded for ownership shares in state-owned firms. The second method allowed managers and employees to buy company assets, Poland adopted this method. The third approach followed in Hungary involved selling majority shares to an outside investor (often a foreign investor). In spite of using a mixture of approaches (e.g. voucher-based sales alongside management-worker buy-outs) and varying degrees of implementation, the different methods of privatisation have resulted in distinct outcomes in the level of development of corporate governance in Central and Eastern Europe.

Boeri and Perasso (1998) outlined that Russia's privatisation process was quite rapid but resulted in much less outsider control and a poor structure given the initial concentration of ownership into the hands of insiders; The Czech Republic's speed of privatisation was very rapid, led to a significant outside ownership (investment funds and banks), but a rather weak control structure; Hungary's privatisation process was less rapid but resulted in a stronger control structure and more outside ownership; Poland's process was slower but achieved a reasonable level of outside ownership and control.

The implementation of radically different incentive and control mechanisms developed using a Western approach has not resulted in significant success.[18] Economic growth in these countries has turned out to be lower than expected. Privatisation does not seem to have brought about the anticipated improvements in corporate efficiency. The state and 'para-state' institutions such as privatisation funds remain the largest shareholders in companies. Internal owners dominate in many companies, while the external owners do not have enough voting power to control the companies and thereby to ensure for themselves appropriate returns. The capital markets are under-developed and do not facilitate the inflow of new capital as intended. Further, market transactions are often based on the abuse of inside information.

Nevertheless, as the process of transformation has become more advanced, much work needs to be done in the area of corporate governance in Central and Eastern Europe. In particular, the EU integration process will serve as a source of constant and steady pressure to improve corporate governance. Even those countries that are not yet being integrated into the EU will experience pressure to reform their corporate governance practices, not for from EU pressure directly, but rather from competition with the EU and elsewhere for foreign direct investment. During the process of further evolution, the distinct characters of governance mechanism will persist both within these transition economies and in comparison with Western systems as a whole. In spite of the influence of economic factors, recent researches (e.g. McCarthy and Puffer 2002, Buck 2003, Roth and Kostova 2003) stress that social institutions like traditions, social norms and customs must be considered when explaining development of formal and modern governance structure in transition economies.

In summary, there are primary distinctions between the three broad systems of corporate governance. Corporate governance issues are different across the countries. The actual practices adopted in addressing the issues therefore vary accordingly. Different corporate governance systems have incentive and control structures that entail different trade-offs.

1.5 The evolution of corporate governance and debate

The preceding discussion has highlighted the great cross-national differences of corporate governance system in terms of the essential aspects. Corporate governance systems however are not static, they evolve constantly as the business environment changes, both at the level of regulation and in practice, not only in advanced economies but also in emerging markets. The origins and development of corporate governance regimes have been discussed at great length in the existing literature.[19] This section focuses on the salient changes in the two major competing systems (i.e. the Anglo-American system and German-Japanese system) since the mid-1990s, when institutional transformation has been most pronounced. It also tries to explain the evolution and persistence of national differences by using existing theories.

1.5.1 Empirical evidence of change

The Anglo-American system and German-Japanese system of corporate governance has begun to change significantly since the second half of the 1990s. The sources for change have come from a broad range of internal and external factors.[20] There is considerable independence between them, and the pressures for change are varied in different countries.

Among these two key driving forces can be identified. First, the strong stock market correction has exposed some systematic weaknesses in respect of auditing and disclosure. In particular a series of corporate scandals and failures in a number of countries has raised serious questions about whether boards have been able to exercise independent judgement over the monitoring of management. Second, globalising product market, and especially the liberalisation of international financial markets has increased cross-border mergers and acquisitions as well as the activity of international investors. Faced with global competition, corporate governance systems have been under pressure for adjustment in searching for sustainable competitiveness.

In the US, since the 1980s, large institutional investors, consisting of pension funds, mutual funds, insurance companies and others have become shareholders of an increasing number of corporations. Corporate governance has evolved to include large shareholder or financial investor monitoring, though institutional investors have not acquired the kind of concentrated ownership positions required to be able to play a dominant role in the corporate governance process (Edwards and Hubbard 2000). Corporate structures have evolved that not only maximise shareholder value, but also the value of the firm (Halpern 2000). This has been seen as a legacy of the LBO, which introduced strong monitoring by a party with a financial interest in the equity of the firm.

Considerable changes have also occurred in response to the problems and pressures of the Enron, WorldCom, Tyco scandals, as evidenced by extensive revision of governance rules and regulations in 2002. The Sarbanes-Oxley Act of 2002 (the most far-reaching corporate reform legislation since the New Deal was introduce in the 1930s), as well as new governance guidelines from the NYSE and NASDAQ (e.g. new listing requirements, governance rating agencies, and tougher judicial opinions about corporate governance issues), at the most general level aim to fix the audit process, increase board independence, and improve disclosure and transparency.[21]

In the UK, the collapse of the Maxwell publishing group at the end of 1980s initiated the Cadbury Code of 1992, and cases through the 1990s such as Poly Peck, BCCI and Marconi stimulated a series of further recommendations. The Combined Code issued in 2003, incorporates the conclusions of many reports including Cadbury, Hampel, Greenbury, Turnbull, Smith and Higgs. It has provided a major avenue for board reform, as well as an important new approach to industry self-regulation.[22]

Despite the reforms of rules and regulations, the debate on companies' responsibilities to other stakeholders, other than their shareholders, has been increasing. For instance, the Royal Society of Arts (RSA) Inquiry in the UK produced a study called 'Tomorrow's Company' in 1995, which suggested responsibilities to a wider range of stakeholders. In addition, the UK economy is arguably more 'stakeholder economy' like. The free market property rights launched by Mrs Thatcher from 1979 has taken the opposite direction under the Labour Party regime (Clarke 1998). As a consequence, Companies are becoming more sensitive to long-term stakeholder relationship.

Changes in the German system are more pronounced than that of American and British counterparts, as a result of internationalisation and deregulation of the capital markets throughout the second half of the 1990s. An array of literature has documented a series of changes affected the main aspects of the system. The legal reforms have promoted greater transparency and disclosure (Cromme 2005). The proportion of shares held by the foreign and domestic institutional investors have increased, while the large banks have reduced their long-term shareholding and seats in the supervisor board. Investor protection and the institutional basis for the control of management have improved considerably (Haeckethal et al 2005; Vitols 2005). A share-related bonus has become common for senior managers in large firms. Shareholder value is now widely used, and many large firms have set up 'investor relation' departments along Anglo-American lines and adopted international accounting standards (Ferner and Varul 1999). Firms have increased the proportion of value added they devote to dividends and reduced that devoted to labour (Beyer and Hassel 2002).

The transition process in Japan is slow but rather dramatic. The notable business network that was developed and perfected in the country's high growth period, has become obsolete and no longer workable in the era of prolonged deepening economic recession and globalisation. The traditional keiretsu linkages have been unravelled, as a consequence of mega-mergers within the main bank system and the reorganisation of large manufacturers (Shimotani 2004). The committee system introduced through legal reforms, allows firms to adopt the Anglo-American style of board system that use committees with a majority of outside directors. As various legal changes have been implemented to strengthen the external monitoring function within the board and shareholder rights, both foreign and domestic institutional investors have also become increasingly active in their involvement in corporate governance (Seki 2005). Incentive schemes and managerial stock options have been introduced changing the pattern of managerial compensation. There are also some signs suggesting an imminent demise of 'life time employment' practices (Genda and Rebick 2000).

1.5.2 The evolving debate

Contemporary study on comparative corporate governance was initially centred on the issue of differences in national governance practices. In the 1980s and early 1990s there was a debate about the strengths and weaknesses of different national systems for generating competitiveness for corporations themselves and the national economies as a whole. There was considerable interest in the superiority of German and Japanese systems during this period, when both of the countries experienced economic booms. The operating advantages of its greater reliance on associations and networks in the governance of firms had been extensively reported (e.g. Franks and Mayer 1992; Gilson and Roe 1993; Kester 1992 and Turnbull 1995), which were looked to by their US counterparts for guidance for reform of their domestic market governance regime.[23]

The focus of the debate has shifted from difference to change since the second half of the 1990s. With the success of a 'new economy' in the US, the Anglo-American system has become admired in producing superior economic performance, in particular its robust ability to self-correct in the wake of external shocks (Boot and Macy 1998; Gilson 1998). America's triumph is buttressed by the dramatic downturn of economics in Japan and German. It is in such a context that the process of change which can be empirically observed above has initiated a fresh debate on institutional transformation and how it might be conceptualised. In particular, it has been argued whether the changes in corporate governance signal radical system transformation and a process of convergence, or whether they can be absorbed into existing institutions by processes of institutional adjustment.

Some scholars argue that there are growing pressures (e.g., economic efficiency, global competition) on national corporate governance systems to converge on a model that supports a focus on shareholder value, i.e. a model closely resembling the Anglo-American model (Nestor and Thompson 2001; Hansmann and Kraakman 2002; Kester 1996). Many others however contend that the systems' differences will persist, and corporate governance systems around the world will continue to diverge (Bebchuk and Roe 1998; Bratton and McCahery 1999; Branson 2001).

The change in view during the 1980s and early 1990s corresponds more to external events (i.e. the changing situations of countries' economies) than to developments in the corporate governance. Although the two competing regimes have each appeared to be 'dominant' at particular points in time, the striking corporate governance problems experienced in each make it clear that, as evidence shows, neither one is perfect. After the Enron scandal and other corporate crashes commencing in 2001, the viability and integrity of the US system of corporate governance has been called into question.[24] This has triggered a rethinking and re-examination of frameworks for corporate governance across countries globally, which is claimed going beyond the scope of aftermath of Asian financial crisis (OECD 2004). The debate over convergence and divergence has shifted further by focusing on a country's distinctive economic purpose and institutional structure in adjustments of the existing model or systemic changes.[25]

1.5.3 Theoretical analysis of institutional change and persistence

The evolution of corporate governance and related working hypotheses have their theoretical grounds. Contemporary research has indeed generated a variety of theoretical perspectives on the dynamics of corporate governance systems, though the link between these perspectives and empirical evidence is arguably quite weak (O'Sullivan 2003).

One of the influential theoretical approaches for conceptualising the evolution process of corporate governance is the cross-reference hypothesis, which presupposes that corporate governance systems are divisible. One system's components can be adapted for use in another system without significant frictions or perverse effects (Kester 1996). Some scholars further contend that each system can and should learn from each other, the failures of one system can be ameliorated through interpolation of devices form other systems (Aoki 1990; Roe 1994). This implies that different corporate governance regimes possess equal competitiveness.

From this perspective, the developments of corporate governance systems around the world are sometimes seen in terms of 'hybridisation' of national systems (Jackson 2003). Hybrids may prove stable if practices can be configured to 'fit' within a firm-specific comparative environment, existing firm coalitions or a national institutional context (Streeck and Thelen 2005). Conflicting logics may sometimes even help balance each other and preserve beneficial requisite variety in the long run. For instance, Old structural elements from stakeholder-oriented models (e.g. employee co-determination) are being recombined with newer elements of shareholder-oriented models (e.g. transparency and disclosure) so as to arguably produce distinct 'hybrid' best practices based on those unique combinations of features.

Another prevailing approach is rooted in neoclassical economics, which advocates the central role of the equity market and the pursuit of shareholder value in the development of firms and countries. According to this perspective, the shareholder-oriented system reflects the operation of efficient evolutionary processes (Miller 1997; Macey 1998). It holds that when corporations are run to maximise shareholder value, the economic performance of both the particular corporation and the economy as a whole can be enhanced.[26] The stock market boom throughout the 1990s and the prosperity of the US economy in the late 1990s have proved that the Anglo-American system of corporate governance works best on this count (Hansmann and Kraakman 2002).

With this trend in globalisation, in which the integration of global financial markets has radically changed the corporate financial landscape in a global way, and brought firms of different countries in direct competition, convergence towards shareholder value will lead to the more efficient allocation of capital and hence improve the investors' access to investment opportunities and companies' access to financing (O'Sullivan 2003). Companies (and the nation) will consequently gain major competitive advantages. Economic efficiency thus drives the existing systems with the shareholder at the centre as a result of an evolutionary process of the capital market.[27]

Derived from traditional institutional theory, which addresses the embededness of corporations in a nexus of formal and informal rules (North 1990; Powell and DiMaggio 1991), comparative study largely remains to conceptualise corporate governance in terms of its embeddedness in different social contexts. The role of institutions on formation and evolution of corporate governance is seen in two dimensions: first, institutions pose constraints which stem from coercive political regulation (Roe 1994), imitation of cognitive models in response to uncertainty (Dobbin 1994), or other normative pressures to establish legitimacy (Biggart 1991). Second, institutions may also create opportunities for specialisation around diverse economic 'logics' and thereby yield comparative institutional advantages for different business systems or varieties of capitalism (Whitley 1999; Hall and Soskice 2001). Institutional environments are nationally distinct, they therefore drive corporate governance practices to become more homogenous within countries and diversified across countries. The national differences of corporate governance systems in turn reflect the influence of various institutions.

This type of institutional theory provides theoretical rationale for an explanation of the evolution of corporate governance on the one hand. On the other hand, it underpins the arguments against other competing hypotheses. In opposing the cross-reference approach, Schmidt and Spindler (2002) introduced the concept of complementarity of path dependence,[28] and demonstrated that national corporate governance systems are regarded as consistent systems of complementary elements. Institutional changes may be unstable if their components lack complementarities — resulting in further institutional change, inefficient outcomes, or abandonment of an initial change (Bratton and McCahery 1999). This is no more evidence than in the privatisation process in the transitional economies of Central and Eastern Europe, where corporate governance practices are being imported from systems used in traditional market-based economies. Bratton and McCahery further (2002) argued that each national governance system is tied together by a complex incentive structure and trade offs. Interdependencies between each system's components and the incentives of its actors create significant barriers to cross reference to and from other systems. Therefore neither global convergence that eliminates systemic differences nor the emergence of a hybrid best practice can safely be projected.

The superiority of the Anglo-American approach to corporate governance is also rejected by different strands of the theory. Roe (2000) argued that the American system of ownership and control was a political and historical contingent dating back to the American Revolution. Specifically, Berle-Means corporation (i.e. ownership dispersion) and exclusive reliance on the market for corporate control in the US was primarily the result of politics that forced corporate ownership to remain fragmented and deterred big financial institutions from taking a close interest in the activities of corporations. Wymeersch (2002) contended that in the long run economic structure and efficiency may be unrelated to governance convergence. The lessons from the early 1990s show, the effect of corporate governance on economic efficiency may be very mistaken. Economic efficiency is determined more by the business cycle, monetary policies, and fundamental changes in technology than by governance mechanisms.

To sum up, empirical evidence has shown that corporate governance is very much an evolving area. Its development has essentially been driven by historical and institutional contingency. This is particularly evident in the corporate governance reforms in the major economies in recent years. Comparative corporate governance has tried to conceptualise the dynamics of integration and diversity of corporate governance systems by developing various theoretical approaches. Although the theoretical debate is unlike to reach a consensus, empirical evidence suggests that equal importance should be placed on both the significant changes and the persistence of the differences of corporate governance regimes across global economies.

1.6 Conclusions

This chapter presents an overview of existing literature concerning the main aspects of corporate governance. Corporate governance is a relatively new subject and it is essentially tied in with the notion of the corporation and their practices. The evolution of the theory of the firm has underpinned the development of the theories of corporate governance. The different theoretical approaches and the diversity of practices around the world almost defies a common definition.

The cross-country historical evidence indicates that corporate governance issues in a transition economy differ from that in a developed market economy, even among advanced economies, corporate governance problems also vary. Different corporate governance problems ask for different governance solutions. The different forms of corporate governance have proved to derive from and be successful under different contingencies, and no single form has yet emerged as being universally superior, and therefore become normative.

For a better understanding of the complex issues of corporate governance, both in the developed economies and particularly in the developing and transition economies, we need to go beyond the current mechanisms and institutions of corporate governance, to consider more broadly questions of how corporations allocate resources and returns, and how they contribute to economic development. This entails further study of the relationships between firms and the institutional environment in which they exist.

Chapter 2 Corporate governance of banks

2.1 Introduction

The previous chapter presented a general overview of corporate governance. This chapter turns to the specific corporate governance issues of banks. Banks are a pivotal component of any economy. As the principal financial intermediary, banks provide financing for commercial enterprises, basic services to a broad segment of the population and access to payment systems. When banks efficiently mobilize and allocate funds, this lowers the cost of capital to firms, boosts capital formation, and stimulates productivity growth. Banking crises (defined as much or all of bank capital being exhausted), for instance, the Savings and Loan crisis in the US; the financial crisis in Asia, can be extremely costly in terms of the direct costs to taxpayers and to the economic growth (Forbes 2004). Thus the functioning of banks has ramifications for the operations of firms and prosperity of nations.[1] whilst the governance of banks has faced increasing challenges, in particular, the trends of globalisation, deregulation and financial innovation bring about high risk for banking institutions which has potentially weakened traditional governance process.

Little attention, however, has been paid to the corporate governance of banks. This is particularly salient in contrast to the fact that a significant amount of attention has been paid to the role that the banks themselves play in the governance of other non-financial firms (discussed in chapter 1). There has been little research, either empirical or theoretical, on this topic. Early literature is limited mainly to empirical research using data on the US banks (Diamond 1984; Saunders et al 1990; Allen and Cebenoyan 1991; Prowse 1995; Gorton and Rosen 1995), which assumes that banks conform to the concept of the firm adopted in the Agency Theory, banks are treated as if they were the same as any other firm. Recent research attempts to address the unique corporate governance problems of the banking firm (Caprio and Levine 2002; Macey and O'Hara 2003 a, b; Levine 2003). It argues that the banks have significant differences with respect to corporations in other economic sectors. Corporate governance reforms in the non-financial sector may not be appropriate for banks. This justifies a special interest in banks' governance problems (Prowse 1997; Adams and Mehran 2003).

This chapter reviews the key issues of corporate governance of banking firms. The emphasis is place on an overview of the special features of banks and their governance mechanisms. The chapter is organised as follows. First, there is a discussion of the differences between banks and other non financial firms in terms of their corporate governance, addressing the question of why banks are different. There is then a review of the corporate governance practice of banks, which is considered in three dimensions, i.e. ownership, regulation and internal control mechanisms. Finally, conclusions are presented.

2.2 Corporate governance problems of banks

The typical principal-agent problem between managers and shareholders exists in every firm. The agency problem of banks however is likely to be particularly acute (Macey and O'Hara 2003a). Because this problem is raised to a new dimension in many aspects in the banking context, due to a number of institutional characteristics particular to banks.

2.2.1 Corporate governance structure

The number of parties with a stake (interest) in a bank's activity complicates the governance of banking institutions. Banks are distinguished from other business firms in that they provide deposit and loan products. Banks are in the business of managing assets, which are funded by deposits or other liabilities (Heffernan 1996). In other words, banks' liabilities are largely in the form of deposits, which are available to their creditors/depositors on demand. Therefore, in addition to investors (shareholders), and the other large number of stakeholders (such as employees, debtors, and suppliers etc), whose economic well-being depends on the health of banks, depositors' savings are also at stake. When banks fail, they can adversely affect household wealth. Thus depositors have a direct interest in bank performance.

Moreover, the nature of the banking business decides that the structure of a bank's balance sheet is very different from that of other firms. On the one hand, since banks rely heavily on deposit receipt for the mobilisation of funds, they typically have a high debt-equity ratio. On the other hand, banks also have a liquidity function issuing liquid liabilities and holding illiquid assets. Banks consequently critically rely on depositor/creditor confidence. These features of banking business make banks very vulnerable to shocks and pose broader risks to the economy.[2] Banks therefore are subject to a high level of government regulation. Regulation alters the parameters of the agency relationship in banks by introducing a new party, i.e. regulators, who act on behalf of society at large and develop substantive standards and other risk management procedures which correspond to the overall economic and operational risk faced by banks.

Furthermore, closely related to the above point, governmental interests are also at stake. In a broader sense, the stability of the banking sector has a large positive externality. Banks are the key institutions maintaining the payment system of an economy that is essential for the stability of the financial sector. Financial sector stability in turn has a profound externality for the economy as a whole. It is argued that the banking system is particularly vulnerable to contagion effects (Diamond and Dybvig 1983), a mismanaged bank may lead to a bank run or collapse, which can cause failure in providing liquidity to other sectors of the economy, and serious erosion of public confidence in the banking system as well as runs on solvent banks, giving a great impact on the real economy.[3] Thus governments usually have a strong interest in the stability of the banking sector, which manifests itself in, for instance, regulations, deposit insurance and government ownership of banks.

Finally, rating agencies also have an interest in banks' performance. Ederington et al. (1987) showed that ratings bring information to the marketplace beyond that conveyed by publicly available information alone. By providing independent analyses of the strengths and weaknesses of banks, rating agencies play a significant role particularly in influencing corporate governance of banks. To internal stakeholders, i.e. managements and boards, their comments can be early warning signals which can impel bank strengthening measures. To external stakeholders, for instance, investors/lenders and depositors, they provide clear measure of creditworthiness of banks; regulators also use credit ratings to determine regulatory capital requirements and permit investments.

2.2.2 Government's safety nets

Most countries have financial safety nets, including such major policies as explicit or implicit government deposit insurance or guarantees,[4] and bank regulation and supervision,[5] which aim at limiting the contagion of a bank failure to other solvent banks and making financial system breakdowns less likely and limiting their costs if they occur. These safety nets however affect the incentives of private stakeholders to monitor banks and widen the governance gap.

In theory, bank depositors appear particularly well positioned to impose discipline on bank management (Garten 1986). Bank deposits form an essential ongoing source of funds and the concerns over possible bank runs suggest that depositors do react to changes in bank risk. For instance, faced by increasing costs and greater uncertainty, depositors can either demand a higher return or withdraw their deposits (Demirguc_Kunt and Huizinga 1999; Berger 1991). In practice, such incentives for monitoring bank risk taking are adversely affected by explicit government deposit insurance schemes, and implicit guarantees, i.e. 'too big to fail' policy. Specifically, Rochet (1992) and Blum (2002) argued that in the absence of corporate governance problems between bank shareholders and managers, if bank deposits are uninsured, the bank's risk choice will be efficient. The reason is that banks internalise the impact of their risk choice on depositors since these in turn will demand higher compensation if the bank incurs higher risk. In such a world there is no moral hazard. Conversely, if deposits are insured, then the bank will choose a higher than the efficient risk profile at the expense of depositors. The reason is that depositors will not demand a higher return in response to higher risk choices by the bank. In such a world the bank's choice of its risk of default is subject to moral hazard.[6]

The moral hazard problem associated with government guarantees can also occur in banks. Under government deposit guarantees, a bank's ability to attract deposits no longer reflects the risk of their asset portfolio. It makes it difficult to hold bank managers accountable for their poor performance, and to make the threat of any legal and bankruptcy procedures credible. Banks may also not be interested in improving their corporate governance, since they do not need to rely on large uninsured depositors who might have strong incentives to monitor them. As a consequence, banks are encouraged to finance high-risk, high-return projects.[7] There seems to be considerable support for the notion that these incentives have contributed to the financial crises experienced in Western banking, for instance, the US Savings & Loan crisis of the 1980s.[8]

Similarly, government regulations and intervention can also encourge moral hazard behavior, though advocates of deposit insurance often claim that the risk of moral hazard can be contained through effective prudential regulation and supervision of the banking system. Llewellyn (2000) argued that the presence of regulatory agencies may have an impact on the incentives faced by private sector providers of bank corporate governance. Various private stakeholders of banks may look to the government whenever banks are in trouble. Excessively intrusive regulation and supervision may not only reduce the incentives of market participants to monitor banks, but also the banks directors', weakening both the effectiveness of market discipline and internal corporate governance (AEPC 2002).

2.2.3 Opaqueness

Banks' activities are more opaque than non financial firms, which make the information asymmetry and the agency problem particularly serious (Caprio and Levine 2002; Levine 2003). This type of opacity is reflected in the difficulty of evaluating the quality of loan portfolio of a bank, because banks' loans are not generally traded in liquid secondary markets. It also has to do with the difficulties that surround the valuation of bank assets for which there are no objective values, particularly when loans become non-performing. Rules for loan classification, loan loss provisioning, and income recognition seek to correct this information problem, but such rules are difficult to enforce in reality. Banks can hide problems easily, partly due to the intertemporal nature of banking (i.e. the feature of intermediation process), banks can alters the risk composition of their assets more quickly than most non financial firms, for instance, bad loans can be hidden by extending loans to clients that have failed to pay previous debts. In addition, structural changes in the banking industry, together with unprecedented levels of financial innovation, resulting from the trends of globalisation, universal banking and the use of new technology, have exacerbated the opacity of the banking business. A bank's scope is often hard to grasp and their operations may be impossible for outside observers, even banking supervisors, to monitor.

This opaqueness restricts the corporate governance actions of a bank's private stakeholders. It is particularly problematic for depositors, who are relatively financially unsophisticated and therefore unable to judge adequately the quality of bank assets, and thus the default probability of individual banks (Baltensperger and Dermine 1987). Consequently, this gives strong incentives to bank insiders to pursue their own interests at the expense of the interests of other stakeholders. The board of directors may be easily manipulated or bypassed for any serious evaluation of bank managers, and shareholders may not have adequate information for them to meaningfully participate in corporate decision-making. There are a number of examples of abuses and systematic looting by bank managers or controlling owners. The collapse of Barings in 1995 is a typical example of the information problems.[9]

2.2.4 Market competition

Much of the literature asserts that competition is usually not keen in the banking sector. To the extent that external controls coming from the product market competition and the threat of takeover directly disciplines the behavior of managers (discussed in chapter 1), this turns out to be weaker in banks than in other firms (Prowse 1997).

In part, because it lacks information. The opacity of banking weakens both of these forces. Levine (2003) argued that product market competition is less intense in banking, because banks are prone to form long term relationships with their clients in order to overcome information problems, for instance, notably in Germany and Japan. Whilst it is conducive to mitigate information asymmetry and allows efficient monitoring, it often causes barriers to competition. Takeovers would also be expected to be less frequently where information is poor. The regulatory delay associated with the approval process and the ownership of banks by government (see more on this below) may further effectively prevent hostile takeovers (Caprio and Levine 2002).

Inadequate competition is also largely attributable to various government regulations for the stability of the financial market, such as entry barriers and restriction of services provided, and the government ownership of banks in some countries. Weak competition also characterised the market for corporate control: hostile takeovers tends to be rare in the banking sector (Prowse 1997). Barth et al. (2001) showed that ownership may be dispersed by government regulation (as it is in 41 of the 107 countries for which the authors had data) and thus takeovers may be impeded directly or through prohibitions on bank ownership by certain kinds of companies. Consequently, bank managers do not have strong incentives to adopt a good corporate governance system in order to lower their cost of capital or safeguard their management control.

In sum, it seems clear that the agency problem in banks as corporations is structurally different from that found in non financial firms. Given the complexity of the corporate governance structure in banks, in particular the public interest dimension, a broader view of corporate governance should be adopted in the case of banking institutions. Macey and O'Hara (2003a,b) argued that the scope of the duties and obligations of bank directors should be expanded to ensure the safety and soundness of banks. This implies that their duties should go beyond shareholders to include other stakeholders, i.e. depositors/creditors, government and the public.

2.3 Bank corporate governance in practice

Since banks pose unique corporate governance problems, the corporate governance of banks should address these issues. This means that bank governance would be different from that of non financial institutions by going beyond addressing the typical principal-agent problem. This section reviews the practices of bank governance from both external mechanisms, i.e. ownership structure, regulation and supervision, and internal mechanisms.

2.3.1 Ownership structure and governance

As discussed in the previous chapter, the firms' ownership structure is a primary determinant of the extent of agency problems, which has important implications for the corporate governance. This may manifest itself within the context of banks hinging upon the relationship among banks, the government and big business. In some countries, banks are diffusely owned by minority shareholders. In other cases, where either banks are controlled by the financial conglomerate or holding companies, or private ownership concentration is not allowed, the banks are heavily intervened in and controlled by the government.

2.3.1.1 Dispersed ownership versus concentrated ownership

Unlike most other industries, ownership restrictions in the banking sector, are prevalent across countries (Barth et al 2001). It is motivated by many considerations including the concern of connection of economic power of credit, conflict of interests, and stability of the financial sector. Typically there is an ownership ceiling for a single entity or requirement of the approval of the financial authorities when shareholdings exceed certain levels. Restriction on ownership has a significant impact on the distribution of power of a bank's shareholders.

US banking is characterised as dispersed ownership as a result of the ownership restrictions. Since the banking crisis and economic depression of the 1930s, attempts have focused on separating banking from commerce at the ownership level.[10] In 1933, responding to the general belief that the nation's banking and economic problems had been caused by conflicts of interest between banks and their securities affiliates, the Glass-Steagall Act was enacted, which prohibited affiliations between commercial and investment banking. In 1956, a general and long-standing distrust of large banking conglomerates combined with the increased merger activity of the 1940s and early 1950s led to the passage of the Banking Holding Company Act (BHCA), which separated banking from commerce by restricting the activities of owners and affiliates of banks. The BHCA defined bank holding companies and established a framework for their regulation by the Federal Reserve.[11] The restrictions on ownership and affiliation were partly lifted in late 1999, after the enactment of the Gramm-Leach-Bliley Act (GLBA).

The US practice of restrictions on bank ownership contrasts with the practice of most other industrialised countries, since in these countries linkages among banking and commercial entities in the form of ownership and control are common. Barth et al. (2004) presented a relative ranking of countries by permissible banking activities and ownership restrictions, noting that countries generally place greater restrictions on the ability of banks to own non financial firms, than on the ability of non financial firms to own banks. The EU countries are ranked among the least restrictive countries, while the US ranks as one of the most restrictive, although the data used was compiled before the passage of GLBA.[12]

Throughout continental Europe, concentrated ownership is common, and in Japan, where the keiretsu is a dominant business form. The European-style universal bank has greater freedom to be owned by, and to own, non financial firms (Barth et al. 1999). They are characterised by close and long-term relationships between the bank and its commercial and industrial customers. The Japanese keiretsu are conglomerate groupings in which banks are linked to their client companies through equity ownership (discussed in chapter 1). Despite the significant changes in the Japanese banking system, in particular the decline of the keiretsu system (Hoshi and Kashyap 2001), empirical evidence shows that ownership concentration in Japanese banks has been relatively constant over time (Anderson and Campbell II 2004).

The dispersed and concentrated ownership systems raise different corporate governance problems. In the case of banks with a diffuse ownership structure, where ownership restrictions effectively prevent the emergence of controlling shareholders, they give managers much greater power. The numerous small shareholders have little incentives to monitor their banks due to the free-rider problem. Even if they have an interest, they are likely to lack the expertise and to suffer form informational asymmetries. As a result, these shareholders may not be able to exert much influence on the decision-making in banks in spite of their voting and other rights provided in the laws and regulations. The boards of directors also tend to be captured by managers, hardly playing any significant supervisory and monitoring roles.

Concentrated ownership of banks may overcome the problems of insider control. In principle, with a more significant voting share, shareholders may be able to elect their representatives to the board of directors and more effectively negotiate a managerial incentive contract. Theories of ownership structure also predict that heightened uncertainty of a firm's operating environment leads to an increase in ownership concentration in order to motivate or facilitate more intense monitoring of managerial decisions (Demsetz and Lehn 1985).

Concentrated ownership however is not a solution without cost. Banks with concentrated ownership, notably in Germany and Japan, play a dual role as creditor and shareholder, which creates a significant conflict of interest. Banks have an economic incentive to vote against risk-taking at firms to which they have lent money. However, from the perspective of shareholders on whose behalf the banks vote, banks reduce aggregate risk-taking to a suboptimal level and thereby transfer wealth from shareholders to themselves. Furthermore, the presence of the blockholder also has potential costs, since there is a tradeoff between the effectiveness of their monitoring of the bank and the possibility that they exploit other stakeholders or expropriate minority shareholders, for example via connected lending. [13]

2.3.1.2 Government ownership

Government ownership of banks has had a long tradition in both developed and developing economies. Despite a wave of privatisation around the world in the past two decades, about 40 percent of the bank assets around the world are still controlled by state-owned institutions.[14] Government ownership represents a hybrid of dispersed and concentrated ownership. If the government is viewed as a single entity, state-owned banks have very concentrated ownership. Unlike private blockholders, however, government ownership is funded with money that ultimately belongs to the state as a whole and not to the individuals within the government that influence the actions of the bank. In this regard, the ultimate ownership of state-owned banks is, in fact, quite dispersed.

State-owned banks pose special governance problems. Governments can use their state-owned institutions to support excessive government spending and to favour borrowers that are less than creditworthy. The bureaucrat managers thus are not given strong incentives to perform, since they operate under soft budget constraints and other pressures, such as political influence or bureaucratic sectoral interests. Government ownership also reduces the monitoring incentives of private stakeholders, who would assume that their credits are guaranteed. In addition, government ownership thwarts competitive forces, limits the effectiveness of government supervision in the banking sector (Caprio and Levine 2002), and tends to increase the opacity of banks' operations.

Why does government ownership of banks have such implications for corporate governance? It would be helpful to gain insights by examining the rationale for government ownership of banks. There are several different theories of government participation in banking, which have different perspectives in both the existence and the role of state-owned banks. Three main views are reviewed in this section: the development view, the political view and the agency view.

The development view is based on the economic theory of institutions. It states that privately owned banks are important for financial development and thus for economic growth but economic institutions have to be sufficiently developed. If that is not the case it is necessary that the government provides the economy with a proper investment system such as state-owned banks. Gerschenkron (1966), an early advocate of the development view, argued that government ownership of banks contributed to the economic growth of countries which were relatively backward. Unlike private banks, public sector banks may be less concerned about profit maximisation, and more concerned about maximising broader social objectives. State-owned banks of direct credit have often been justified on the grounds that private banks fail to take social returns into account. For example, private banks might not allocate funds to projects with high social returns or to firms located in specific industries (Stiglitz 1993). The existence of market failures in financial and credit markets thus can be cured by creating public financial institutions (Stiglitz and Weiss 1981; Greenwald and Stiglitz 1986). According to this view, government-owned banks contribute to economic development and improve general welfare. Park (1991) further argued that if public sector banks dominate the banking system, then the government can potentially influence private non-bank firms to act in ways which are socially desirable and that are in congruence with the country's development objectives.

The agency view shares with the development view the idea that governments seek to maximise social welfare, but this can generate corruption and misallocation (Banerjee 1997; Hart et al. 1997). According to this view, governments design public financial institutions to address market failures. However, since state-owned enterprises (SOEs) maximise multiple non measurable objectives, Agency costs within government bureaucracy can result in low-powered managerial incentives (Tirole 1994). Certainly, low-powered incentives are not always bad; Laffont and Tirole (1993) showed that, under some circumstances, a concern for quality calls for low-powered incentives. But given the incentive problems associated with the control of SOEs, the agency view concludes that the ultimate efficiency of SOEs depends on the trade-off between internal and allocative efficiency (Tirole 1994). Under this hypothesis, state-owned banks channel resources to socially profitable activities, but public managers exert less effort (or divert more resources) than would their private counterparts. The agency view predicts that in general, whilst state-owned banks serve social objectives and allocate resources where private markets fail, public managers of state-owned banks exert low effort or divert resources for personal benefits, such as career concerns, with an eye toward future job prospects in the private sector.

According to both the development and the agency views, the government role in the economy emerges to perform the economic functions that markets either cannot handle or cannot perform well. Fundamentally different, the political view is based on the assumption that politicians are self-interested individuals who pursue their own personal, political, and economic objectives rather than maximising social welfare. The main objective of politicians is to maintain voting support (Shleifer and Vishny 1994; La Porta et al. 2002). According to this view, politicians create and maintain state-owned banks not to channel funds to economically efficient uses, but rather to maximise their own personal objectives. The result of this political interference is that resource allocation has little or negative impact on economic growth.[15]

Though the agency and the political views make very different assumptions about government objectives, the difference in the empirical implications is not so clearly defined. The merit of the agency view is to show that misgovernance can exist even when the government has the best of intentions.[16] Under both views, some misallocation of resources could be observed, but for different reasons. The agency view claims that the misallocation takes place because managers shirk or divert resources for their private use, but under the political view, the misallocation of resources is a political objective, rather than the result of a lack of incentives. State-owned banks will divert resources to areas where there is more political patronage, will finance friends and supporters of politicians, and will maximise political support, for instance, by maximising employment at the bank level or at other firms.

2.3.2 Regulation and supervision

In most countries, the banking systems are singled out for special regulation and supervision,[17] which is more comprehensive than for other sectors of the economy, given the unique characteristics of banks and the needs to limit their excessive risk taking and the other moral hazard behaviours induced by deposit insurance or guarantees.[18] In particular, in the past two decades, in a series of banking crises around the world, banks have become systematically insolvent. These crises have occurred in developed and developing economies alike.[19] To a large extent, they are the result of poor corporate govenance in the country's banking institutions. The most obvious response to the corporate governance problems of banks is government regulation, particularly bank supervision, bank capital requirements and bank safety and soundness regulation (Macey and O'Hara 2003b). A primary purpose of bank regulation in the contemporary setting is to limit the negative externalities arising from bank failures (Palia and Robert 2003).

From a theoretical perspective, the stakeholder model of corporate governance recognises that powerful stakeholders, such as regulatory authorities, can influence the governance of firms, for instance, Sinha (1998) and Prowse (1997) showed that the bank's regulatory environment has implications for the corporate governance of banks. In particular, the financial regulatory authority's objectives of maintaining systemic stability and protecting vulnerable bank customers, i.e. small depositors, restricts the goal of shareholder wealth maximisation as a mechanism for corporate governance. Prowse (1997) even argued that the most important corporate control mechanism in banking is regulatory intervention.

Given the regulatory authority's objectives, the pivotal importance attached to the banking system (Goodhart et al. 1998), the regulatory authorities conduct regular monitoring and supervision of bank activities to prevent banks from undertaking excessive risk-taking. As Llewellyn (1999) stated that regulation is about changing the behaviour of regulated institutions. The regulatory authority's governance mechanisms are therefore designed to ensure that a bank's management acts in a manner which is consistent with the risk management interests of this powerful stakeholder, and in a way that is beneficial to other bank stakeholders.

National models of banking regulation were found to differ thoroughly when compared internationally before the mid 1980s.[20] For instance, as far as capital reserves were concerned, two models represented the endpoints on the spectrum of regulation: On the one end was the more static or fixed-rate approach long used in the US, as well as in Canada and Japan. On the other end was the more flexible, risk-based approach implemented in the UK and many Continental countries, such as Germany, France, etc. The globalisation of finance however has eroded the capacity of individual nations to impose binding rules on their constituencies and to effectively monitor and enforce them. Banks have used their opportunities for broadening their sphere of activity to circumvent public policies that would impose regulatory costs on them (OECD 1983). Effective risk protection has obviously turned into a problem of collective action on the intergovernmental level.

Hence international coordination of prudential regulation and supervision[21] has become a feature of modern bank regulation. The Basel Committee on Banking Supervision, as the international standard setting body, was a unique example of international cooperation and produced an impact beyond its status as an unofficial and unelected body of international bank regulators.[22] The Basel Committee has distilled principles for corporate governance in banks since its establishment in 1974. Among them, the Basel Capital Accord is a universal benchmark that greatly influences the decision making of international banks.

The Basel Committee utilises the core value of prudential supervision in the Basel Accords (Notrton 1995). The Accords focus on the legal powers of home bank supervisors and the resources available for the regulation of banks on a worldwide basis. Specifically the Basel Accords ensure that banks have adequate management information systems and internal controls, set minimum capital standards, and allow regulators to take corrective action when banks fail to meet the Basel Committee's requirements.

The Committee does not seek to unify all national laws and regulatory practices, but rather to link disparate regulatory regimes with a view towards ensuing that all banks are supervised according to common principles (Cranston 1988). From the view of the participating members, such a collective solution has proved to be 'autonomy-safe' (Scharpf 1994), because national regulation practices could still be continued in the shadow of a quantitative minimum norm.[23] In this case, countries are pressured very little to converge their national, historically evolved cultures of regulation. However, market mechanisms begin to play a more influential role in spreading the application of the standard, for instance, rating agencies begin to take into consideration the 'capital adequacy' of internationally operating banks when evaluating the banks' solvency. Depending on the result of such evaluations, the costs for loans between international banks could be raised considerably. The hope of gaining a competitive edge by conforming to higher security standards finally has convinced bank institutions in countries outside the circle of the Basel member states to adopt the new norm (Genschel and Plumper 1997).

Owing to its central position in the regulation and supervision of banks, a brief summary of the Basel Accord is needed. In 1988, the Committee developed a capital measurement system usually referred to as the Basel Accord I.[24] The Accord advocated two principle objectives: first, to increase bank capital and reduce credit risk. Second, to establish a level-playing field so that a bank based in one economy would not receive a competitive advantage by enjoying a low capital adequacy requirement than a bank based in another country (Scott and Shinsaku 1994). The guidelines adopted contained three primary elements. The first element was a system of risk-based assets banks held. This was intended to eliminate the problem of two banks having an identical capital/assets ratio even though one bank held a significantly higher amount of risky assets than the other. The second element was a definition of what constituted 'regulatory capital'. Differing accounting definitions of the member countries led to the potential for differing amounts of capital support for the risk-defined asset categories. The third element of the Accord was the inclusion of off-balance sheet portfolios in the determination of the amount of risk and therefore the amount of capital a bank was required to maintain.

After several modifications and almost a decade of experience with the original Accord, the Basel Committee's new accord, well known as Basel Accord II, had been in development since 1999 and a revised framework was published in November 2005, which reflects the increasing expertise available in quantifying risk. Two additional goals are added to the objectives of the revised Accord. In addition to promoting a sound financial system and competitive equality, the Committee desires to address risks in a more comprehensive way and also render the rules applicable to banks of all sizes and levels of sophistication.

Basel Accord II has three pillars. The first pillar is a revised version of Basel I dealing with improved minimum capital requirements. The most significant change is an increase in the ability of banks to characterise the risk of their commercial and industrial loans by using either public rating agencies or the bank's own internal rating system. The second pillar focuses on the supervisory review process and particularly relates to the governance of banks. The Basel Committee has developed four principles of supervisory review, which highlight that regulatory authorities should go beyond the traditional analysis of financial data and consider such things as the bank's strategy, its willingness to accept risk, the markets served, and the level of diversification. The authorities should take corrective action whenever problems are anticipated, and the review should be coordinated across national borders. The third pillar envisions greater market discipline.[25] This is supposed to complement the other two pillars and the Committee has developed a set of disclosure requirements to allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution.

2.3.3 Internal governance mechanisms

Corporate governance literature recognises that in additional to firms' ownership, there are several aspects of firms' board, and compensation structure, which can also work as effective governance mechanisms or devices. For instance, the board of directors performs the essential role of monitoring management (Fama and Jensen 1983). Managerial compensation can also work as an important mechanism that influences managers to take actions that maximise the value of the firm (Murphy 1999; Core et al. 2001). How do banking firms compare with firms in other industries in the use of these mechanisms of corporate governance? Furthermore, given the nature of the banking industry exposed as it is to various risks, does the operation of internal control systems deserve separate attention?

2.3.3.1 Board of directors

Agency theory identifies the board of directors as the primary internal control mechanism enabling firm principals to monitor management behaviour. According to the theory, one of the main tasks of the board is to specifically carry out the monitoring function on behalf of the firm's owners, acting to remove managers who misuse firm assets and participating in the formulation of strategic decisions which have a considerable impact on shareholder investments (Waldo 1985; Fleischer et al. 1988).[26]

According to law, boards have two fiduciary duties to firms: the duty of care and the duty of loyalty (Macey and O'Hara 2003a). Boards of banking firms share the same responsibilities with that of non financial firms, whilst additional responsibilities have been placed on a bank's board by regulators. These usually take the form of guidance, regulations and laws, which reflect interests in safe and sound banking institutions.

The Basel committee on Banking Supervision (1999) recognises that boards of directors of banks are primarily responsible for good corporate governance, and views the following practices as critical elements of the corporate governance process:

- Establishing strategic objectives and guiding corporate values: recognizing the importance of preventing corruption and other practices that diminish the quality of corporate governance such as self-dealing, favours given to related parties, and other abuse of conflicts of interests.

- Setting and enforcing clear lines of responsibility and accountability throughout the organisation.

- Ensuring that board members are qualified, have a clear understanding of their roles in corporate governance, and are not subject to undue influence from management or outside concerns. Bank boards are also advised to have specialised committees including: risk management, audit, compensation, and nomination.

- Effectively utilising the work conducted by internal and external auditors in recognition of their important control function.

- Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment: motivating senior managers and other key personnel to act in the best interests of the bank.

- Conducting corporate governance in a transparent manner: publicly disclosing information on board and senior management structures as well as organisational structure, incentive structure of the bank, and transactions with affiliates and related parties.

2.3.3.2 Compensation of executives

As a specific tool for aligning the interests of banks managers with those of shareholders, remuneration of senior management and other key personnel is considered an essential corporate governance mechanism. Corporate executives are given compensation and incentives through three primary mechanisms: flow compensation including the base salary, bonus, new equity grants, etc.; capital gains on their portfolio of stocks and options; and the markets' assessment of their human capital that is affected by their performance in their current jobs (Antle and Smith 1986; Jensen and Murphy 1990). Among these components, the growth in the use of stock options in executive compensation has become increasingly controversial in recent years.

Proponents argue that, equity incentives and stock-based compensation can reduce agency problems. Because they link the compensation of CEOs with changes in shareholder wealth, and may increase shareholder wealth by motivating top management to undertake more value-enhancing decisions.[27] Houston and James (1995) documented a significant positive relationship between CEO stock holdings and bank charter value. They argued that compensation in the banking industry does not promote risk-taking. Consistent with this argument, Becher et al. (2005) presented empirical evidence of the US banks in 1990s, and contended that banks utilising a high degree of equity-based compensation for directors are associated with higher growth without a similar increase in risk.

However, some scholars argue that incentive compensation is not effective. Given the serious information asymmetry problems in banking, earnings and other short term performance outcomes can easily be manipulated at the expense of the long term health of banks. McConnell and Servaes (1990) showed that after some level of managerial ownership, managers exert insufficient effort, collect private benefits and entrench themselves at the expense of other investors. Several studies also suggested that at high levels of managerial ownership there is a resurgence of entrenchment behaviour (Morck, et al. 1988; Short and Keasey 1999). Gorton and Rosen (1995) showed evidence that managerial entrenchment was more important than the moral hazard problem in explaining the dramatic increase in bank failures in the 1980s. Stock options can give managers the incentive to take excessive risk and to fraudulently manipulate the company's stock price in order to enhance the value of the options (Yermack 1995; Aboody and Kasznik 2000).

Despite the debate and the increase in the use of equity-based compensation for bank executives, bank executives tend to receive less shares and hold fewer stock options in their total compensation compared with those executives in other industries (Houston and James 1995; Booth et al. 2002). There are several reasons for such a difference. First, low-growth industries like banking rely less on stock-based compensation.[28] Boards can observe, monitor and evaluate the actions of CEOs of firms and industries with low-growth opportunities much more easily than they can in firms or industries with high-growth opportunities, thus boards in such industries should rely more on fixed rather than on stock-based compensation (Smith and Watts 1992; Mehran 1992). In addition, banks are heavily regulated and supervised, to the extent that regulators may substitute for some of the monitoring functions of ownership (Demsetz and Lehn 1985). Hence there may be less need for equity-based compensation for banks' executives. Moreover, the operation of bank's business relies more on deposit than on equity. The incentives of aligning executives interests with those of shareholders in banks therefore may not be strong.

2.3.3.3 Internal control

A system of internal controls is a critical component of bank management, which underlies the safe and sound operations of banking institutions. Internal control is a process, effected by the board of directors, senior management and all levels of personnel. It is not solely a procedure or policy that is performed at a certain point in time, but rather it is continually operating at all levels within a bank. It is designed to achieve the following objectives: effectiveness and efficiency of operations; reliability of financial information; compliance with applicable laws and regulations (The Basel committee 1998). Various systems of accounting, internal audit, risk management, credit review, and compliance all support internal control by independently monitoring the effectiveness of the control processes.

The Basel committee on Banking Supervision (1998) evaluates internal control systems for banks, and identifies five interrelated elements that consist of the system. They include:

- Management oversight and accountability, and development of a strong control culture;

- Assessment of the risk of certain banking activities including those of off-balance sheet;

- Key control activities such as segregation of duties, approval, verification, reconciliation, and reviews of operating performance;

- Communication of information between levels of management within the bank, especially in the upward communication of problems;

- Audit programs and other monitoring activities.

For banking institutions, risk management has become a critical management process in a new financial environment for their continuity, stability, and prosperity. Operational risk of banking institutions is being driven by a number of factors including globalisation, increasing competition, new technologies, new product, product sophistication, new markets and distribution channels, cultural diversity of staff and clients, staff turnover etc. The soundness of banks depends very much on their capacity to identify, measure, monitor and control various risks relating to liquidity, credit, exposure concentration, interest and exchange rates, etc. Effective risk management is inseparably related to sound corporate governance. Increasingly, governance guidelines are explicit about internal control of risk management.

The management of risk in a banking firm consists of three elements: first, the accurate measurement and monitoring of risk; second, controlling and pricing exposures; and third, the holding of adequate capital and reserves to meet unexpected losses. The trend in supervisory oversight in recent years has been to work on each of these aspects. Numerous papers from the Basel Committee have provided guidance to best practice in the management of the various risks confronting managers of financial institutions: credit risk; interest rate risk; operational, legal and other risks.[29] At the same time, as is well-known, supervisors have been refining the measurement of the amount of capital that is needed to provide an appropriate cushion against these risks.

To sum up, corporate governance of banks comprises three essential elements: ownership structure; regulation and supervision; internal governance mechanisms. Each element has distinctive features tailored for a bank's unique governance problems. This is particular salient in, for instance, government ownership of banks, regulation and supervision under universal standard, internal controls.

2.4 Conclusions

It seems rational that a broader view should be adopted on corporate governance of banks. The structure of bank balance sheets, particularly a bank's highly leveraged condition and the mismatch in the term structure and liquidity of their assets and liabilities, supports the argument that bank directors should owe fiduciary duties to fixed claimants as well as to equity claimants. The importance of banks to the stability of the financial system also manifests a broader public role of banks in the payments system. The existence of the government deposit insurance and guarantees makes banking institutions facing particularly acute moral hazard problems. This together with the opaqueness of banking business and information asymmetry, necessitates the heavier regulation of banks. It is generally agreed that the external controls coming from takeovers and product-market competition turn out to be weaker in banks than in other firms. Banking governance relies more on the workings of internal mechanisms, such as the supervision and control exercised by the board of directors, along with the regulatory constraints.

It is important to realise that there is no evidence that any universal set of best practices is appropriate for promoting well-functioning banks. The ownership structure of banks varies stemming from the complexities of each country's economic, legal and political systems, and their individual conditions and needs. Similarly, there is also striking variation in the banking regulation and supervision systems. The Basel Committee finalises its list of 'best practices' for the regulation and supervision of banks, countries around the world are urged to adopt them in the belief that the banking sectors in countries adopting these practices will function better, thereby promoting growth and stability. However, no one size fits all, there is no simple set of 'best practices' to banking regulation and supervision in countries around the world (Barth et al. 2004). The detailed regulations and supervisory practices should be combined to produce an extensive checklist of best practices in which more checks are better than fewer.

Chapter 3 Methodology

3.1 Introduction

Researchers tend to consider themselves as belonging to either the qualitative or quantitative schools, with each traditionally being subjected to distinctly different paradigms (Layder 1993), or being interactive between or combining both methods (Brannen 1992). Different research approaches have distinctive strengths and weaknesses, Yin (1994) suggests three conditions for choosing a research strategy: the type of research questions, the control of an investigator has over actual behavioural events, and the focus on contemporary versus historical phenomena. This research employs a qualitative — case study approach, which is considered the most appropriate research method in view of the research objectives.

The purpose of this chapter is to outline and explain the research methodology employed in this project. The next section of the chapter discusses the research strategy adopted, and highlights the reasons why the chosen methodology is considered the most suitable for addressing the research questions. Subsequent sections three and four outline the data collection and analysis respectively. Section five discusses the issues in relation to reliability and validity. Conclusions are presented in the final section.

3.2 Research strategy

3.2.1 Why case study?

In seeking to address the issues raised in this research, the research could adopt positivist or constructionist methods (Easterby-smith et al 2002). Adopting a positivist perspective would entail concentrating on the objective factual details of corporate governance reform in the banking sector. Such a perspective is suited to a quantitative study, which tends towards ascertaining what has happened and when it happened. However, while these objective facts are certainly important to this research, an analysis limited to these facts would not meet the objectives of this research, which is to understand how and why China fixes its corporate governance mechanism. Furthermore, corporate governance reform in the China's banking sector is an ongoing process. There are few reliable large data sets available, coupled with the complex and distinct institutional and regulatory context, which makes established research methods less reliable.

Whereas the social constructionist approach has the ability to look at how change progresses over time, to understand people's meanings, to adjust to new issues and ideas as they emerge (Easterby-Smith et al 2002). In particular, the 'how' and 'why' nature of the research questions, rather than the alternative 'what' and 'where' questions, make this project particularly suited to case study according to Yin (1994).

This is because of the depth of analysis that a case study affords; a depth that is only achievable using qualitative data. The particular advantage of qualitative research is that it does not need to reduce each phenomenon to independent, isolated parts (Patton 2002), such a reduction is required for a statistical study, and although it assesses the influence of each factor being tested, an assessment of the interplay of these factors and the completeness of the list of determining factors is much more subjective in nature, only a qualitative, in-depth approach can properly address this. In addition, by using in-depth questioning, the research draws upon a wide variety of personal interpretations from within the banking sector and beyond. This provides alternative interpretations and additional influencing factors that can broaden the investigation and make it more accurate. Finally, this research also meets the other 'criteria' for case study as presented by Yin (1994), i.e. the observer has little control over the events being studied; the contemporary phenomenon studied is undivorced from its real life context.

3.2.2 Triangulation

Triangulation is traditionally defined as the combination of methodologies in the study of the same phenomenon (Denzin 1970). The triangulation approach adopted in this research is closely associated with Denzin's 'multiple data sets', since it utilises both qualitative data and quantitative data gathered from different sources. The data collected in the fieldwork is a mixture of qualitative and quantitative material. Each type of data fulfils certain objectives effectively and the two combine to create a more complete piece of work through triangulation (Jick 1979). In particular, Linking qualitative data and quantitative data allows one to confirm and corroborate each kind of data; to elaborate or develop analysis, providing rich detail; and to initiate new lines of thinking through attention to surprise or paradoxes, providing fresh insight (Miles and Huberman 1994). The triangulation of in-depth qualitative and basic quantitative data is expected to generate a more accurate and complete picture of the process of corporate governance reform in China's banking sector.

3.2.3 Theory development approach

This research has elements of both an inductive and deductive approach. It is more inductive than deductive. A strictly deductive approach would be to test the hypotheses developed from literature. It entails using a standard, homogeneous theoretical foundation, and an empirical work is based on research questions that are specific to be termed hypotheses. Developing and testing hypotheses in this case would imply a level of objectivity embracing the positivist perspective as discussed above, that is not consistent with the exploratory nature of this research. The relevant factors can not be identified accurately and understood fully until fieldwork is undertaken (Easterby-Smith et al 2002).

Although the inductive approach plays essential roles in developing theoretical ideas during the data analysis process which is 'grounded' in actual examples, this research can not reject the deductive approach completely. Because using a 'pure' grounded theory (or inductive) approach (Strauss and Corbin 1997) would relegate the existing literature to the background, looking solely at the specific cases to build an entirely new theory. Although there are undoubted merits to this on paper, there has been much theory already developed to claim its redundancy, which may result in the lack of a clear view of where the research is supposed to lead. This would be inadequate in increasing the confidence, the validity and the robustness of the findings (Saunders et al 2003).

3.2.4 Chosen subjects

This research looks at China's banking sector with a focus on the state-owned banks. Full use of anecdotes and illustrations would provide a richer understanding of the issues in relation to the whole process of corporate governance reforms. This research therefore chooses two major state-owned banks as subjects, namely the Bank of China and the China Construction Bank. The reasons for this selection are twofold: first, as two of the big four banks, they hold a dominant position in China's banking sector. Second, as the pilot banks for shareholding reforms chosen by the Chinese government, the two banks have undergone an unprecedented restructuring. They are the first two of the Big Four that are listed in stock markets.

3.3 Data collection

There are two types of information sources, namely primary and secondary data. Secondary data contains information which is already available elsewhere and has been obtained for other purpose of research. Primary data, on the other hand, consists of information obtained for some specific purposes (Kolter et al 1999). In order to obtain the benefits available from both, this research uses both primary and secondary data.

3.3.1 Primary data

For this research, two methods were considered to obtain primary data: interviews and questionnaires. It was decided that questionnaires were not a good method of conducting research in this case. The disadvantages of this method are that it requires simple questions, there is no opportunity for probing beyond a given answer, lack of control over who fills out the questionnaire, and a low response rate were deemed to outweigh the advantages. The nature of the research objectives determines that the use of qualitative in-depth interviews as a method of data collection is advantageous. It allows the researcher to delve much deeper into a topic, provides the opportunity to ask many long sequenced open ended questions, uses screening questions and gives the ability to probe answers. This is particularly the case for such issues as financial and organisational restructuring, strategies and politics, which are sensitive subjects in China. A face-to face interview arouses initial interest and increases the rate of participation. It also enables the researcher to ask complex questions that my require explanation and consequently allows to clarification of any ambiguous answers.

Having decided upon interviews as a primary method of the research, the researcher conducted the field work between February and August 2005, a total of 46 people were interviewed [1] (see Table 1). The following sections outline the details of the interviews.[2]

3.3.1.1 Selection of interviewees

The research questions determined that bank managers were the key informants. In order to acquire a comprehensive cross-section of views, for each bank, interviewees were selected from different major departments of a bank's headquarters, for instance, restructuring and listing, risk management, non-performing assets management, asset and liability management, corporate banking, and retail banking. The interviewees came from different levels of seniority within the bank. The senior managers obviously had insights into the general issues. While junior managers were less likely to have an opinion in this respect, they were able to provide insights at the operational level.

Although bank mangers were selected as key informants, this was unlikely to serve the objectives of the research sufficiently. Because the change patterns of corporate governance is a highly complex process, going far beyond changes in the banks. The purpose of the interview was not only to gain a qualitative picture but also an understanding of the general trend of the reform and the implications behind the process. This entailed a further investigation of the state policies on banking reform as well as state-owned enterprise reform as a whole. The researcher therefore endeavoured to solicit a wide range of comments from different perspectives by broadening the scope of selection to including the officials from the state institutions, i.e. the People's Bank of China (PBOC), the China Banking Regulatory Commission (CBRC) and the Ministry of Finance (MOF), the Central

Huijin Investment Company (Central Huijin, now known as China SAFE Investments Ltd.), which are in directly involved in banking sector reforms; industrial analysts (e.g. PricewaterhouseCoopers, Ernst &Young), journalists (e.g. China Financial News), academics (e.g. the Development Research Centre of the State Council, the China Academy of Social Sciences, the Beijing University, the University of Central Finance an Economics) who are indirectly involved in or interested in banking reforms (See Table 1).

3.3.1.2 Gaining access

Existing research has often encountered problems in identifying and gaining access to key informants (Beamish 1988). This research was no exception in terms of the sensitive issues concerning the targeted banks and the wide coverage of the fields of the interviewees. To minimise these problems, the researcher, based on the criteria identified above, built up profiles of suitable interviewees by using two methods. The principal method was the 'snowball sampling' method, i.e. asking persons already interviewed whether they knew anyone who may contribute to the research issues. Another method used was to find the names and contact details of potential interviewees from newspapers, journals and websites.

The researcher then sought access by using the independent approach, which entailed making contact with targeted informants directly, rather than formally involving the organisations they belonged to (which is termed as 'front-door' approach[3]), The advantage of this approach as Gronning (1997) argued is that it allows the researcher to build up direct researcher-respondent relations by circumventing the corporate gatekeepers and steering away from the problems of conditional access. The interviewees are not selected by the organisation, and thus when sensitive issues are being discussed they seem to be more candid, knowing that what they say is likely to remain confidential. The researcher's experience during the course of research proved that this approach was also more efficient and successful than the 'front-door' approach in terms of saving time and increasing accessibility.

The researcher's personal relationships in China played a large part in carrying out this approach, in particular in gaining access to the chosen banks. The researcher asked personal friends working in the banking sector to provide introductions to the potential interviewees in the banks. As a result of such an internal recommendation, all the key informants in the banks were successfully approached, and it was found that bank managers were more open-minded and willing to talk. The researcher also made contacts with other targeted interviewees spontaneously without friends' assistance. With some perseverance, the majority of them participated, one politely declined, and one did not reply. Table 3.1 provides some brief details of the interviewees.

Table 3.1 Categorisation of interviewees

Bank manager			Government official	academic	industry analyst	journalist	Total
Senior	Middle	Junior					
7	11	4	9	10	3	2	46
22							

3.3.1.3 Format of interviews

There are three main approaches to in-depth interviewing that differ largely in the extent to which the interview questions are determined and standardised beforehand: structured, semi-structured, and unstructured interviewing. Each approach serves a different purpose and has different preparation and instrumentation requirements. The structured interviewing consists of a set of open-ended questions carefully worded and arranged in advance. It is commonly done in marketing research. Respondents are often shown cards or are given a question with a set of answers to chose from. The sequence of questions is also fixed (Frankfort-Nachmias 1996). This method seemed too rigid for conducting interviews with government authorities and bank officials. One of the reasons for conducting the interviews was to solicit their subjective opinions of the process, something that would be difficult using such a structured approach. Unstructured interviewing, is used in sociology for life study reports. It relies primarily on the spontaneous generation of questions in the natural flow of an interaction. While certainly not suffering from the drawbacks of the structured interview, this approach seemed in this case to run too high a risk of uncovering too much random information without context.

Thus it was decided that a semi-structured approach was the most effective way to conduct this research. It is commonly used in corporate interviewing (Schoenberger 1997), interviewees were contacted and appointments were scheduled. They were informed of the reason for the interview, and given an idea of the type of questions that were to be asked. This approach involves the preparation of an interview checklist that contains a predetermined set of questions or issues to be explored during an interview. The order and the actual working of the questions are not determined in advance. The advantage of adopting a semi-structured interviewing is that it makes interviewing a number of different interviewees more systematic and comprehensive by limiting the issues to be taken up in the interview.

This research adopted what Patton (2002) terms the 'general interview guide approach'. This set out a list of issues to explore with each interviewee, which was highlighted by a review of existing literature generally and the reforms in China' banking sector in particular. The issues were loosely structured around four main themes, namely the state-own enterprise (SOE) reforms and banking evolution, the reforms in regulation and supervision, the resolution of non-performing loans (NPLs), the restructuring within the state-owned banks. Within each main theme, sub-themes and issues were also raised. As the data collection process progressed, for instance, from the pilot interviews at the early stage of the research conducted via telephone to the major fieldwork, these themes were inevitably modified and developed. New themes emerged and were incorporated into future interviews. The themes however did not include standardised questions. The reasons were twofold: firstly, the nature of the research questions required flexibility within the interview so that the researchers could follow up new points or alternative interpretations. Secondly, given the various backgrounds of the interviewees, this allowed the researcher far greater manoeuvrability to tailor the questions in order to make full use of the interviewees' expertise.

The researcher tried to use the informal style of interviewing. In most cases, the language used was Chinese (English was used in two interviews with English speakers). Before each interview, an appointment was made via telephone or Email, explaining the purpose of the research and gave the brief questions to be asked. The manner of the interview was often more a sharing of information between interviewer and interviewee, as well as a way for the interviewer to present his view on the reform, and listen to the interviewees' opinion of how accurate these view were with an insiders' opinion. It is worth mentioning that the researcher had been in touch with some key informants via telephone and Email (i.e. follow-up interviews) throughout the rest of the period of the research since major fieldwork was completed. This allowed the researcher to collect up-to-date information which was very important to further explore various issues of the on going reform of the banks. The research has been a success in this respect and the analysis of the material gathered has greatly benefited from taking this approach. [4]

Each interview lasted for an average of forty five minutes. All the interviews were recorded by note-taking, or by tape-recorder. Taping the interviews was considered preferable to making notes during and after each interview, since this allowed the researcher to follow up interesting points without the distraction of note taking and also captured the thoughts of each interviewee more accurately. The researcher therefore always asked for permission for the use of tape-recorder after assuring confidentiality. However, most of the interviewees, in particular those who work in the banks, declined to allow their statement to be recorded. This was not a surprise, given the confidential and political sensitive nature of the information. Only four interviewees agreed to the use of a tape recorder. The rest of the interviews were recorded by note-taking according to the Yin's (1994) proposed guideline.

3.3.2 Secondary data

There was a wide range of sources utilised by this research to gather secondary data. These included government information, such as the Almanac of Chinese Statistics, the Almanac of China's Finance and Banking, reports of the PBOC and the CBRC; industry sources, e.g. annual reports of the banks, industrial analysis; journals; newspapers; and websites. Particular attention was also paid to relevant regulations and provisions on banking.

3.4 Data analysis

This research did not make a clear cut differentiation between the data collection and the data analysis process by following the constructionist route: there was an element of creating, testing and modifying analytic categories as an iterative process (Symon and Cassell 1998) throughout the whole research process.

All the interview notes and tapes were transcribed immediately after each interview. This was done in its entirety rather than selectively (Strauss and Corbin 1997). The researcher managed this task without using external help. Although this added significantly to the time taken for the analysis, the researcher found that it was an extremely valuable first step to immerse in the data and gain insights into the patterns as well as identify coding processes. It was also essential to assure the validity of the research findings.

Rudimentary codes were constructed around the four main themes as discussed earlier, which had initially guided the interviews. The codes then served as a basis to begin coding the interview transcripts during the fieldwork, imposing some order and structure on the data collected, and ensuring that the key issues of the research were addressed. However, in the process of coding the code itself was revised in the light of ongoing data collection and analysis. This flexibility allowed the generation and development of new ideas and themes which emerged from the data, enabling new insights to be explored further.

There were seven primary codes, covering the following key issues:

- SOE reforms
- Banking evolution
- Reforms in regulation
- Reforms in supervision
- NPL issues
- NPL solution
- Restructuring of the banks

Within each of the codes, secondary codes or tertiary codes were developed in order to obtain a manageable amount of data in each subject.

A word processing package was used to help organise and analyse the derived text. The transcription process brought familiarisation with the text to such an extent that manual analysis was both more preferable and more manageable than using software, e.g. NUDIST. The data were divided into segments and categorised according to the appropriate codes, and using Word documents and Excel spreadsheets, they were effectively placed within a matrix for analysis, as recommended by Miles and Huberman (1994).

Regardless of the data organising style adopted, qualitative data interpretation is a personal experience (Crabtree and Miller 1999). Understanding the unprecedented transformation process of China's banking sector presents a particular set of rewards and challenges. It was found that simply reading the data literally did not make much sense for such a purpose. An interpretive approach (Mason 2002) therefore was adopted. The data was read through and beyond. The researcher mainly concerned with what the text was trying to say, what the interviewees' comments or opinions could be inferred, and accounts of how the data made sense of the social phenomena.

3.5 Reliability and validity

The issue of reliability and validity of qualitative case study research can be addressed by a rigorous case design and analysis process (Yin 1994). Firstly, a high level of validity is possible through in-depth qualitative interviews (Saunders et al. 2003). The main reason for the potential superiority of this approach for obtaining information is that the flexible and responsive interaction, which is possible between interviewer and interviewee, allows meanings to be probed, and topics to be covered from a variety of angles. Although interview, in contrast to quantitative approach, is frequently criticised for its incapability of making generalisations to an entire population,[5] the primary aim of this research is to explore the transformation process of China's banking sector, the findings are used to address the theoretical issues discussed in the Chapters One and Two. In doing so, the research can draw upon far more detailed information than a piece of quantitative research, and thereby add greater value and establish the validity of the research.

Secondly, the reliability and validity of data collection and analysis is achieved by triangulating data sources and interpretations. The anonymity of the interviewees eliminates the informant biase (Miles and Huberman 1994). Data sources are triangulated by comparing secondary data with primary data, and by comparing quantitative data with qualitative data. Because different sources that have different bias and different strengths can complement each other (Miles and Huberman 1994). When faced with the choice of stating estimations given in an interview, or a concrete number found in a secondary source, the researcher chooses to state the secondary source as a matter of clarification. However, if the numbers varied widely, several sources are quoted.

Thirdly, the researcher's personal background enhances the reliability of the research. A decade work experience in the China's SOE provides the researcher with an inside view of China's enterprise reforms. Such participant-observer experience makes, to a great extent, a sense of ethnography, and enables the researcher to gain an empathic understanding regarding the SOE reforms and Chinese institutions as a whole. The researcher's personal knowledge of the banking sector which derived from close working with the banks, also contributes significantly to the research. It brings reliability to the data collection and analysis by helping to develop an understanding of the industrial context and enabling the researcher to elicit more fulsome replies, as the interviewees perceive the researcher to be technically conversant and competent.

3.6 Conclusions

This chapter has outlined the methodological issues including the research strategy and the research designs. The methodological approach employed by this research departs from the traditional positivist methods. However, in differing from this perspective, deeper qualitative and exploratory research is able to bring an added dimension to the study of the dynamic corporate governance reforms in China's banking sector, and offer a better possibility of understanding such a historic process. Conclusions in favour of case study have emerged. The rigorous research designs in the data collection and the analysis process have ensured the reliability and validity of the methodological approach.

Chapter 4 The evolution of corporate governance in China's banking sector

4.1 Introduction

As an integral component of the overall programme of China's economic reform, China's banking reforms have been grounded on the background of the country's economic transition process.[1] Corporate governance in the banking sector has evolved gradually and experienced distinct stages in the past twenty five years. It is a result of the top-down approach of the reform, and also a choice of the purpose of getting adaptable in a changing institutional environment.

This chapter identifies a two-stage evolutionary process, where the first eighteen years between 1979 and 1997 constitute the first stage, the second stage beginning in 1998. The two stages of reform display distinctive objectives, approaches, features and levels of depth. In the first stage, the reform was essentially carried out incrementally to construct the framework and infrastructure of the banking sector. The governance of the banks during this period was characterized by strong government administrative control and weak regulation and supervision. Since 1998, the banking reform has gone deeper. Resolving the stock problems has become the main focus, leading to the emergence of corporate governance as the core issue of the reform.

The objective of this chapter is two-fold. First, it places the evolution of the banking sector in the context of China's overall corporate governance approach to enterprise reform, and provides a critical analysis of the issues in relation to the reform of SOE. Second, a detailed discussion of each stage is presented, which includes the causes, the nature and the process. The aims are to provide an overview on the development of corporate governance in the banking sector and offer new insights into the roles that the Chinese dynamic institutional factors play in the process of evolution, and thus give a general background for the rest of the thesis.

This chapter is organised as follows. In the next section, SOE reform and institutional constraints are discussed. The third section details and analyses the first stage of development of the banking sector, including the process and the nature. In the following section, the second stage of evolution is discussed, with the focus on the causes, steps and characteristics. Conclusions are drawn in the final section.

4.2 Background: the corporate governance reform of SOE

China's SOBs are historically closely connected with SOEs. Unlike the close bank-firm relationships in Germany and Japan as discussed in the preceding chapter, the interdependence between SOBs and SOEs originally stemmed from the central planning system, and had further been developed throughout much of the reform period in the 1980s and 1990s. SOBs largely fulfilled a fiscal function in financing SOEs and played crucial roles in keeping SOEs in business.[2] The legacy problems of SOBs, such as the mounting non-performing loans and declining capital adequacy, are closely associated with SOEs. Nowadays, SOBs have become more market focused, while the relationships between banks and enterprises are still naturally close, given the fact that SOBs have retained the predominant position as an external source of financing of enterprises, because the country's domestic capital market is still relatively undeveloped.[3] The success of banking reform would hinge on the success of enterprise reform, and vice versa. China's economic reform is entering a stage in which the enterprise and banking reforms intertwine and become the major bottleneck. To find a solution is obviously not an easy task, and beyond the scope of this study. Nevertheless, a historic perspective on the process of SOE reform will be conducive to a profound understanding of the past and present emphases on the corporate governance issues in the SOBs.

4.2.1 SOE reform and debate

The problem of reforming SOE in all transitional economies is enormously complicated. One of the greatest challenges facing policy makers is choosing the ways in which SOE can be restructured and the sequence by which reform measures can be carried out.[4] Choices are different to some extent from one nation to another, however, they are made based on two common grounds: firstly, an explicit reflection of the country's distinctive institutional environment. Secondly, an implicit reflection of the assumptions about the way (e.g. privatisation) things work.

For Chinese policy makers and leading economists, the prevailing assumption seems to be that what really counts in SOE reform is 'ownership'. State ownership of economic entities is generally accepted exasperating the principal-agent problem,[5] because of the ambiguous property rights. SOEs, in principle, are owned by the state, but control rights are divided or shared between government bureaucrats and enterprise managers. Although bureaucrats are supposed to act as owners (principals), they are not legally entitled to the residual income rights that owners of private enterprises would normally have. The absence of owners, combined with inadequate monitoring and soft budget constraints fundamentally contribute to the poor performance of SOEs. So, in this view, the underlying force in driving enterprise performance is the placement of property rights in appropriate hands. Because this view is accepted, reform debates usually revolve around more instrumental issues of how to separate the enterprise from the state, how to extend autonomy to managers, and how to 'clarify' property rights.

The earlier reforms introduced in the 1980s, centred on the expanding managerial decision-making autonomy and incentives through and contract responsibility system. The main purpose of this scheme was freeing enterprises managers from political intervention and decentralization of governmental authority. Under this new system, the relationship between SOEs, usually represented by their managers, and their supervisory agencies was shifted to one which was contract based with multiyear targets and incentives. The managers who participated in the programme faced substantial risks and awards, as their performance was linked to their enterprises' performance. They were given greater control over their enterprises' operations, including sales, giving bonus to employees, rationalising work force. These autonomies were further expanded in 1992, when the government gave the managers authorities to make production decisions, negotiate prices for inputs and outputs, make investment decisions, hire workers, and determine remunerations.

The outcomes of the contract responsibility system were mixed. Considerable success was achieved in terms of the increasing autonomy of managers and the enhancing market-orientation of SOEs' management. An empirical study by Shirley and Xu (2001) found that performance contract improved productivity in slightly more than half of the cases. On average, however, it did not improve performance and may have made it worse. A more important drawback of the reforms would be the increased agency costs. Over time, SOE managers had gradually acquired considerable discretion over the use of the state assets, while there was no effective monitoring and controlling mechanism in place. This created conditions for moral hazard and rent-seeking behaviour of management. The agency costs of the increased autonomy had manifested in various incentives for managers to acquire private benefits of control via on-the-job consumption, asset stripping, decapitalisation, wage manipulation, and tax evasion. It was argued that the initial efforts to boost efficiency of SOEs through simply tying management remuneration with performance did not address the issue of property rights, this fundamentally contributed to the increased agency costs.

The subsequent SOE reforms since the early 1990s have shifted to focusing upon clarifying property rights through corporatisation scheme. This new initiative was essentially aiming at converting traditional SOEs into commercially viable entities by subjecting them to a new and different set of rules, for instance, a framework for the modern corporate governance of SOE, in which continued state involvement in several sectors was seen as necessary to the long term development of the economy. Corporatisation was first associated with defining property rights of legal entities, i.e. corporate property rights. After corporatisation, an enterprise, as a legal entity, had property rights over its assets. According to the Chinese Company Law, promulgated in 1994, three major forms of companies were identified: wholly state-owned companies, shareholding companies, limited liability companies.

In order to strengthen the supervision and management of state assets, and separate state shareholding function from regulatory function, the government introduced a complementary reform to the state asset management system. A multi-tiered network of institutions has been created. A number of state holding companies (SHC), have been established to exercise the state's ownership rights and management of the state assets. In 2003, the State-owned Assets Supervision and Administration Commission (SASAC) was established to further streamline control of SOEs by unifying the duty of managing assets, personnel and affairs.

Economists agree that corporatisation is a useful step of SOE reform even without privatisation. Corporatisation helps to hold managers responsible for the assets of the company, prevent further asset thefts, provide a mechanism for information exchanges, set a stage for selling shares, and separate the state from enterprises (Lipton and Sachs 1990, Shleifer and Boycko 1993). This argument is evident from the experiences of Eastern Europe and Russia where corporatisation was carried out before privatisation.

For China, the general perception in academic circle seems to suggest that corporatisation has not seen to be practicably effective in terms of the achievement of its intended objectives. It is argued that after corporatisation, property rights of SOE seem to have been clarified based upon the Company Law. While the theoretical owners (principal) of the state assets, the citizenry of China, are far too dispersed and powerless to play any real monitoring role. This leaves open the issue of who should be monitoring the managers. The newly established SHC, that are legally entitled to the residual income rights, in principle should act as the representative of the state assets and operate as commercial entities. However, evidence suggests that they do not exercise its rights as a shareholder to influence management effectively, but tend to be heavily influenced by their upper-level agencies (state asset management committees), which continue to function like a government administrative department. More important, the question now becomes how these new bosses of Chinese corporations are to be monitored and disciplined.

The reforms of property rights at the end of the 1990s led to privatisation of SOEs. The privatisation process began with small and medium-sized enterprises (SMEs), and spread to large enterprises soon after. Management buy-out (MBO) played a central role in this process.[7] MBO practiced in China has its own 'characteristics' (Li 2004), which are distinguished from that of the US and the UK. MBO in western countries is simply a form of economic activity on the part of corporate managers. While the significance of MBO in China is much beyond that, it is a means of system transition from state ownership to mixed ownership, and it is also a means of property rights transfer carried out under the premise of economy structural adjustment.

In addition, in most MBOs of listed SOEs in China, the shares are not purchased from the market. The managers exploit a structural flaw of the Chinese stock market, where shares both in and out of circulation coexist. There is a large gap between the price of outstanding shares and that of shares not in circulation. Managers damage the interests of the majority of shareholders by gaining control of a firm at very low insider prices through a negotiated transfer of non-circulated shares, rather than an open purchase of outstanding shares.

Furthermore, managers should purchase shares based on their fair market values. However, in the Chinese MBO practice, managers do not have sufficient/any funds for their purchases, but borrow from enterprises, their subsidiary companies, banks, or simply a part of loans the enterprises borrowed from banks. As a result, managers obtain the huge benefits without paying the cost or shouldering any risk.

In the beginning of the introduction of MBO, Chinese policy makers and most economists regarded it as an effective way of SOE reform, since it was credited with the ability to provide enterprises with effective motivating mechanism and ensure stable returns on investments. However, in reality, MBOs failed to play their expected roles in 'modernising' SOEs. Problems such as non-availability of laws and regulations, information asymmetry, as well as non-disclosure of transactions, have certainly resulted in acts of self-buying and self-selling, collusion, and buying cheap after making loss, that have caused state-owned assets loss during the MBO implementation.

In response to the increasing criticisms on the draining of state assets, The MOF called a stop to all MBOs in March 2003, pending the issue of more detailed regulations. In April 2003 SASAC was established, which released two documents on MBO in December 2003 and January 2004 respectively. A dozen leading domestic companies launched MBOs soon after. In August 2004, the debate in academic circle became intensified and eventually triggered a nationwide discussion on whether China needs MBO and whether SOEs need reforms in property rights.[8] As a result of the discussion, the MOF and the SASAC jointly issued an interim regulation in April 2005, which mandated that MBO will no longer apply to large SOEs. And based on their actual conditions, some SMEs should explore this practice in a standardised way only after the ownership of state assets is clearly defined. Authorities must ensure the process is more open and transparent so that the interests of all involved parties are guaranteed.

China's SOE reform has been, to date, uncompleted and an ongoing process. The key aspect of China's approaches to governance restructuring of SOE has focused on reform of property rights, which has been motivated by the need to improve economic efficiency of SOEs.[9] In its more progressive experiments over the last twenty years, the reform process has appeared haphazard and in a non linear fashion.[10] From expanding managers' autonomy to shareholding reform, and to privatisation through MBO, they have yet to resolve the sensitive issue that who should own – state holding company, managers, private citizens, mutual funds, foreigners. The debate on the issue has been concomitant with the SOE reforms, the evaluation after each time of debate have had a direct bearing on the direction and speed of the next step reform. How to comprehend the process of SOE reforms to date? In other words, what are the underlying issues behind those phenomena? This chapter tries to offer insights by looking at China's dynamic institutions.

4.2.2 The implications of dynamic institutions

The process of SOE reforms has been determined to a large extent by China's reform strategy, which has appeared in an unplanned and improvised nature. Unlike systemic transition in Central and East European countries, the market-oriented reform in China was initiated voluntarily and driven by the recognition that a centrally planned economy was no longer viable and changes were required to promote economic growth. This is a systematic project that will encounter enormous and unprecedented problems. The major challenge faced by China is not just to transform its economic system, but also its existing institutions, which was set up and developed primarily to serve the socialist economy based on central planning and dominated by the Chinese Communist Party (CCP). This will inevitably involve in larger political and social issues. Neither a ready and sophisticated theory, nor a successful precedent could provide guidelines in this regard.[11] Consequently, the Chinese policy makers have adopted a trial and error strategy. The reform policies have featured a high degree of incremental adjustment based on the political and economic conditions in reality.

During the initial period of reform between 1978 and 1992, the basic institutional framework of central planning remained. The purpose of the reform was essentially to improve the socialist economy. Economic planning and SOE were still the leading players of the Chinese economy, markets forces first introduced for resource allocations were only tolerated as supplementary tools. The reform initiatives were made to respond to particular ideological, political and economic constraints. SOE reform, for instance, was carried out through decentralisation from government to enterprises, aimed at increasing decision-making autonomy and financial incentives. This reform was not explicitly involved in dealing with ownership issue, despite the significant degree of insider control it caused. However, even without formal privatisation in this period, significant control rights and incomes had been transferred to managers. This may be consistent with the ambitions of some economists who advocated it, because they regarded the contract responsibility system as a substitute for privatisation.[12]

After nearly fifteen years of decentralised process and gradually deepening the role of markets, a national consensus favouring continuous expansion of market mechanisms has eventually been reached, which was symbolised by Deng Xiaoping's speech during his tour to southern China in 1992. The Fourteenth National Congress of the CCP held in the same year, designated the ultimate reform goal — to build up a 'socialist market economy' with Chinese 'characteristics', i.e. a competitive market characterised by the predominance of state ownership.[13] The breaking-away from traditional ideology has paved the way for the further reforms of property rights. The Third Plenary of the Fourteenth CCP's Congress held in 1993, for the first time announced the establishment of a modern enterprise system, featuring corporate governance structures that separate the government from enterprises. Systematic experimentation with the shareholding system began.

However, the progress in corporatisation had been very slow, because the majority of SOEs were heavily debt-ridden, and could not be easily corporatised into shareholding companies without drastic financial restructuring and recapitalisation. More importantly, the newly established corporate governance mechanisms did not appear to function as effective as initially expected, which was arguably attributed to the dominant state shares. Against such background, a far-reaching policy aimed at ownership diversification of the state sector, was adopted in the Fifteenth Congress of the CCP held in 1997. The central component of the policy, so called 'seize the large while letting the others go'(*Zhuada fangxiao*), involves that the state retains full control for the large SOEs in the strategic sectors, meanwhile phases out from the SMEs. Few specific practical measures for divestiture had in fact been formulated besides privatisation through MBO.[14]

China's economic reforms have so far placed priority on 'efficiency' rather than 'fairness'. It has resulted in the dynamic growth for more than two decades, while a range of social problems have also emerged, in particular, the growing income disparity. This problem has been exasperated further by the malpractice of MBO. Especially given the political context of MBO in China,[15] where MBO is used as a means to turn political power into financial capital.[16] The privatisation under this circumstances has failed to spread the benefits among the people, it has also violated worker's rights and made them falling into victims to the privatisation.[17] The ongoing debate on the draining of state assets and ownership reform is not actually a new one, it has long been a hot topic for discussion by government officials, economists and the public. The re-emergence of the arguments only remind the Chinese policy makers that the reforms without fairness are not accepted by the public, this has been already evident from the experience of transition economies in Central and Eastern Europe. If this critical issue is not dealt with properly, social stability and the reform itself are likely to be jeopardised.

Against this background, the CCP officially put forward the historical goal of 'building a socialist harmonious society' at the Fourth Plenum of the CCP Central Committee held in September 2004. The main characteristics of a harmonious society involve putting people first and making all social activities beneficial to people's subsistence, enjoyment and development. In a harmonious society, the political environment is stable, the economy is prosperous, people live in peace and work in comfort and social welfare improves. It also advocates an overall, co-ordinated and sustainable development concept, making the interests of different sectors balanced. [18] This may suggest that the Chinese government is consciously implementing the basic concepts of people first and government for the people, and placing an unprecedented emphasis on resolving urgent problems facing the overwhelming majority of the people. The issuance of the new regulation on MBO may be a significant sign, if it is not a coincidence, that the Chinese governance has put 'fairness' on the reform agenda. This will have far-reaching effects on the further SOE reforms.

4.2.3 Summary

From the preceding discussion, one can see that the experience of China's economic reforms essentially seeks to resolve two puzzles: is the state ownership dominated economic system compatible with the free market system? If they are compatible, how could the two systems be integrated? Without a definite model in mind, China has undergone a lengthy path of adjusting reform objectives. From 'a planned economy with some market adjustment', to 'a combination of plan and market', and to 'a socialist market economy', the reform to date has remained unfinished. This implies that no final solution has yet been found. In the same vein, in developing corporate governance system, although it has been recognised in China that a governance regime bares the country's own characteristics, China has so far lacked confidence in seeking its own characteristics and integrating those characteristics with the international best practices.

In addition, although the whole reforms programme did not have a blueprint when reforms started, each stage of the reforms had been pre-planned and remained firmly controlled by the Chinese government. The approaches adopted were tailored for the ultimate principle of economic growth and political stability, in other words, how much it can gain from the reform and how much it may lose if it reforms. This may offer an explanation for why each stage of the reforms had fallen short of targets.

The questions arise: To what extent would these institutional factors shape the banking governance reforms? Would banking reform go around the same circle as the SOE reforms? Or would it try a different path? The answers will be provided through the discussions in the subsequent sections.

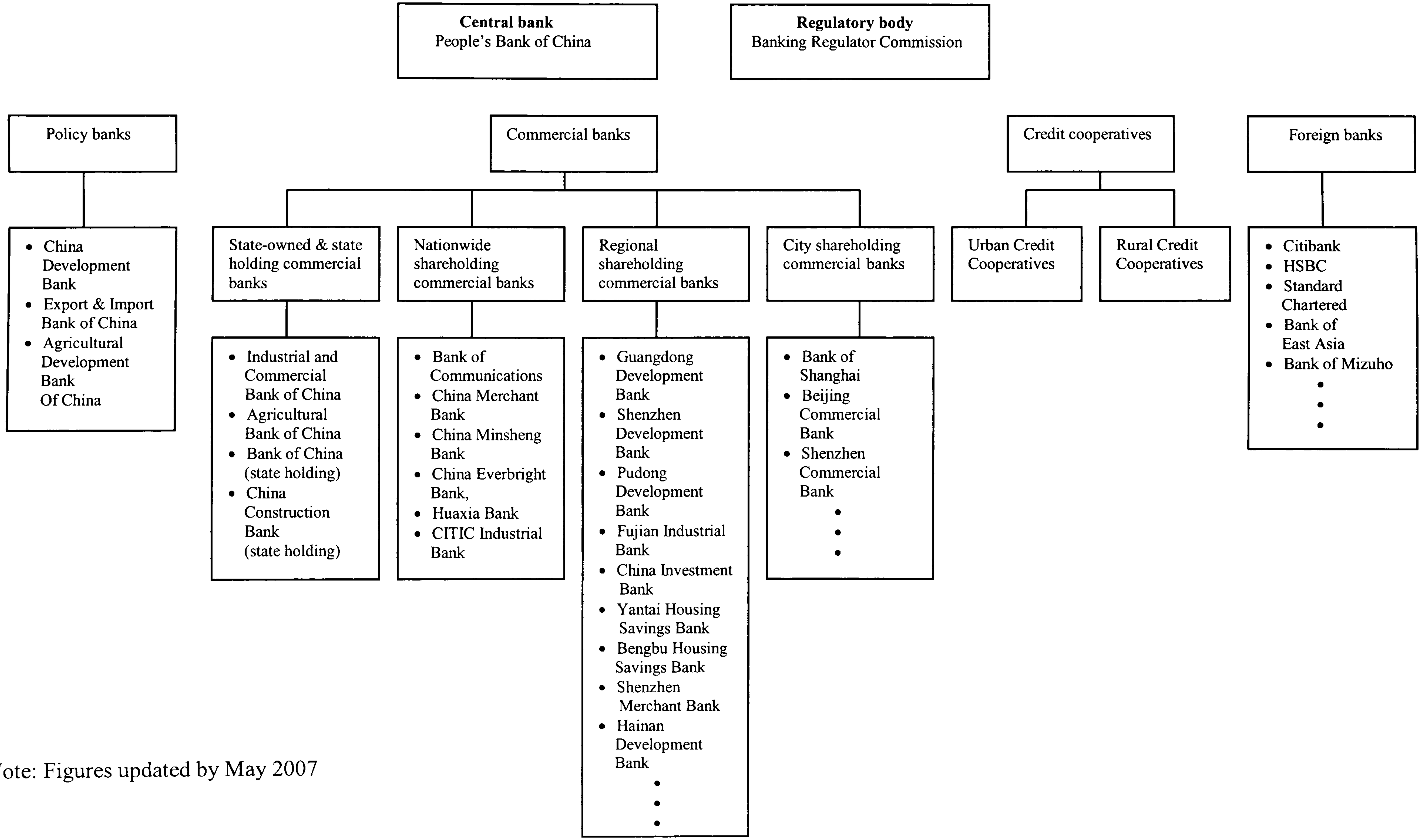
4.3 The first stage (1979-1997): administrative-type governance

China's banking system (see Figure 4.1) took shape and gradually developed after the establishment of the PBOC in 1949. For a long period of time under the planning system, the PBOC was the only bank in China that had assumed all the banking functions, including the responsibilities of the central bank, deposit-taking and commercial lending activities, development project financing, and management of the country's foreign currency reserve. The state budget financing power was predominant. The MOF was the sole capital supplier of all SOEs. As part of the economic reforms beginning in 1979, banking reform received the government's immediate attention.

The primary task was to build a modern banking framework by clearly defining the functions between treasury and banks, the central bank and commercial banks, as well as policy lending and commercial lending.

The first wave of reforms since 1979 began with transforming the highly centralised bureaucratically mono-bank system to a diversified and functionally more specialised system. Four specialised banks were established or re-established. The Agriculture Bank of China was re-established in 1979.[19] It provided banking services to rural business and individuals and focused on the development of the agriculture and rural economy. The China Construction Bank was reconstituted in 1979,[20] specialised in handling fixed asset investment, construction of infrastructure and the development of large enterprises. The Bank of China (BOC) was separated from the operation of PBOC in 1979.[21] It focused on deposits and loans of foreign exchange and international settlement, provided funds for import and export. The Industrial and Commercial Bank of China (ICBC) was subsequently established in 1983. It was mainly responsible for receiving deposits from urban and rural

Figure 4.1 **China's banking system**



Note: Figures updated by May 2007

individuals, provided working capital and settlements for urban industrial and commercial enterprises.

In 1984, the PBOC became the official central bank, and independent from the MOF. Its commercial functions were separated from the administrative functions of the banking system. Its main responsibilities were to make macro monetary policies; control the money supply, interest rates and exchange rates; serve as the treasury of the central government; regulate financial markets; formulate the overall credit and loan plan.

During the second half of the 1980s, many diversified forms of banking and non-banking financial institutions were established to meet the increasingly complex and growing needs of a modernising economy, these included regional banks, insurance companies, trust and investment companies, leasing companies. One new type of banking institution was the shareholding commercial bank,[22] in which various levels of government, Chinese institutions, and in rare cases individuals, hold shares. The most important ones included the Bank of Communications, the Shenzhen Development Bank, the China International Trust and Investment Corporation (CITIC), Industrial Bank, China Everbright Bank, Hua Xia Bank, China Investment Bank, China Merchant's Bank, Guangdong Development Bank, Fujian Xingye Bank, The Shanghai Pudong Development Bank, Hainan Development Bank, and China Minsheng Bank.

Since the establishment of the specialised banking system, the operations of the PBOC and the big four banks had been directly subject to the government administrative control. Although the PBOC singled out its central bank role and became the specialised regulator of the banking sector, it was not an independent body, but a ministry under the State Council. While it was responsible for making the country's monetary policy, the policy remained largely subject to the macroeconomic policies formulated by other ministries such as the State Development and Planning Commission, the State Economic and Trade Commission and the MOF. In the meantime, its supervision effectiveness was constrained by a lack of comprehensive and clearly defined regulations and laws, independent institutional framework, qualified staff and policy enforcement efficiency, as well as by a poor status for the collection and analysis of regulatory data.[23]

Similarly, although the big four specialised banks became economic entities, they were subordinate to the State Council, and became part of the government bureaucracy and development institutions. The traditional mission of the banks clearly concentrated on a particular sector with a specific development orientation. There were strict controls over the business scopes of the banks to ensure their monopoly position. Each bank could only conduct business in the designated areas, which were regulated by the central government. The big four banks developed a vast network of branches, sub-branches, business offices, and have since dominated the Chinese financial market (see Table 4.1). As a result, although the numbers of banks increased, the whole banking sector still lacked competition.

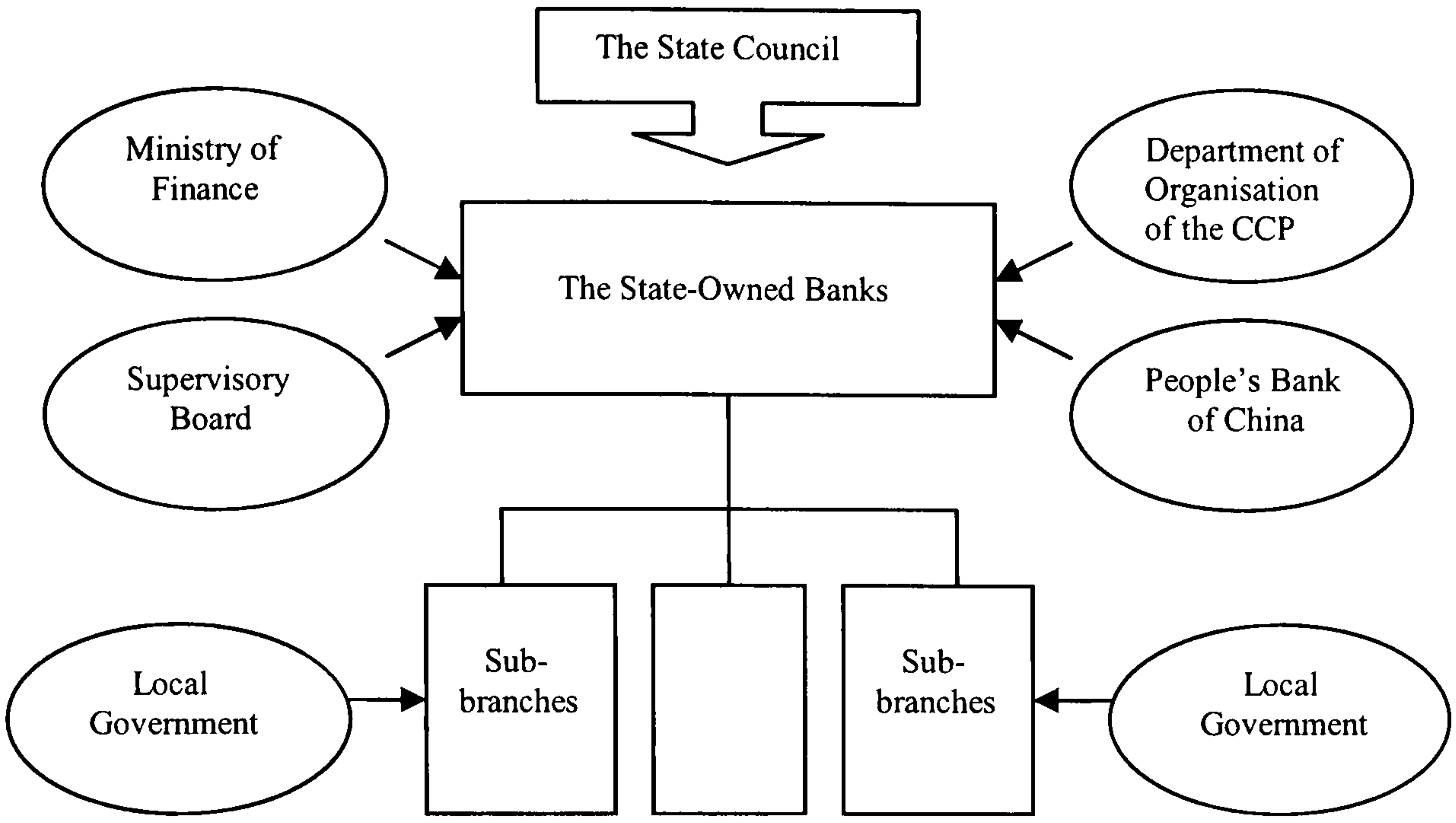
Table 4.1 Market share of the Big Four (Percent)

	1995	1996	1997	1998	1999
Total asset	69.08	69.13	61.99	63.77	64.32
Total deposit	61.04	61.43	62.17	63.09	63.73
Total loan	61.19	59.28	59.83	61.96	61.30

Sources: Almanac of China's Finance and Banking (various years)

The involvement of the government in the banks' operations was also evident in the strict control over the credit allocation and the interest rates. The government formulated and implemented an annual credit plan, which set mandatory quota for all the banks on new loans to be made each year and their allocation to specific sector. Under this system, the government not only used it as a main instrument of controlling money supply, but also to maximise the development impact of the banks' lending. The big four banks were required to support government's objectives ranging from the expansion of priority sectors to the support of the operations of loss making SOEs. To support particular activities, the government also relied on administered interest rates. Interest rates for both deposits and loans were controlled based on the financial conditions of most SOEs. Because even a slight increase of the credit interest rate would not only ultimately cause reduction of the profitability of SOEs, but would also translate into increasing output price and inflation rate as a whole.

Figure 4.2 The traditional governance structure of the SOBs



Source: Author

In addition, each of the big four banks was a body at the quasi-ministry level in the central government, mangers at various levels in the big four banks were appointed and monitored by the Communist Party. Senior positions and salaries were determined by ranks or political connections. The governors of the banks normally possessed high status within the Party and play dual roles of banker and politician. There was no clear demarcation of responsibility between the Party Committee and top managers. The internal governance of the banks was instituted by administrative hierarchy and bureaucracy in terms of the business operation, personnel, remuneration and incentives systems. The branches and sub-branches of the banks developed very close relationships with the local governments, even closer than the relationships with their own bank head offices, since hiring decisions for bank managers were typically made by the local governments, not by the management at the bank head offices that were responsible for their operations. Figure 4.2 illustrates the governance structure of the SOBs in this stage.

The second wave of reforms started in 1994. The further efforts towards market-oriented transformation gained the momentum from the adoption of the goal of establishing socialist market economy. In order to reduce government interference in bank operations and release the policy lending responsibility from the commercial banking functions of the big four specialised banks, three policy banks were created in 1994. These included the China Development Bank, specialising in national infrastructure finance; the Export and Import Bank of China, providing foreign trade finance; the Agriculture Development Bank of China, financing the agriculture development projects. The MOF directed these banks to provide capital or make loans to SOEs or national infrastructure projects.

Regulatory regimes also changed. Two major laws governing China's banking sector, i.e. The Law of the People's Bank of China and The Commercial Bank Law, were enacted in 1995. The former one aimed to make the PBOC a genuine central bank with both supervision power and independence, while the Commercial Bank Law emphasised the need for financial institutions to incorporate commercial criteria into their lending practices. Following the release of the new law, the four specialised banks began to gradually transform into modern commercial banks. Prudent lending practices emerged, as the banks began to manage their loan portfolios by asset/liability ratio. Rigid division business boundaries also became blurred, and the banks actively competed for business. Despite some government influence in the lending decisions that called for banks to invest in infrastructure projects, all the banks gained substantial independence in their daily operations. They began evaluating projects based on borrowers' repayment capacities, collateral and overall customer relationships.

The significance of these reforms was that they promoted a market driven banking system and generally advance the rule of law, both are crucial components for the economic reforms. These reforms, however, were confined to the existing institutional framework without being able to touch the real commercial banking principles. This is reflected in two aspects. First, The Law of the People's Bank of China gave powers to the PBOC to implement monetary policy and to exercise supervision over the banks, but the new regulatory regime was weak on both independence and supervision effectiveness. As a central bank, the PBOC still suffered a lack of sufficient independence, for instance, the determination of the interest rates on loans remained subject to government control, and the supervision effectiveness was still constrained to some extent by its capabilities as discussed above.

Second, the big four banks were still overshadowed by the government administrative control. The Commercial Banking Law clarified the status of the banks as state-owned commercial bank. An external board of supervisors, other than a board of directors, was required to establish in each of the banks. Thus the banks did not have board of directors or special body for monitoring management. Instead the government agencies, such as the PBOC and the MOF, played the function of the board of directors in strategic decision making. The newly established board of supervisors only monitored conformity with banking law and regulations, but did not have role in governance or oversight of bank management.[24] The supervisors were only accountable to the government, as they were appointed by the central government. Accordingly, the SOBs were still managed in the way that more like quasi-government agencies than commercial entities.

To sum up, the significant contributions of the first round of reform was twofold: From the macro perspective, a two-tier banking system with commercial banks as the foundation was established, which changed the traditional highly centralised system into more decentralised and liberalised one. The separation of the banking business not only made the system working more efficiently, but also could raise more capital to fulfil the needs of rapid economic growth. From the micro perspective, the reforms attempted to expand autonomy, flexibility and boost competition to some extent in the banking sector, which laid a foundation for the further transformations.

The reforms in this stage, however, appeared a very slow pace and lagged far behind the progress in other sectors. The banking sector had long been regarded as 'an external financial environment' of the economic reforms,[25] which was required to maintain stability and provide support for the country's economic growth, in particular at the time when SOE reforms received priority. As a result of the reform strategy, a typical quantitative approach was adopted. The reforms had been carried out mainly through policy adjustment and structural adjustment within the exiting institutional framework, which featured the strong government administrative control and weak regulation and supervision.

4.4 The second stage (1998-present): instituting corporate governance

China's ambitious efforts to reform and restructure the banking system began in 1998 and accelerated rapidly after the accession to the World Trade Organisation (WTO). The emphasis of the reforms shifted to address the stock issues of the SOBs with a focal point on corporate governance. The underlying stimulus for the change of reform policy came from the deteriorating condition of the SOBs.

Behind the impressive expansion in the first stage of transformation, China's SOBs were still under the strong grip of the state and largely insulated from market discipline even after two decades of the economic reform. The banks did not have full autonomy in making lending decisions. They were often forced to bail out loss making SOEs. In the case of default or delinquency, the SOBs lacked the power to force payment. In return, profitability was not and could not be used as the performance indicators, the banks found it to be a good excuse for doing poorly. The severe moral hazard thus widely spread in China's banking management, made it difficult to control operational risks. The formal and informal policy lending further blunted the incentives of banking management to develop and maintain a credit culture. Modern risk management systems were almost non-existent in the banks. As a consequence, the SOBs suffered from huge amounts of NPLs, declining profitability and inadequate capital.

Banking sector became a fragile component in the Chinese economy. The continuing fragility in the system could become a major obstacle to the ongoing economic reform. In particular, the NPLs imposed both macroeconomic and microeconomic costs. Since it could eat away the gains that had been made and drag down the country's overall economic performance, and it also posed constraints to the effective use of monetary policy to stimulate domestic economy.[26] In the long term, sustaining future economic growth in China will depend increasingly on functioning banking sector that will lead to improve efficiency in the allocation and use of capital. This broad recognition by the Chinese government made banking reform an increasing urgent task.

The sense of urgency of further fundamental reforms was increased substantially due to two contingent events. The first was the Asian financial crisis. A number of Asian countries experienced banking crisis in 1997 and 1998, which caused tremendous destructions to the countries' economic growth. Although China weathered the crisis, lessons had been learned that a sound banking system was crucial for an economy to withstand external shocks. The low degree of liberalization may prevent a financial crisis, but it offered no cure to the banks' problems. Delaying fundamental reforms could greatly increase the possibility that the financial distress would develop into systemic crisis. Delay would also be costly, since the longer the banks continue to lend under imprudent policies, the larger would be the size of required bank recapitalisation.

The second was the WTO entry. China officially joined the WTO in December 2001. Under its commitment to the WTO, China has agreed to abolish, in phases, the geographic and client restrictions on dealing with overseas banks within five years after entry.[27] China's SOBs will be subjected to greater competition from foreign institutions. This would represent both the opportunities and challenges the banks face. In the long term, foreign bank entry would boost the efficiency of domestic banks. In the short term, however, there was a concern that WTO accession would adversely affect viability of the banking sector, as China's SOBs that lacked capital, developed skills and capabilities, advanced information technology and superior management expertise, would not be in a position to compete effectively with foreign banks. So preparations for the coming challenges of WTO accession heightened the importance of the institutional strengthening necessary to achieve sustained, profitable economic growth in China's banking sector.

The Chinese government has taken comprehensive measures in an effort to transform the SOBs into the modern financial enterprises. This has generally involved in two dimensions: reducing the government administrative control over the banks' operations and building corporate governance mechanism.

In order to free the banks from the government direct intervention, three major reform programs had been implemented. First, in January 1998, the PBOC abolished the credit plan system that had been implemented in China for as long as half a century,[28] and replaced it with an indicative and non binding target, which served only as a reference for the banks to plan their business. The banks have since been responsible for their lending decisions and have had no obligation any longer to extend loans to SOEs.

Second, an important breakthrough was achieved in the interest rates deregulation. Since 1996 a floating interest rate system has been introduced, which has given the banks limit autonomy to adjust lending interest rates within a certain margin below and above the administered rates. In October 2004, the upper limit on lending rate and lower limit for deposit rates were lifted.[29] This was a crucial step to improve banks' risk management skills, as it will allow the banks to price loans according to risk assessment.

Another important reform was the institutional restructure of the PBOC in 1998. The central bank replaced the 32 provincial branches, which had been previously established based on the Chinese administrative system, with 9 regional branches and streamlined city branches where duplication existed. The new system effectively prevented the government officials at the provincial level from interfering with the decision making of the branch offices, and also provided a better position for the PBOC to conduct unified monetary policy and financial supervision.

On the other hand, the Chinese government has simultaneously carried out a drastic programme in seeking to establish an effective corporate governance mechanism in the banking sector. The reforms have focused mainly on three aspects:[30] The first is financial restructuring. Two major policies have been introduced by the government to improve asset quality of the banks, including recapitalisation through injecting equity, creation of four Asset Management Companies (AMCs) to take over and liquidate the NPLs. The second is instituting regulation and supervision framework. This has reflected in the regulatory improvements, in particular, the adoption of international best practices in accounting, loan classification and provision, disclosures and transparency, and also in the supervisory strengthening by creating a new independent agency, i.e. the China's Banking Regulatory Commission. The third is building internal governance mechanism in the banks. The major efforts have been placed on the creation of new ownership structures and checks and balances regimes through shareholding reforms, and institutional strengthening in the form of credit management, risk and financial management.

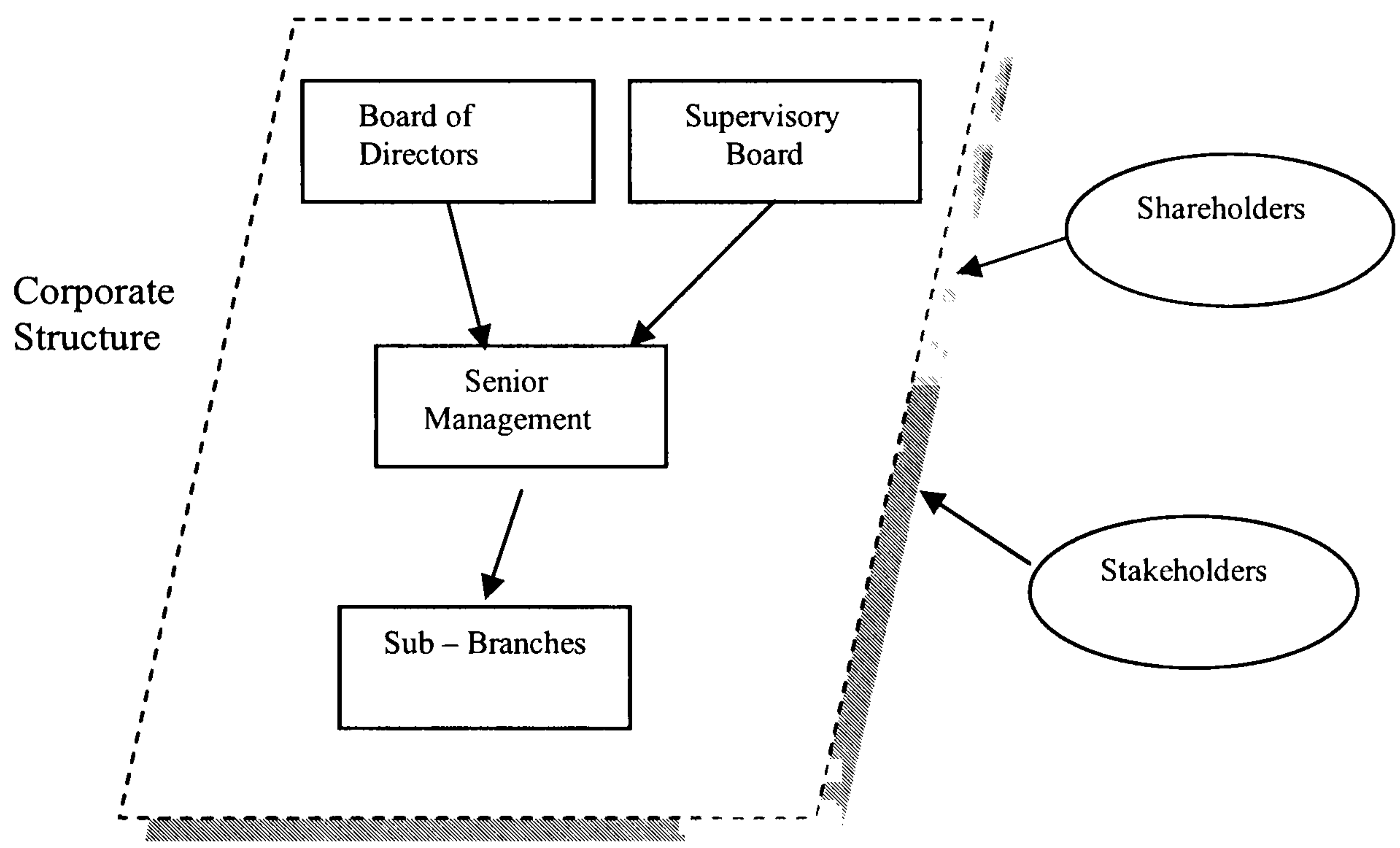
A breakthrough of the reforms should be emphasised, that is the creation of the Central Huijin Investment Co. The company was set up in December 2003. It was originally designated as a special-purpose wholly state-owned commercial entity to help restructure the Big Four. The company has accomplished bailouts of the BOC, the CCB and the ICBC with a combined US$60 billion of foreign exchange reserve received from the central bank,[31] and played a key role on their public listings. Following the move, the company has been authorised to manage the capital injection in the banks by the State Council. It thus assumes the ownership of the SOBs, which formally held by the MOF. Although the final position of the company is still uncertain,[32] the creation of the company has made significant difference in terms of governance of the SOBs. Because through ownership transfer, the company has become the legitimate residual claimants of the SOBs, this has been deemed as a solution in addressing the fundamental issue of the state ownership, which is presumed to result from the ambiguity and inevitable splitting of control and cash flow rights in the banks. In addition, the company should be better placed than the government agencies to fulfil the role of a commercially-oriented shareholder in disciplining and monitoring the banks. It therefore has been used as a means to lessen administrative intervention in the SOBs by the government.

Two major features can be observed in this stage of reforms. Firstly, the overall reform approach is seemingly well designed. It has a clear objective and has been implemented gradually. Although the reform initiative ultimately resemble the one of SOE reform, which focuses exclusively on the property rights, the government seems to have learned the lessons from the previous SOE reforms that autonomy without corresponding restraints could only expand opportunities for rent seeking. Efforts have been made to address both the issues of autonomy and governance. The greater liberalisations have been done cautiously, and entirely rested on the improvement of regulation and supervision, so as to ensure a smooth transformation, at least in the short term, and maintain stability in the economy as a whole.

Moreover, the reforms in the three major aspects as discussed above are complementary. The financial restructuring creates favourable conditions for the SOBs to conduct business on the pure commercial principles, which is the prerequisite for the corporate governance reforms. While it constitutes only one step of the whole process, this is because the strong balance sheets would not necessarily guarantee the future health of the banks. Institutional strengthening of credit and risk management capabilities must build within the banks to prevent new NPLs occurring and achieve lasting effectiveness in the lending process. There is also a need for a strong regulatory and supervisory framework for the smooth operations of the banks, for helping to improve efficiency, safety, liquidity, for increasing efficient transfer of information and adding to financial discipline.

In summary, the SOBs have undergone a profound transformation since 1998 from a qualitative point of view. A new governance structure of the SOB has been established (see Figure 4.3). The ownership, asset quality and governance issues of the banks have been addressed through institutional reforms. The tendency concerning the role of government control in the banks, though the reform is a ongoing process, has seen moving towards an indirect form of control in line with the tenet of separation between ownership and management.

Figure 4.3 The new governance structure of the SOBs



Source: Author

4.5 Conclusions

This chapter provides an overview of the evolution of the corporate governance in China's banking sector, including the background, general stages and approaches. The main findings may be summarised as follows.

First, the government retains control of the SOBs, which has seen little change throughout the reforms process. Even after the banks have been transformed into shareholding companies, where there has been only partial divestment and the state has not relinquished any control in terms of the dominance in ownership and appointment of key personnel. What the reform efforts has brought about, however, is the significant changes in the ways that the government conducts its control, which have seen shifting from a system of direct influence and control of management to control through indirect forms. The government has given the banks full autonomy to make decisions for the business by abandoning its administrative control on the one hand, on the other hand, the government has strengthened the control through new institutions, for instance, prudential regulation and oversight, internal control system, which are more indirect and in line with the international norms.

Second, corporate governance reforms of the SOBs have all been a strategic choice in the whole process of economic reform. The forms, approaches and pace are all subject to the dynamic political and economic institutions. The reform of the SOB generally lags far behind the SOE reform. The ownership restructuring, among the government's more aggressive governance reforms, fundamentally replicates the initiatives of the SOE reform. The inconsistencies in the reform path are not only caused by incomplete information, but also the sense of transformation in the banking sector, which is underlined by the multiple and often conflicting objectives of the government's reform plan. Since the Chinese government has to strike a proper balance between the banking restructuring and the sustained economic development.

These findings imply that the Chinese government has attempted to introduce new governance regime into the banking sector without substantially diminishing the role of government as owner. It is unlikely that the government would play its role as a passive shareholder. The government, however, has become increasingly aware of the importance of what interventions would be appropriate in what contexts, and efforts have been made to build the institutions and capacities to intervene effectively.

Chapter 5 Rehabilitating the state-owned banks: Chinese approach

5.1 Introduction

One of the central issues, when discussing the problems related to China's banking sector, is the financial vulnerability, in the form of NPLs and undercapitalisation. The mounting bad loans amassed during the decades of China's economic reform and low capital adequacy ratios have not only been the biggest obstacles to the reform of the state-owned lenders, but have also affected the stability and economic prospects of Chinese economy. Strengthening the balance sheets of the state-owned banks has therefore been given a top priority by the Chinese government in the process of the banks' restructuring and governance reforms since 1998. Comprehensive solution measures have been taken including capital injections, write-offs of non-performing assets (NPAs), approval of issuance of subordinated bond, and use of AMCs.

This chapter provides a holistic view on the Chinese approach in restoring the health of the SOBs. Drawn largely upon the experience of the BOC and the CCB, this chapter reviews the process of financial restructuring of the SOBs, examines the banks' unique set of problems, and evaluates the ways in which the problems of asset quality and capital adequacy have been tackled. The purpose of this chapter is to offer a better understanding on the corporate governance reform of the SOBs from outset.

In the following sections, this chapter begins with a review of the historical fragility of the SOBs, which focuses on the seriousness of the NPLs and inadequate capital. The causes are also discussed. This chapter then examines the set of approaches adopted by the Chinese government in rehabilitating the SOBs, including the capital injection and the NPLs resolution. This is followed by a discussion of the impact of the approaches on the banks' balance sheets. The problems and challenges are highlighted. Conclusions are presented in the last section.

5.2 The financial fragility of the SOBs prior to the late 1990s

5.2.1 Non performing loans

Information on legacy NPLs of the Big Four before the late 1990s is very limited. Prior to the early 1990s, China had appeared to make little effort in classifying the bank loans by their quality. This partly reflects the historical evolution of China's banking system as discussed in Chapter 4. Estimating the exact level of the NPLs is therefore difficult. The difficulty is further complicated by incomplete disclosure. Chinese authorities did not release such financial information as the amount of NPLs to the outside world, because the information had been considered vital to national security.[1] In addition, China adopted a unique loan classification system before 1998, which was based on actual loan performance and less stringent,[2] and thus make its statistics not internationally comparable.

The NPLs problem of the SOBs was first raised officially by the Chinese government in 1995, when Zhu Rongji, who was the vice premier of the State Council, required the SOBs to reduce the bad loans by 3 percent every year in a national banking conference. Whilst ironically despite the write-offs of RMB93.8 billion (US$11.4 billion) during 1996-1998,[3] the NPLs had continuously increased at an average annual rate of 3 percent until 1999 when the NPLs resolutions scheme was initiated.[4]

The official estimate of the NPL ratio of the Big Four was 20 percent in 1995.[5] In 1997 the NPL ratio increased to 24 percent.[6] In 1999, before the NPLs being transferred off the balance sheets of the banks, the Big Four held total NPLs amounted to RMB2400 billion (US$290 billion),[7] which indicates that the NPL ratio was around 36 percent of the total loans, or 29.3 percent of the GDP in 1999. Taken into consideration the fact that this estimate was based on the old loan classification system, the NPLs in the Big Four under the five category loan classification system must be considerably larger than the official figures.[8] Compared with the post financial crisis NPLs levels in the East Asian economies, for example, Thailand 25 percent, South Korea 19 percent, Indonesia 55 percent, Malaysia 17 percent (Asian Development Bank 2001), the sheer volume of the NPLs in the SOBs is very high.

The seriousness of the NPLs problem can be demonstrated by the clean up cost. Based on the official estimate of the NPLs at the end of 1999, suppose the recoverable rate is 25 percent,[9] the total cost for the banks' restructuring is around RMB18000 billion (US$2177 billion), which is equivalent to 22 percent of the GDP at end-1999. This figure is higher than that of most countries which had experienced bank restructuring (see Table 5.1). It also clearly shows the huge burden of the Chinese banking system, as well as the tremendous cost of restructuring it.

Table 5.1 Fiscal cost of bank restructuring

As a percentage of GDP

Kuwait	45	Finland	9.9
Chile	33	Poland	5.7
Venezuela	17	Ghana	6.0
Spain	15	Philippines	4.0
Mexico	12-15	Indonesia	2.0
Hungary	12.2	Argentina	0.3

Source: Dziobek and Pazarbasiogu (1999)

5.2.2 Capital adequacy

China only began imposing supervision on capital adequacy of the SOBs in 1996 after the promulgation of the Commercial Bank Law. Although the requirements of capital adequacy were in place, the standards were not able to reflect the true capital level of the banks until the SOBs became fully in line with the standards of the Basel Accord I in 2004[10]. Information on the actual capital adequacy of the SOBs before the late 1990s was sparse, even the government and banks itself did not know the answer. However the available data of the banks' pay-in capital, total assets and profitability in the 1990s could provide a broader picture of the banks' capital conditions.

Bank capital is generally composed of core capital (Tier 1 capital) and supplementary capital (Tier 2 capital).[11] In China, there had been almost no difference between the two Tiers of capital in the SOBs in 1990s. Since the banks had been lack of means in acquiring supplementary capital, for instance, through making general loan loss provisions, or issuing subordinated debt,[12] the bank's core capital that was mainly constituted by the pay-in capital and retained profits, was thus almost equivalent to the total capital of the banks. Since the government had been the only shareholder of the banks before the banks' ownership reform beginning in 2004, it was the only viable source of the banks' capital. This capital was identified in the banks' balance sheets as pay-in capital. As shown in Table 5.2, the pay-in capital of the Big Four had been declining against the banks' assets in the 1990s. Between 1990 and 1997, before the government first capital injection in 1998, the banks' assets grew 3 times more than their pay-in capital. The pay-in capital of the banks actually fell by 65 percent, from 7.8 percent in 1990 to 2.2 percent in 1997.

Table 5.2 Pay-in capital and assets of the SOBs in the 1990s

Year	Capital (RMB billion)	Assets (RMB billion)	Capital to assets* ratio
1990	131.6	1683.8	7.8
1991	148.2	2061.4	7.2
1992	182.2	2426.9	7.5
1993	220.7	2987.2	7.4
1994	217.3	4084.1	5.3
1995	181.9	5138.2	3.6
1996	192.7	6324.7	3.1
1997	210.6	7783.2	2.7
1998	484.6	9086.6	5.3

Sources: Almanac of China's Finance and Banking (various years)
Note: * Author's calculation

In addition to the pay-in capital, the banks' retained profit was an important source of the banks' capital. The profitability of the banks had been falling in the 1990s. Between 1990 and 1997, the banks' pre-tax profits dropped by more than 100 percent. The ROA fell by nearly 90 percent (see Table 5.3).

According to an official estimate, the average CAR of the Big Four was only 2.28 percent in 1997.[13] If it was calculated based on the standards of Basel Accord I, the figure should be between –1.72 percent and –2.72 percent.[14] This suggests that the Big Four as a group were technically insolvent. Even after the first round of the capital injections in 1998, the weak capital positions of the banks had seen little change, because the CAR was only raised to 4.6 percent (see further discussion below).[15]

Table 5.3 Profitability of the SOBs in the 1990s

Year	Pre-tax profit (RMB billion)	Return on assets (ROA percent)	Return on equity (ROE percent)
1990	24.23	1.44	18.4
1991	29.93	1.45	20.2
1992	32.47	1.34	17.8
1993	27.34	0.91	10.5
1994	16.96	0.42	7.8
1995	22.21	0.43	12.2
1996	23.38	0.37	12.1
1997	11.97	0.15	5.7
1998	13.91	0.15	2.9

Sources: Almanac of China's Finance and Banking (various years)

5.2.3 Causes

Banks face a wide range of complex risks in running their day-to-day business, including risks relating to credit, liquidity, exposure concentration, interest rates, exchange rates, settlement, and internal operations. While NPL are always a problem of banks, this is determined by the nature of banks' business, in particular the role as the most important channel of financial intermediation in the economy. Banks make profit by issuing credit which returns with interest. But debtors may fail to pay interest and/or repay principal. As a consequence, banks may increase their liabilities.

NPL is a global issue. Few countries have not suffered NPL problem in the past decades, from the US in the early 1980s to the ongoing cases in Asia, Europe and Latin America. The distressed assets have seen arising as a result of different sources. They generally fall into three categories. The first is macroeconomic cycles. Banks in all economies expand credit during economic booms, when recessions occur, massive borrowers' business could fail and bring systemic defaults on the portfolios. The second is associated with flaws in banks' lending and risk management practices. This is a global phenomenon, banks are not likely to scrutinise loans on the ground of safety with such deficiencies. Finally, institutional factors, for instance, government-directed investment in Korea and Indonesia, main bank system (Keiretsu) in Japan, also contribute banks' problem loans.

It is frequently argued that China's NPL problem results from soft budget constraint, i.e. years of political influences on bank lending or actual policy lending to loss-making SOEs. Lardy (1998) defines policy loans in China as loans extended at the behest of the governmental authorities at the central and local level rather than as a result of normal commercial bank decision making. Qian (1994) elaborates two forms of policy loans in China: policy loans for development purposes and policy loans to subsidise loss-making SOEs. Nevertheless, they focus on the negative effects of policy loans, such as creating moral hazard, reducing the efficiency of financial system. Dwight (2004) develops a public finance approach, and presents a different view by emphasising the positive role of the NPLs in China, i.e. the NPLs provide an efficient method to reduce the excess burden of taxation and promote employment.

This chapter offers an alternative view by closely looking at the important realities of the stage of the development in Chinese economy. China's NPLs arose from a special relationship between a special class of creditors, the big four SOBs, and the special class of borrowers, SOEs, during a special period, from the middle of the 1980s to the late 1990s. They may be characterised as SOBs specific, SOEs specific and period specific, which are unique and different from that discerned in other countries. China's NPL problem, in essence, reflected the fundamental issues of how the Chinese economy operates.

China did not face the problem of NPLs under central planning system. SOEs were run as workshops of the planned economy, government budgets were allocated to enterprises automatically according to the annual economic plan of the central government, at the same time enterprises returned almost all their profits to the MOF. The government budget had remained a dominant role in direct financing SOEs until 1983, even after five years of economic reform. As a part of the fiscal reform embarked on in 1983, the SOE financing through direct state budget was shifted to bank loans (bo gai dai). Throughout much of the 1980s and 1990s, the SOBs served as cashiers of the government, providing capital at low or even negative real rates of interest. SOEs, in turn, operating under chronically soft budget conditions, became highly leveraged.

What impetus drove this significant policy change? The answer may rest on three factors. Firstly, the 'weak' fiscal revenue versus 'strong' finance structure. Prior to the reforms, financial resources in China were highly centralised. The revenue capacity of the fiscal system declined significantly during the 1980s and the 1990s, largely due to the inefficient and loss-making SOEs.[16] The share of fiscal revenues to GDP decreased from 31 percent in 1978 to 12 percent in the late 1990s. During the same period, however, the ratio of household savings to GDP increased dramatically from 5.8 percent to 70 percent (see Table 5.4). The ever growing amounts of household savings flushing into the Big Four dominated banking system has been the result of the monopoly of financial resources by the state, whereby households have had little choice but to hold bank deposits. As a consequence of decentralisation of financial resources, Chinese government had to reduce the expenditures facing increasing pressures on keeping fiscal deficit modest (see Table 5.5), and was unable to subsidise the SOEs with fiscal finance. Instead, the government sought financial resources from the SOBs in the form of policy loans.

Table 5.4 Weak fiscal and strong finance structure (*Percent*)

Year	Fiscal Revenue/GDP	Saving Deposit/GDP	Loan / GDP
1978	31.24	5.81	n.a.
1980	25.67	8.84	53.44
1981	24.18	10.77	56.86
1982	22.90	12.76	56.65
1983	23.03	15.04	57.82
1984	22.91	16.94	61.63
1985	22.36	18.10	65.88
1986	20.80	21.93	74.40
1987	18.39	25.69	82.71
1988	15.79	25.47	76.17
1989	15.76	30.44	79.16
1990	15.84	37.92	87.16
1991	14.57	42.13	92.16
1992	13.08	43.34	90.30
1993	12.56	42.62	84.32
1994	11.19	46.06	91.27
1995	10.71	50.72	87.55
1996	10.87	56.74	90.21
1997	11.60	62.15	100.19
1998	12.60	68.17	108.76
1999	13.90	70.60	114.23
2000	15.00	72.92	111.15
2001	16.80	78.18	117.08
2002	18.00	84.88	136.53
2003	18.60	n.a.	147.00

Sources: China Statistical Yearbook (various years)
Note: n.a.: Not available

Table 5.5 Total revenue and expenditure

RMB 100 million

Period	Total Revenue	Total Expenditure	Balance
1976-1980	5089.61	5282.44	-192.83
1981-1985	7402.75	7483.18	-80.43
1986-1990	12280.60	12865.67	-585.07
1991-1995	22442.10	24387.46	-1945.36
1996-2000	50774.39	57043.46	-6269.07
2001-2003	57004.93	65605.68	-8600.75

Sources: China Statistical Yearbook (various years)
Note: Exclude foreign and domestic debts

In addition, bank financing fits the need of development strategy. China, similar to the East Asian growth mode, has adopted an incrementalist reform approach and has long been pursuing rapid expansion of the economy. Over the past two decades, the average rate of real GDP growth was 9.4 percent. Sustaining such rapid growth year after year requires an extraordinary capital raising capability, and continuous investment activities which gain momentum from exogenous forces. This entails that the government plays dominant role in investment allocation, and deploys financial resources through the state controlled banking system. The bank centric finance in China, dominated by the SOBs, has been further strengthened due to the preference of indirect finance of the government. Increasing the share of direct finance, for instance, capital market, bond market, would inevitably diversify the households' savings, and consequently increase the costs of the government in raising capital. This concern has led to the underdevelopment of the capital market in China up to now.

Furthermore, SOEs play crucial role in the economic development and social stability. It is important to recognised that China's reform started before the state sector was in drastic decline, contrary to the situation of former Soviet Union in the late 1980s.[17] Chinese economy, before the reform during 1952-1978, could grow at an average rate of 6 percent,[18] in which the SOEs were the sole contributors. The share of the SOEs in gross industrial output gradually declined during the reform period, for instance, from over 78 percent in 1979 to 28 percent in 1999.[18] This was resulted from many factors, such as the rapid expansion of non-state sector, the uneven taxation, and the inadequate management and inappropriate investment choices within the SOEs. However, the social burdens of the SOEs were considered to be the major cause. The SOEs in China were historically not confined to making profits but also to take care of such social responsibilities as housing, education, health-care and other services for their workers on behalf of the government. Between 1980 and 1994, enterprise expenditures on social welfare increased sixfold in the mid-1990s, it was roughly half of the SOEs' wage bill (Huang et al 1999). Supporting the SOEs, including subsidising loss-making SOEs through bank financing had become the major government policy until the late 1990s. In 1998, nearly 82.8 percent of total outstanding loans of the SOBs were directed to the SOEs, against 91.1 percent in 1978.[20]

In sum, the NPLs in Chinese banking system are essentially fiscal costs or reform costs to the government. It is manifested by the government's capital injections and loan transfer scheme. Reassessed the export-led growth from the experience of other Asian countries, Chinese government is clearly recognised that China's long term growth is likely hinge on the performance of domestic industries. Revitalising the SOEs remains the central issue in the Chinese economic reform. This may imply that the success of banking reform depends on the degree of progress in reforming the state industrial sector, the functional behaviour of the government, and the legal, fiscal, and social welfare systems that form the social-economic environment in which Chinese banks operate.

5.3 Chinese approach in bank rehabilitation

Bank restructuring often has to be accompanied by bank rehabilitation, using either flow or stock approach, which are based on recapitalisation and disposal of impaired assets and/or debt restructuring respectively. Many diverse measures have been employed for this purpose. Commonly used measures, as cross country evidence indicates, include central bank liquidity support, asset management units, merger with other banks, bond and new equity issuance. Most countries pursue a mix of these approaches.[21] Transitional economies in Central and Eastern Europe, such as the Czech Republic, Hungary and Poland, dealt with NPLs by either a centralised (so-called hospital bank) or decentralised asset management units. Fund injection was also used by the governments in the Czech Republic and Hungary.[22] Asian economies affected by the

East Asian financial crises have seen an increase in domestic merger and acquisition activities in the past five years, for instance, Japan, Taiwan and Malaysia, bank consolidation created larger institutions that were better capitalised. At the same time, AMCs have been extensively used in the region for disposal of impaired assets.[23]

Compared with other countries, China faces its own unique challenges in dealing with asset quality of SOBs. The Big Four confronted mounting bad debt and chronic undercapitalisation simultaneously. In addition, the Chinese government had to restore the economic solvency of the banks in a short period before the domestic market fully opened up to foreign financial institutions at the end of 2006. More importantly, the constraint of inadequate fiscal resources further raised difficulties in funding the restructuring of banks. Nevertheless, Chinese policy makers found an original solution for fixing the financial fragility. A set of measures combining flow and stock solutions had been adopted, including strengthening the bank's capital base through cash injections with foreign exchange reserve, and approval of issuance of subordinated bond. On the other hand, resolving bad assets by debt write-off and creation of AMCs. This section examines these approaches from the two aspects.

5.3.1 Recapitalisation

In response to the challenges, in particular the fiscal pressures, as discussed above, the Chinese government had to give priority to solving the weak capital adequacy problem with the limited fiscal resources, given the urgency of the problem as well as the differences it would make in comparison with NPLs issue. The initiative of replenishment of banks' capital has been implemented through two avenues, i.e. capital injection and approval of issuance of subordinated bonds.

The Chinese government stepped in to support the Big Four with two capital infusions in 1998 and 2003, which were carried out in distinctive ways. In August 1998, the PBOC lowered the bank reserve requirement from 13 percent to 8 percent, freeing up about RMB377 billion of bank funds that banks could used to purchase bonds issued by the MOF worth RMB270 billion (US$32.5 billion). The MOF then infused the entire proceeds into the Big Four. This process was, in essence, two swap transactions, i.e. an asset swap of bond for reserve deposits between the banks and the MOF; a liability swap of equity for central bank borrowing between the banks and the PBOC.[24] This recapitalisation scheme cost nearly 3.5 percent of GDP in 1998, and raised the combined capital of the Big Four to RMB478 billion (US$57.8 billion).

It had been widely reported that the average CAR of the banks after the injection was brought to 8 percent as the scheme targeted. Even the PBOC and the MOF once believed that the recapitalisation scheme had achieved that target. However, the capital injection actually only raised the CAR to 4.64 percent. The failure of the effort was caused by two factors. The first was that the evaluation for the capital gap at the end of 1997 was based on the available data prior to the end of June 1997, while it underestimated the large increase of the banks' risk-weighted assets and the decrease of capital during the second half of the year. In fact, to raise the CAR of the banks to 8 percent at year end 1997, it would have had to require RMB336.5 billion (US$40.7 billion), while the amount of RMB270 billion only raised the CAR to 6.87 percent. Another factor was that the banks were required to submit consolidated financial reports since 1998, this resulted in the increase of RMB32.3 billion (US$3.9 billion) in bad debts and RMB2211.6 billion (US$267.4 billion) in risk-weighted assets by the end of 1998. The average CAR of the banks consequently fell by 2.23 percent at the year end.

Table 5.6 Capital adequacy of the Big Four 2000-03

(*Percent*)

Year	BOC		CCB		ICBC		ABC
	CAR	T1	CAR	T1	CAR	T1	CAR T1
2000	8.31	8.16	6.51	6.71	5.38	5.38	n.a.
2001	8.30	8.30	6.88	6.59	5.76	5.76	n.a.
2002	8.15	7.85	6.91	5.78	5.54	5.46	n.a.
2003	6.98	7.11	6.51	5.88	5.52	4.77	n.a.

Sources: Annual Reports of the banks (various years)
Notes: 1. The capital adequacy requirements are based on the Chinese standard
2. T1 denotes Tier 1 risk weighted ratio
3. CAR denotes total risk weighted ratio
n.a.: Not available

Table 5.6 shows that between 2000 and 2003 the CARs of the Big Four had been declining, though the degrees were varied. The capital base of each bank was still insufficient by the 1998 Basle standards, not to mention the fact that far less loan loss provisions were made. The reasons were that the total lending of the banks increased by a large margin at an average annual rate of 17 percent during the period (see Table 5.7). Meanwhile, new NPLs recurred and lowered the CARs of the banks, though they were not created entirely by new loans turning bad.[25] The deteriorating quality of the banks' assets implies that additional financial assistance would be necessary.

Table 5.7 Outstanding loans of the Big Four 1999-04

Year	1999	2000	2001	2002	2003	2004
Amount (RMB Trillion)	6.75	6.85	7.23	8.5	10.07	11.09
Annual loan growth* (Percent)	4.75	1.51	9.11	14.1	18.5	10.1

Source: PBOC
Note: * Author's calculation.
n.a.: Not available.

In the late December 2003, the Chinese government launched an aggressive programme with a proposal of more than US$100 billion to be earmarked for recapitalisation of the Big Four, which aimed at transforming the banks into shareholding entities before the planned IPO. The BOC and the CCB first benefited from this plan, each of which received US$22.5 billion on 30 December 2003. The two banks were considered to be healthier among the Big Four, and were chosen by the central government as pilot institutions to test the country's banking reforms.[26] The ICBC, China's biggest lender, received US$15 billion as a part of sizable recapitalisation package for the bank on 21 April 2005. The last in line is the ABC, the amount and timing of the injection has remained unknown, but the answer is not long in coming.

Compared with the prior injection, the most notable feature of this plan is infusing cash from the country's vast foreign exchange reserves. The creative use of foreign reserves to recapitalise banks not only greatly alleviates the fiscal pressures but also open a new channel for making use of foreign reserves. Furthermore, this method offers a workable solution to the two problems of reviving the banks and revaluation of the Renminbi, the country's currency.

In addition to capital injection, the SOBs were granted to issue subordinated bonds to improve capital adequacy levels in June 2004.[27] The bonds rank after other bank liabilities in terms of claims on bank assets. It will be included in the calculation of Tier 2 capital. It is a prevailing practice internationally that commercial banks issues bonds. In developed countries, subordinated bonds have become an important source for the supplementary capital of banks. It has played significant roles in increasing banks' liquidity, reducing costs of raising capital, strengthening the discipline of market.

Although subordinated bond has remained novel among investors in China, the ultimate size of the market remains unclear, and the illiquidity and lack of meaningful credit ratings could also slow down market acceptance, the issuance of subordinated bond in the inter-bank bond market has broadened the availability of fund-raising channels without affecting overall systemic risk. It makes particular difference in strengthening the capital base for the SOBs prior their IPOs. It is estimated that the Big Four may issue subordinated bonds amounted up to RMB300 billion (US$36.3 billion).[28] During 2004 and 2005, the BOC and the CCB had issued totally RMB60 billion (US$7.2 billion) and RMB40 billion (US$4.84 billion) worth of subordinated bonds respectively, the ICBC sold RMB35 billion (US$4.2 billion).[29]

5.3.2 NPLs resolution

Recapitalisation, as a flow solution, attempts to allow banks to strengthen their capital bases and increase the banks' capability in making profits, while it does not explicitly address the stock of bad debt in the banks. Evidence across countries suggests that flow solution is only successful when banking distress is limited (Klingebiel 1999, p.3). Stock option tends to be necessary in cases where banking problem is systemic. One common feature in using this option is the establishment of AMCs to tackle the NPL problems. The most notable case is the U.S. Resolution Trust Company (RTC), which was set up, in response to the banking crisis of the 1980s and early 1990s, to resolve bad loans from the portfolios of failed Saving and Loan Associations (S&Ls). Over its seven-year life, the RTC succeeded in achieving recovery rate of 86 percent on total assets transferred. The final cost to the U.S. government was under $100 billion against the originally predicted $400 billion.[30] RTC has hence become a model for the rest of the world, in Korea, for instance, the Korea Asset Management Corporation promptly purchased almost 80 per cent of total NPLs from banks at market value in the aftermath of the financial crisis; in Malaysia, the national AMC, Danaharta, purchased 41 per cent of total NPLs in the banking system.[31] There are other examples in which bank-specific, rather than centralised, AMCs have been formed.

China set up four AMCs in 1999 to work out the bad loans of the Big Four. These are the Cinda AMC, the Huarong AMC, the Great Wall AMC, and the Orient AMC. Each of them has registered capital of RMB 10 billion (US$1.2 billion) and is directly funded by the MOF. At the time of their establishment, the AMCs received RMB1394 billion (US$168 billion) in NPLs from the Big Four (see Table 5.8). In order to finance the purchase of the banks' assets that have been transferred to them, each AMC issued ten-year bonds, guaranteed by the MOF, to their designated banks respectively in the Big Four.

Table 5.8 China's AMCs and its designated SOBs

(RMB billion)

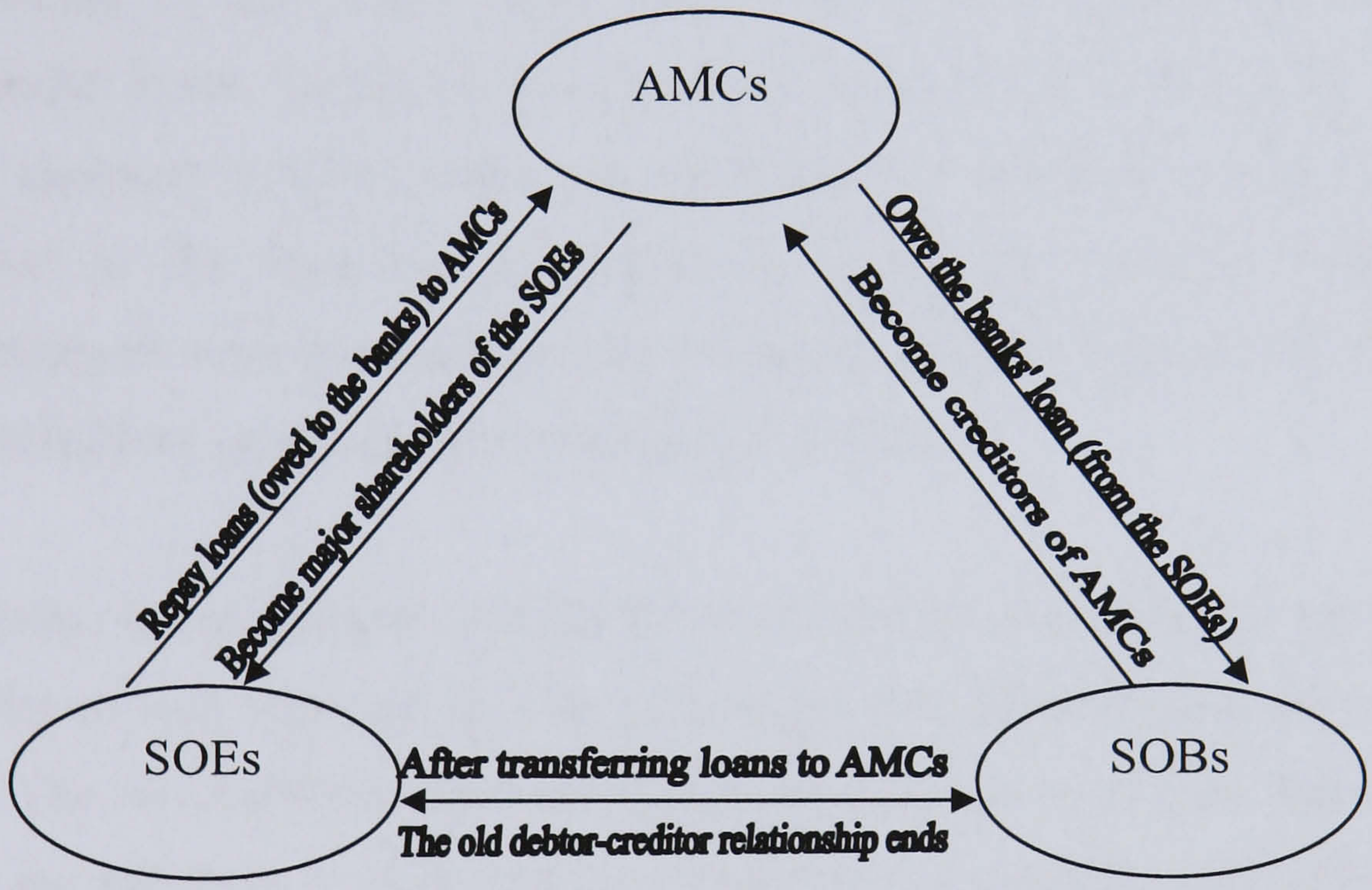
AMCs	SOBs	NPEs Aquired	Registered Capital	Lifespan
Cinda	CCB	373 (US$45.1 billion)	10 (US$1.2 billion)	10 years
Huarong	ICBC	407.7 (US$49.3 billion)		
Great Wall	ABC	345.8 (US$41.8 billion)		
Orient	BOC	267.4 (US$32.3 billion)		

Sources: PBOC, MOF
Note: NPEs acquired by the Cinda does not include the amount of RMB278.7 billion (US$33.7 billion) 'Doubtful' loans which were purchased from the BOC and the CCB in June 2004.

The establishment of China's four AMCs represents the most aggressive attempt by the government to improve the asset quality of the SOBs. China, in essence, uses the NPL resolution process to introduce a new set of institutions into the market place. China created four separated centralised agencies rather than a single centralised loan workout agency. Despite the consideration of difficulties in dealing with the huge portfolio of

NPLs, the proper incentives for competition would be the major concern for such an arrangement. The incentives may not only be fostered within the AMCs, and within the banks, but also between the AMCs and the banks. Because although each of the AMCs has its own corresponding bank, the four AMCs, in terms of their legal status, are wholly state-owned, non-bank financial institutions under the supervision of the MOF and the PBOC. Such independence has been further strengthened by the introduction of a biding system for acquiring NPLs after the initial NPLs transfer. Effective competition may also be expected in the future, given the likelihood that the AMCs would be developed into investment banks when their ten-year lifespan ends.

Figure 5.1 Institutional links among the AMCs, the SOBs and the SOEs



Source: Author

Moreover, the AMCs are expected to perform multiple functions, as both a rapid asset disposal vehicle and SOE restructuring agency. On the one hand, the AMCs play its essential role in restoring the health of the bank's balance sheets. Because using public funds to take NPLs off the books of the banks, is clearly the fastest way for the banks to lower their NPL ratio to acceptable international level without diminishing their minimum CAR of 8 percent. Their major task during their lifespan is to recover approximately RMB2.4 trillion (US$290 billion) in NPLs owed to the Big Four by the SOEs. On the other hand, unlike other countries' AMCs, for example, RTC in the U.S., as a public agency, had a narrower focus on its duty, which was to maximise net value returns from the disposition of failed institutions and their assets.[32] China's AMCs, in many ways, are an arm of the government and a crucial part of the country's overall restructuring programme for the state sector. Because lack of investment banks and venture capitalists in China, the AMCs are performing task of rehabilitating the loss making large SOEs and eventually liquidate their stakes by selling or listing the shares of the enterprises. Figure 5.1 illustrates the institutional links among the AMCs, the SOBs and the SOEs in China.

Besides the above feature, there are other features that can also be discerned in the process of resolving NPLs in China. Firstly, not all the bank's NPLs were transferred to the AMCs, some portion of NPLs remained in the banks' balance sheets. Loans transferred to the AMCs were subject to those classified as 'Substandard' and 'Doubtful' loans. Loans classified as 'Loss' were left and to be written off by the banks. This approach is clearly take the advantages of decentralise loans workout method adopted in the transition economies in Central and Eastern Europe. The banks' capability to work out loans can be preserved on the one hand. On the other hand, it may effectively preclude the moral hazard problem.

Secondly, China presents a gradually evolutionary feature in the ways that NPLs are transferred and disposed of. The government has implemented two NPL transfers to date. The two transfers were carried out in different ways. The first transfer of NPLs from the Big Four to their corresponding AMCs involved a strict exchange at the face value of the loans, without any discount to take account of the real, or market, value of doubtful or uncollectible loans. The direct replacement of bad assets with the good assets, i.e. the AMCs' interest-yielding bonds, substantially benefited the banks in terms of enhancing their asset quality and possibly their future profitability. For example, the Big Four achieved an average 9.7 percent reduction of NPLs after the first loans transfer. Since the second transfer in June 2004, a market-oriented biding system has been introduced, which has brought more competitiveness into the Chinese NPL market. It was the Cinda AMC that eventually won the bid and purchased a portfolio of RMB278.7 billion (US$33.7 billion) NPLs from the CCB and the BOC, and became the two banks' wholesaler of distress assets.

The disposal of NPLs can be accomplished in two general ways, i.e. asset disposal and debt restructuring. Asset disposal entails short-term asset management, and often involves liquidation and bankruptcy proceedings against the debtor. Debt restructuring strategy is long term focused, and aims at maximising the recovery value of the NPLs. China's AMCs uses a hybrid of the two types, which is largely determined by the multiple objectives they shouldered.

During the early stage of the NPLs resolution process, the government pursued their industrial policy through AMCs, which intended to facilitate reorganisation of the SOEs' capital structure, promote their profitability and economic viability by reducing the debt burden. So, the major activity of the AMCs focused on enterprises' restructuring through debt-equity swaps, which were selected by the State Economic and Trade Commission (SETC) and not the AMCs themselves. The debts were transferred into equities the AMCs controlled in the enterprises. Normally, a new holding company would be launched after the swap based on the new equity structure. Since the first swap took place in September 1999, the four AMCs had reached the agreements with more than 580 SOEs by the end of 2000, which involved over RMB 400 billion (US$48.4 billion) of debt.[33] After debt-equity transactions, the liability-asset ratio of these enterprises fell from 73 percent to 53 percent. Nearly 80 percent of them consequently successfully turned around and became profitable in the same year.[34] However the debt-equity swap raised great concerns about widespread loan defaulting, because, in theory at least, this instrument was likely to invite moral hazard problem. For instance, it may actually encourage even profitable SOEs to stop paying interests on the bank loans so that they could qualify for debt relief.

Since 2001, the debt-to-equity swaps have been reined in by the Chinese government, and only a few deals have been approved. The four AMCs have actively carried out NPL disposal programme through asset disposal methods such as revised repayment plans with borrowers, discounted borrowers payoffs, collateral sales, and selling assets to third party investors. In particular, attracting foreign capital to help dispose of bad loans and raise the recovery rates has become a principle objective of the government. So far, all the AMCs have sold asset packages to foreign investors, often through public bidding and auction (see Table 5.9). For example, from the first auction to foreign investors in November 2001 to January 2004, Huarong AMC had sold RMB36.7 billion

(US$4.4 billion) worth of NPLs to foreign institutions, which took up about 25.2 per cent of the total NPLs it disposed during the period.

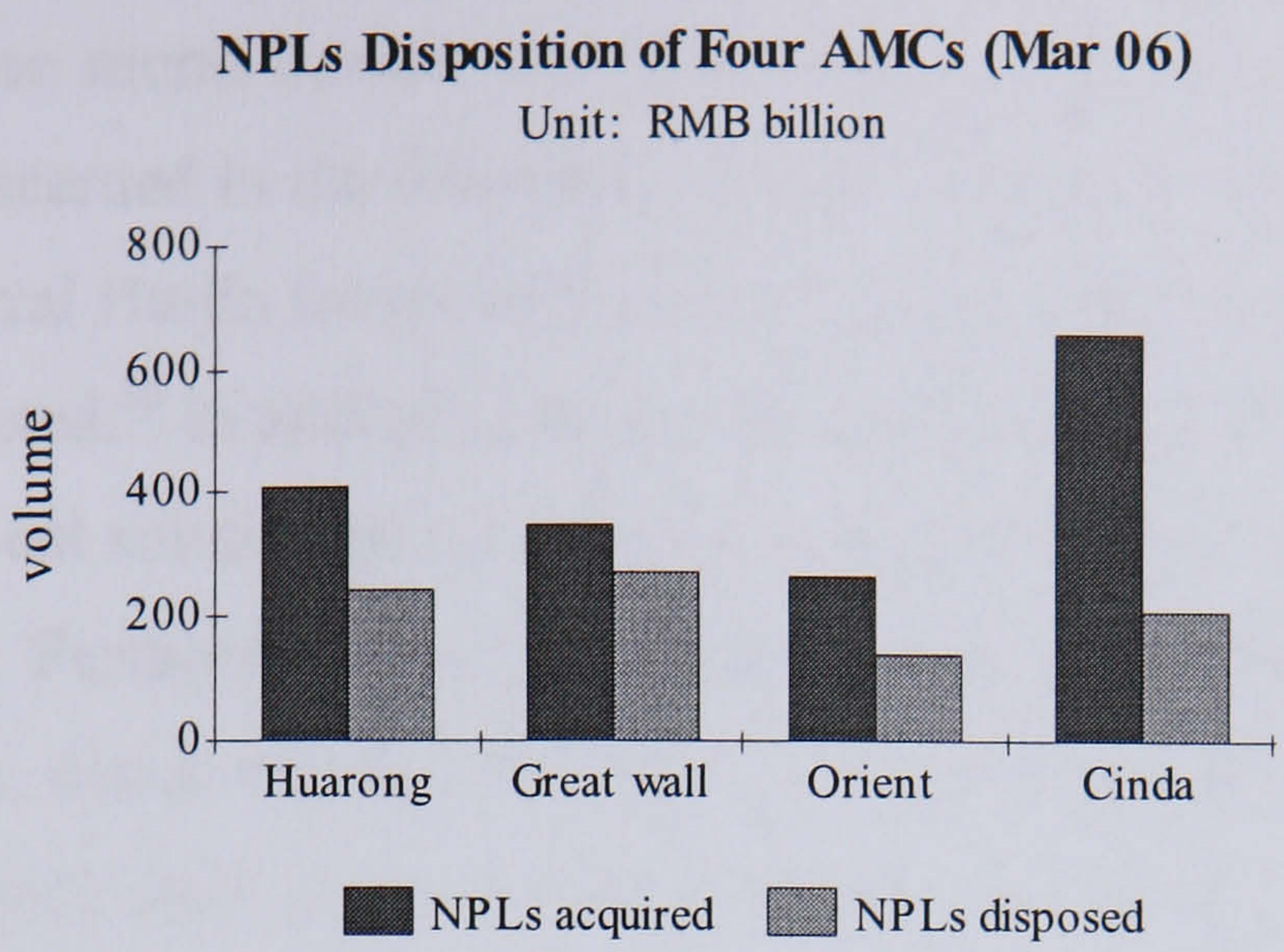
Table 5.9 AMCs' NPL transactions with foreign investors

Seller	Bid Date	Buyer	Face Value (RMB billion)
Huarong	November 01	Consortium led by Morgan Stanley Goldman Sachs	12.8 (US$1.55 billion)
	June 03	Citic Trust	13.3 (US$1.6 billion)
	December 03	Consortium of GE Capital and Morgan Stanley	1.8 (US$0.22 billion)
		Ao YIEr, Morgan Stanley, Citigroup, UBS, Goldman Sachs Lehman Brothers, JP Morgan	22.2 (US$2.68 billion)
Orient	December 01	Chenery & Associates	1.8 (US$0.22 billion)
Great Wall	July 02	Goldman Sachs	8.1 (US$0.98 billion)
Cinda	January 03	Deutsche Bank	2.6 (US$0.31 billion)

Sources: The companies' websites, CBRC

By the end of March 2006, according to the CBRC,[35] the four AMCs had resolved a total of RMB866.34 billion in NPAs (US$109.7 billion) and collected RMB180.56 billion (US$22.9 billion) in cash with recovery ratio of 20.84 percent. To be specific, the total NPAs had been resolved by China Huarong AMC amounted to RMB246.8 billion (US$31.3 billion) and RMB54.66 billion (US$6.9 billion) were collected in cash with recovery ratio of 22.15 percent; China Great Wall AMC had disposed RMB270.78 billion (US$34.3 billion), RMB27.83 billion (US$3.5 billion) or 10.28 percent were collected in cash. China Orient AMC had disposed RMB141.99 billion (US$18 billion), and recovered RMB32.81 billion (US$4.2 billion) in cash, accounting 23.11 percent. China Cinda Asset had resolved RMB206.77 billion (US$26.2 billion) in NPAs, RMB65.26 billion (US$8.3 billion) or 31.56 percent were collected. Figure 5.2 shows the progress of the disposition of the AMCs.

Figure 5.2



Source: CBRC

Despite the impressive progress in NPLs workout with asset disposal method, this approach has confronted a number hurdles in China. The underlying issue is that the likely involvement of liquidation and bankruptcy proceedings may cause people to lose their jobs and consequently pose threat to social stability, which is certainly inconsistent with the political concerns of the Chinese policymakers. Moreover, the legal framework, in particular the Bankruptcy Law, makes it difficult to undertake bankruptcy proceedings. Although the legal environment in China has seen a significant improvement and appeared to be in favour of resolution of NPLs, the hard issues, especially with respect to closing down SOEs and job losses have yet to be clearly addressed. The bankruptcy of SOEs in China still remains largely a political matter rather than an economic one.

5.3.3 Theoretical implications

The provision of financial assistance to the banks, like deposit insurance and government guarantees, is often criticised on the ground of moral hazard. Because this approach is a simple swap of good assets for bad assets at the taxpayers' expense, which is ultimately prone to protecting the bad banks managers against their own prudent management, and hence invites risky lending and beget new bailouts. A conventional measure to preclude moral hazard in many countries is to increase regulation and supervision followed by recapitalisation and disposal of NPAs. In addition, making a credible commitment to a one-off bailout by a government can effectively address the problem, which is evident in some transition economies in Central Eastern Europe.

The Chinese government has become aware of the problem, specific efforts have been made to minimise moral hazard in the process of rehabilitation of the SOBs. These efforts can be discerned in the following aspects. First, after the second capital infusion, a company, Central Huijin Investment Limited was set up to ensure proper management of the funds injected.[36] In addition, the legacy problems of the banks were resolved once for all, the clear-cut solution left the banks' managers with no excuse for the future bad assets occurred.. Furthermore, a reasonable amount of problem loans were remained within the banks, which allowed the banks to write them off with their own capital or work them out with their own capability. Finally, the banks have been able to access capital market through IPOs or subordinated bond offerings,[37] which enables them to obtain additional capital required by the capital adequacy regulations. This has placed market-induced imperative on banks to strengthen their balance sheets.

Apart from these efforts, more radical measures have also been taken, which focuses on the longer term solutions of moral hazard. Firstly, stress on using commercial lending criteria. To shield banks from political pressure, individuals and nonbank organisations may not interfere in bank operations. The SOBs have no longer been obliged to grant policy loans for development purpose since the amendment of the Commercial Bank Law in 2003. They have become increasingly aware of the excessive risks they have taken on, and have begun to pick and choose which enterprises they do business with. Starting as early as in 2000, credit to SOEs with overdue bank loans was cut off in several provinces, this policy is now being adopted throughout the country.[38] To reduce risk exposure, loans must be made against collateral, banks must assess borrower creditworthiness, and loans to a single borrower must not exceed 10 percent of bank capital. The banks may not give unsecured loans to related parties or provide secured loans on preferential terms.[39]

Secondly, strengthening SOE finances and management. Unlike conventional approach which only fixes banks, the Chinese approach overhauls enterprises along with banks. The polices of loans workout within the banks and debt restructuring through the AMCs lead to restructuring enterprises, the borrowers, not only the banks, the creditors. SOEs are encouraged to adopt commercial practices. They are no longer can assume that the SOBs will automatically provide financing. To prevent rising NPLs, the Chinese SOEs have been undergoing significant restructuring since 1998. As part of this process, 460

SOEs were shut down; US$6.0 billion in NPLs were written off in 2001; nearly 26 million workers were separated from SOEs during 1998-2001; and nearly $10 billion were spent in 2002 to consolidate unprofitable SOEs (Moreno, 2002).

It should be recognised that Chinese approaches have effectively mitigated the problem of moral hazard. However whether the problem could be adequately addressed remains doubtful. The reason is twofold: first, the dominance of state ownership. Given the unique status of the SOBs in the Chinese economy, privatising SOBs by selling them to either domestic or foreign investors is not a strategy that China can take from the experience of transition economies in Central and Eastern Europe. There has been little sign to date that the Chinese government plans to loosen its control of the SOBs.[40] The pervasive belief among the Chinese policy makers is that ultimate control should remain firmly in government hands. Second, less credible commitment to new bailout. Although Chinese policymakers have insisted in recent years that after the banks bailouts since 1998 there would be no more 'free lunches', the problem of 'too big to fail' is stubborn and would dwarf the government commitment. The government wanted the Big Four to make a quick recovery and regain financial stability on the one hand. On the other hand, however, the government has expected them to financially stimulate the Chinese economy. Under the bank-centred financial system, banks should be actively supplying credit and taking risk in order to stimulate economic expansion.

5.4 Impact of the approach

The impact of the restructuring approach on the banks' balance sheets has been marked. Apart from the ABC, the balance sheets of the rest three banks are now in healthy shape, as evidenced by lower NPL levels, enhanced provisions and a stronger capital base. The success of their IPOs has been an endorsement of such restructuring efforts.

5.4.1 NPL

Table 5.10 and Table 5.11 present statistics on trends in the evolving NPLs of the Big Four during 2000-2005. As shown in Table 5.11, the Big Four had achieved real reduction on both stock and ratio of NPL. Total outstanding NPLs, as measured by the internationally accepted five-category loan classification, fell continuously from

RMB2300 billion (US$278 billion) in 2001 to RMB1072 billion (US$134 billion) in 2005. The average ratio of NPLs to total loans, during the same period, was down from 30.6 percent to 10.5 percent. Table 6 displays detailed status of NPLs in the Big Four individually during 2000-2005, all the banks were seen decline on NPLs in varying degrees, among which BOC and CCB notably brought the NPL ratio down 22.6 percent and 16.4 percent respectively in the comparable period from 2000 to 2005.

Table 5.10 NPLs of the Big Four 2000-05 (*Percent*)

Year	BOC	CCB	ICBC	ABC
2000	27.20	20.27	34.17	n.a.
2001	27.51	19.21	29.8	42.12
2002	22.49	15.17	25.69	36.63
2003	16.29	9.12	21.24	30.66
2004	5.12	3.92	21.16	26.8
2005	4.62	3.84	4.69	26.17

Sources: Annual Reports of the banks (various years)
Note: n.a.: Not available.

Table 5.11 Total NPLs of the Big Four 2001-05

Year	2001	2002	2003	2004	2005
Ratio (Percent)	30.6	26.12	20.36	15.62	10.49
Amount (RMB billion)	2300 (US$278)	2200 (US$266)	1916.8 (US$232)	1575.1 (US$191)	1072.5 (US$134)

Sources: PBOC, CBRC
Note: PBOC first released total NPL amounts under the five-category loan classification system beginning in 2001

Important progress was made in addressing the problem of loss arising from non credit asset. Non performing asset includes losses on both credit and non credit asset. The statistics of NPLs released by the government and the banks had been mainly subjected to the NPL on the credit asset before 2003. The NPL on non-credit asset (such as overdue interest receivable, loss on investment and disposal of collateral as well as fraud) and off-balance sheet items had never been reported publicly before BOC and CCB released their 2003 Annual Reports on May and June 2004 respectively.

From the end of 2003 through the first half of 2004, the BOC and the CCB strengthened their disposal of non-performing assets. The BOC, a bank with the best position in information disclosure among the Big Four, reported first time ever in *2003 Annual Report* that the bank wrote off RMB8.6 billion (US$1.0 billion) in overdue interest receivable from previous years and RMB2.7 billion (US$326 million) loss on the transfer of certain equity investments to China Orient AMC. The scale of loss in the CCB began to surface from 2002 when the bank started dealing with the losses decisively, RMB10.9 billion (US$1.3 billion) and RMB22.24 billion (US$2.69 billion) were written off in 2002 and 2003 respectively. Despite these efforts, the bank, at the end of 2003, still had over RMB70 billion (US$8.46 billion) of loss remaining to be cleaned up. The CCB eventually had a chance to get rid of the historical financial burdens in September 2004 by transferring them to its holding company, China Jianyin Investment limited, which was established following a split of the institution into two parts.[41] After the transfer, the ratio of non-performing asset of the bank became equivalent of its NPL ratio, which was reduced remarkably to 3.75 percent at the end of 2004 from 9.12 percent at year end 2003.

Despite the improvement of the asset quality, however concerns associated with the decline of NPLs remain, and needs to be addressed.

Firstly, the substantial increase of loan volume may dilute the NPLs. As indicated in Table 5.7, during 2001-2003, the ratio of total outstanding loans to GDP increased 30 percent from 117 percent in 2001 to almost 147 percent at year-end 2003, an all-time high (see Table 5.4). In particular, the Big Four had total loans of RMB8.5 trillion (US$1.0 trillion) at the end of 2002, while in the first half of 2003 alone, the overall extended loans reported by the PBOC stood at RMB1.9 trillion (US$230 billion), which exceeded the total amount in 2002. Although statistics for the Big Four were not specifically identified, given the loan market share of 61.4 percent in 2003, the Big Four were deemed as a primary contributor to this substantial loan increase. Total loans (i.e. denominator) were augmented, while NPLs (i.e. numerator) were unlikely to be rapidly expanded, so the outcome was almost obvious. At the same time, the possibility that problem loans could be rolled over through the issuances of new loans may exist.

Moreover, the rapid loan growth raises concerns about flow problem. New lending that may become non-performing. A rapid growth in lending will place demands on the banks' credit and risk management skills to avoid new bad loans, as experienced in Korea after the 1997 crisis. Blindly investing in a number of 'over-heated' industrial sectors, such as steel, cement and aluminium, and the residential property sector in major cities may make it difficult to prevent new bad loans. The macroeconomic adjustment measures taken by the Chinese government to engineer a soft landing for the economy since the second half of 2003 will further raise challenges to the flow problem of the banks. The PBOC raised interest rates in late October 2004 for the first time in more than nine years and removed the interest rate ceiling on bank lending.[42] In the middle of March 2005, the decade-long favourable interest rate on private housing loans by commercial banks was lifted.[43] All these factors may have timing effect before another round of NPLs surface.

5.4.2 Capital adequacy

Apart from the ABC, the CARs of the rest of the Big Four have stood above 8 percent of the capital adequacy requirements since 2004 (see Table 5.12). This was an unprecedented improvement, taken the two factors into account.

Table 5.12 Capital adequacy of the Big Four 2004-06

(*Percent*)

Year	BOC		CCB		ICBC		ABC	
	CAR	T1	CAR	T1	CAR	T1	CAR	T1
2004	10.04	8.48	11.29	8.57	n.a	n.a.	n.a.	
2005	10.42	8.08	13.57	11.08	9.89	8.11	n.a.	
2006	13.59	11.44	13.15	10.77	14.05	12.23	n.a.	

Sources: Annual Reports of the banks (various years)
Notes: 1. The capital adequacy requirements are based on Basel I
2. T1 denotes Tier 1 risk weighted ratio
3. CAR denotes total risk weighted ratio
n.a.: Not available

Firstly, this improvement was achieved on the basis of new standards, which were stricter and consistent with Basel I. Before the promulgation of the new capital adequacy regulation in 2004, Chinese banks had calculated CARs based on the previous regulations, which were less prudent compared with the requirements of Basel I, as discussed in Chapter 6. In particular, the large amount of losses arising from non-credit assets was not mandated to deduct from core capital when calculating CAR. Consequently, the core capital ratios had been significantly overstated by the banks. In the CCB, the core capital ratio in 2000 even unreasonably appeared to be bigger than CAR (see Table 5.6).

Secondly, the improvement was also achieved on the basis of increasing efforts on provisioning. The new regulations issued in 2001 and 2002, as discussed in chapter 6, had raised extra pressures on the management of capital adequacy of the banks. This argument may be evidenced by the changes of CARs at the BOC and the CCB during 2002-2004 (see Table 5.6 and Table 5.11). In 2003, the two banks' operating profits before tax and provisions stood at RMB47.22billion (US$5.7 billion) and RMB44.68 billion (US$5.4 billion), an increase of 8 percent and 45 percent from that of prior year respectively.[44] In addition, the two banks each received US$22.5 billion of cash injections from the state at the end of the year. Under these favourable conditions, their CARs, instead of a significant rise as estimated by some analysts, were surprisingly down 1.17 and 0.4 percentage points from a year earlier. The adverse movement resulted from applying the more prudent accounting principles, in particular, making adequate provisions against loans and other assets, and write-offs of losses from non-credit assets. In 2003, the BOC and the CCB set aside RMB24.46 billion (US$2.95 billion) and RMB 22 billion (US$2.66 billion) for provisions, and wrote off RMB 23 billion (US$2.78 billion) and RMB22.69 billion (US$2.74 billion) of legacy losses from non credit assets respectively.[45] The net profits of the two banks were RMB4.59 billion (US$0.56 billion) and RMB0.4 billion (US$0.05 billion) at the year end of 2003, down RMB4.92 billion (US$0.59 billion) and RMB3.89 billion (US$ 0.47 billion) from the prior year.[46] The large drop of net profit inevitably lowered the accumulation of capital in 2003. While the CARs at the two banks since the capital injections have not been comparable with previous ratios due to the different basis of calculations. In other words, they began to reflect the true level of the banks' capital adequacy. The increase of CARs at the BOC and the CCB in 2004 was placed on such solid basis.

The improvement of capital level is real. While the progress is uneven, the solvency of the ABC is still weak and waiting for bailout by the government. The bank has to date never publicly reported its capital strength, but it is believed that the bank's capital adequacy is well below 8 percent. According an updated report, the CAR of the bank at the end of 2005 was -17.37 percent.[47] Moreover, even those banks that have reached the minimum requirement of 8 percent, they will face further pressures on replenishment of capital. The rapid growth of the economy and dominance of indirect finance in China, have created great opportunities for the banks' development. In order to sustain the expansion of loans at an average rate of 20 percent year on year, and meet the minimum capital requirement simultaneously, the banks must increase their capability in raising funds both internally and externally.

5.5 Conclusions

This chapter has examined one important aspect of the restructuring of the SOBs in China: fixing the banks' balance sheets. Experiences from China have indicated that the evolution of asset quality issue is very dynamic. The SOBs had suffered from chronic problems in solvency prior to the late 1990s. The financial indicators themselves, however, would make less sense if they were viewed on their own, given the fact that the banks are government owned. The banks' historical debt burden is essentially fiscal costs to the government. This justifies the active participation of the government in working out the problems.

In the same vein, the strategy for working out bad loans can not be analysed on their own, disregarding their interactions and interrelations with other aspects of economic transition. A clear preference of the Chinese approach has been displayed for recapitalisation and use of the government restructuring institutions – AMCs, which is tailored to the nation's specific economic, political and institutional environment. The magnitude of the problems and the inadequate budgetary resources, appear to be the driving factors in China's choice of approach to financial reform and the bank restructuring methods. The methods chosen allow some deferral of the budgetary cost of bank restructuring. This is evidenced by using foreign exchange reserves to recapitalise banks. This is also the case with the use of the AMCs, which are, in many ways, an arm of the government. The longer-term aim of the AMCs is to rehabilitate the loss making large SOEs. Therefore, unlike conventional practice of AMC which merely overhauls banks, this policy leads to restructuring of enterprises, not only banks, and hence, restructuring borrowers, not only creditors.

Although the overall outcome of the financial restructuring has yet to become clear, as far as the BOC and the CCB are concerned, there is no doubt that the rehabilitation approach has put them on a better footing in the future business operations. Because the swift and decisive actions taken by the government have made a clear-cut solution to the banks' legacy problems and restored the health of balance sheets, which have made a real difference in creating incentives for pursuing profit and preventing moral hazard.

However, the more important issue is whether these one-off benefits can be sustained. Rehabilitation of the SOBs is just the first step of the banking restructuring process. To prevent a build-up flow problem is a much more difficult task than getting rid of the stock problem. Therefore, banks rehabilitation should be accompanied by measures that not only address the immediate stock problem, but also the flow problems of the banks. This requires, in particular, improving bank supervision and compliance, the accountability of management, risk control mechanism, accounting practices. These issues are discussed in the subsequent chapters.

Chapter 6 Reforming bank regulation and supervision in China

6.1 Introduction

As discussed earlier, the banking regulatory framework is one of the most important external forces in shaping behaviour of banks. Instituting the bank regulatory and supervisory framework is an integrated component of the Chinese banking restructuring programme. Gaining experience from both its previous administration of the increasing number of banking institutions and international best practices, China has made significant progress in upgrading its regulatory and supervisory framework since the late 1990s. Current bank regulations and supervisions are involved in almost every aspect of banking business and operation. The banking sector has become one of the most intensively regulated areas of the Chinese economy.

The focus of this chapter is on those aspects of the banking reform process directly related to the banking regulatory and supervisory framework. It attempts to explore how the set of policy evolves, and offers insights into the underlying issues of the changes. The chapter first discusses the legal framework of banking regulation in China, principal laws and rules relevant to banking are examined. This chapter then analyses the characteristics of the banking regulation. It further evaluates the reforms of the institutional structure of the banking regulation and supervision. This is followed by examinations of the prudential regulation and supervision, which include issues related to prudential standards, monitoring and enforcement practices. Finally, conclusions are presented.

6.2 Legal foundation of banking regulation

Banking law framework in China started taking shape in 1995 with the promulgation of the two bank laws. Although the Chinese government had issued a series of regulations and rules to govern the administration of the banking industry in China before 1995, no single formal banking laws had been passed by the National People's Congress (NPC), the highest legislative body in China. Efforts to build a comprehensive legal framework have been accelerated since the late 1990s. The enactment of China's first banking supervision law is a sign of major progress. The formulation of these bank laws, supplemented by the Company Law, the Code of Corporate Governance for Listed

Companies, and a wide rang of administrative rules and measures, provide a solid legal foundation for China's reform of the financial and banking regulatory system, and safeguard the secure and efficient operation of financial institutions.

6.2.1 The Central Banking Law

The Central Banking Law was enacted in March 1995, which is the first banking law in China. The law confirms that the PBOC is the central bank of China, and that it is responsible for the formulation and implementation of monetary policy, and for the supervision of the financial services industry.[1] The aims of the monetary policy are to maintain the stability of currency and to promote economic development.[2] The law mandates that the PBOC performs its functions under the leadership of the State Council. It requires the PBOC to report its plan for the annual supply of banknotes, interest rates, foreign exchange rates and other major issues to the State Council for approval.[3] The law provides that the PBOC shall be free from any interference from any local government, governmental department, association, or individual.[4]

The law gives the PBOC broader powers to supervise and control the entire financial industry which manifests in three aspects. First, the POBC screens and approves the establishment, the change, the termination, and the business scope of financial institutions in accordance with the pertinent regulations.[5] In addition, the specific supervision of certain institutions by the PBOC involves both their general business and specific operations, such as deposits, loans, settlements, provisions for bad debts and interest rates. It may take the form of on-site examinations and off-site surveillance.[6] Third, for the general supervision of the whole financial system, the PBOC has the right to require financial institutions to submit balance sheets, statement of profits and loss, and other financial or accounting reports or statistics.[7]

The Central Banking Law was revised in December 2003. The revised law eliminates the PBOC's regulatory and supervisory functions for the banking institutions, asset management companies, trust and investment companies and other depository financial institutions, and transfers it to the newly set-up Banking Regulatory Commission. However, the PBOC retains a limited supervisory role in its capacity as the lender of last resort. [8]

6.2.2 The Commercial Banking Law

The Commercial Banking Law was promulgated in May 1995, which is the fundamental law for banking activities and operations. It provides the principle structure of commercial banking regulation. Its primary objectives are the safe and sound operation of banks, the protection of the depositors, the enhancement of supervision, the maintenance of the financial order, and the promotion for the development of the socialist market economy.[9]

The law defines commercial banks as juridical persons, which are established in accordance with the Commercial Banking law and the Company Law, and engaged in the business of accepting deposits, lending funds, and managing settlements.[10] The law requires the banks to operate on a commercial basis, asset-liability management ratios is introduced at the same time.[11] It mandates the separation of bank and non-bank financial sector operations by prohibiting commercial banks from conducting domestic trust, investment and insurance business.[12]

On the supervision of commercial banks, the law stipulates that commercial banks should establish sound internal control systems on their business management, cash control and bank security in accordance with the rules set by the PBOC.[13] The PBOC is entitled to perform inspections of a commercial bank from time to time, and to require a commercial bank to furnish any information concerning accounting materials, business contracts and business administration as the PBOC considers necessary.[14]

The Commercial Banking Law was revised along with the amendment of the Central Banking Law simultaneously in December 2003. Changes to the Commercial Banking Law frees the state-owned banks from the requirement to provide loans to special projects approved by the State Council, and permits them to carry out commercial banking activities, such as trading government bonds, dealing in foreign exchange, and offering credit card services.[15] The amended Law also states that commercial banks are prohibited from these activities unless 'the state stipulates otherwise',[16] this leaves open the possibility of allowing commercial banks to engage in non-banking activities.

6.2.3 The Law on Banking Regulation and Supervision

The Law on Banking Regulation and Supervision was approved by the National People's Congress on 27 December 2003, and became effective on 1 February 2004. Promulgation of the law is a significant step in building a legal system for China's banking supervision. The law is aimed at improving banking regulation and supervision, standardizing banking supervisory process and procedures, preventing and mitigating financial risks in the banking industry, protecting the interests of depositors and other customers, and promoting a safe and sound banking industry.[17]

The law clarifies the legal status of the Banking Regulatory Commission, which was established in April 2003 to take over bank supervision functions from the PBOC. According to the law, the Banking Regulatory Commission under the State Council is responsible for the regulation of banking institutions operating in China, including commercial banks, other deposit-taking institutions and policy banks. The law equally applies to asset management companies, trust and investment companies, finance companies and financial leasing companies, and other financial institutions.[18]

The law details the responsibilities and regulatory power of the Commission. They include setting rules and regulations governing banking institutions and their activities; regulating the establishment, change and dissolution of banking institutions, as well as granting banking licenses for commercial banks and their branches; regulating the business activities of banking institutions, including the products and services they offer; setting qualification requirements for, and approving or overseeing the nomination of, directors and senior management personnel of banking institutions; setting guidelines and standards for internal controls and corporate governance of, and disclosure requirements for, banking institutions; conducting on-site examinations and off-site surveillance of the business activities of banking institutions; monitoring the financial condition of banking institutions, including establishing standards or requirements for capital adequacy, asset quality and other financial metrics; and imposing corrective and punitive measures for violations of applicable banking regulations.[19]

The adoption of the law signifies a shift from merely emphasising rule-compliance to underlining both rule-compliance and risk control. The law incorporates the 'Core Principles for Effective Banking Supervision' of Basel Committee by providing that prudential rules and regulations applied to banking institutes encompass risk management, internal controls, capital adequacy, asset quality, loan loss provision, risk connections, and liquidity management.[20]

6.2.4 The Company Law

The Company Law came into effect on 1 July 1994. Its corporate governance provisions are general and cover the basic framework of corporate governance as it existed in global financial markets 20 years ago. According to the Company Law, there are three tiers of control over a company's operations: the shareholders' general meeting, the boards of directors and supervisors, and management. The general shareholders' meeting has the final say over the key issues of the company, such as approval of the management strategy, the financial budget and key investment plans, and the nomination of the boards of directors and supervisors. The board of directors makes key investment plans and the board of supervisors oversees the decision making process and performance of senior management and directors. Management is responsible for day-to-day operations and for implementing the decisions of the board of directors.[21]

6.2.5 The Code of Corporate Governance for Listed Companies

The Code of Corporate Governance for Listed Companies was issued in January 2002. The code is the first comprehensive regulation applicable to all China's domestically listed companies, which aims to introduce solid corporate governance in listed companies by elevating requirements on accounting procedures and information disclosure, introducing independent directors' systems, and tightening the supervision of corporate management.

The code expands the rights of shareholders, and states that minority shareholders should have equal status with other shareholders, and that shareholders should have the right to protect their interests through civil litigation and other legal approaches. The code also gives institutional investors more weight in the decision making process, including in the nomination of directors.[22]

The code attempts to strengthen the roles of the board of directors and supervisors. According to the code, a listed company must establish transparent procedures to select the board of directors, and a listed company in which the controlling shareholder owns a stake in excess of 30 percent should adopt a cumulative voting mechanism to ensure the voting interests of minority shareholders.[23] Listed companies are required to introduce independent directors who do not hold any other positions within the company.[24] The members of the board of supervisors must be permitted access to information relating to the operational status and be allowed to hire independent intermediary agencies for professional consultation, without interference from other company employees.[25]

Finally, the code includes specific provisions on information disclosure. Listed companies are required to disclose promptly any information that may have a substantial impact on the decision making of shareholders or stakeholders. Listed companies should fully disclose prices of related party transactions and prohibit it from providing financial collateral to related entities. The code also requires the listed company to promptly release detailed information on controlling shareholders, and controlling shareholders should honour the independence of the listed company and to avoid interfering or directly competing with the listed entity.[26]

6.3 Characteristics of banking regulation

China's banking regulations can be characterised as both structural regulation and conduct regulation. A broad distinction is drawn between the two types of regulation. Structural regulation comprises regulatory measures concerned with the structure of an industry. Through such regulations, the government decides which firms or individuals are allowed to engage in particular types of business; which activities they can engage in; and where they engage in such activities. Conduct regulation comprises regulatory measures concerned with how a particular industry should conduct business in its chosen field of activity.[27]

6.3.1 Structural regulation

China's banking structural regulations generally encompass rules on entry authorisation, branching restrictions, banking activity limitations, and bank ownership controls.

6.3.1.1 Entry control

Entry control is a typical example of regulatory intervention over industry structure. The traditional method of bank entry control involves the licensing or chartering of banking institutions. By requiring entry criteria, regulators can effectively shape the banking market structure, where only those who meet such criteria can engage in the business. In China, before being able to legally engage in banking business, an institution must obtain a licence from the regulatory authority. Prior to April 2003, the PBOC had the power to license commercial banks, including authorising foreign bank branches. From April 2003 onwards, the CBRC has assumed the licensing function.

In general, the CBRC will approve an application for establishing a commercial bank based upon several criteria, among others: the articles of association of the proposed commercial bank comply with relevant requirements of the Commercial Banking Law and the Company Law;[28] the registered capital of the proposed bank meets the minimum requirement under the Commercial Banking Law;[29] and the directors and senior management of the proposed bank must possess the requisite professional skills and working experience.[30]

Commercial banks are required to obtain the CBRC's approval if they undergo any fundamental change, such as change of name and registered capital, change of the principal place of business for the head office or for a branch, change of business scope as set forth in the business license; any change of shareholders holding 5 percent or more of the commercial bank's total capital or shares; amendment to the articles of association.[31]

6.3.1.2 Branching restrictions

Branching restrictions contain a bank's geographic expansion. China's commercial banks have operated with a branch banking system from the outset, even before the Central Banking Law was enacted. Under the Central Banking Law, the establishment, closure, or relocation of branches by commercial banks were subject to authorisation by the PBOC.

Since the promulgation of the Law on Banking Regulation and Supervision in 2003, An applicant bank is required to apply to the CBRC or its local offices for approval and issuance of an operating license to establish a branch. A branch must have sufficient operating funds commensurate with its scale, and must meet other operating requirements. The sum of the operating funds provided to all branches of a bank may not exceed 60 percent of the total capital of the commercial bank.[32]

The establishment of overseas branches by China's commercial banks is also subject to the CBRC's approval in addition to all applicable local regulations. The criteria include that the applicant bank has been approved to engage in foreign exchange business, has engaged in foreign exchange business for more than 3 years, and has a legitimate source of foreign exchange funds. In addition, the applicant bank is required to have a minimum of RMB80 million (US$9.7 million) equivalent of foreign currency denominated assets.[33]

6.3.1.3 Ownership restrictions

The Chinese government imposes rigid ownership restrictions on investment in commercial banks, in order to maintain the dominance of the state ownership. For the domestic investors, the 1995 Commercial Banking Law stipulated that prior approval from the PBOC is required for any person or organisation to own 10 percent or more of the registered capital or the total issued shares of a commercial bank.[34] This ownership ceiling was tightened by reducing to 5 percent in 2003 under the revised law.[35]

For foreign equity investment in China's commercial banks, there had been no law or regulation to provide a specific legal basis until 2003. Each equity investment had been undertaken case by case and approved by the State Council. The first regulation that governs the foreign investment in Chinese commercial banks was released in December 2003 by the CBRC.[36] The regulation explicitly allows foreign equity participation in Chinese commercial banking institutions, and governs the transactions. According to the regulation, the minority equity interest made available to any single foreign shareholder should not exceed 20 percent, and no foreign stakes in a single domestic bank may be allowed to exceed 25 percent.[37]

6.3.1.4 Scope of banking activities

Statues or regulations usually define the economic scope of the banking business by stipulating which activities banks are allowed to offer, or which activities banks can not engage in. In broad sense, defining banking activities can be a means of differentiating between various types of financial institutions on the basis of their activities. Since the banking crises of the early 1930s, many countries have imposed strict specialisation of banking activities.[38] For instance, some countries segment financial institutions by separating depository institutions from non depository institutions.

The Chinese financial sector is generally designed based on the theory of functional separation. The Insurance Law of 1995, the Security Law of 1998, and the Law on Banking Regulation and Supervision of 2003 provide the legal foundation for the framework of separated financial operating system. Three different government agencies now separately regulate commercial banks, security firms, and insurance companies. In principle, commercial banking is separated from investment banking. Commercial banks are prohibited from engaging in securities business, trust investment business, investing in real estate other than for their own use, investing in domestic corporate bonds, and making equity investments in entities other than commercial banks in China.[39]

Apart from the prohibitions, the Commercial Banking Law defines the range of banking operations. Under the law, commercial banks are permitted to underwrite and deal in the government bonds, financial institutions bonds, and commercial paper issued by qualified non-financial institutions; act as agents in transactions involving securities, including bonds issued by the government, corporate entities and financial institutions; provide institutional and individual investors with comprehensive asset management advisory services; act as financial advisers in connection with large infrastructure projects, mergers and acquisitions, and bankruptcy reorganisations; act as custodians for asset management companies and investment funds.

In addition, commercial banks are permitted to act as agents to sell insurance products through their distribution networks. Commercial banks seeking to provide insurance agency services are required to comply with any applicable rules issued by the CIRC, the regulator of the insurance industry. Under the 'Derivative Business Measures', commercial banks are permitted to conduct derivatives business upon approval by the CBRC. Under the 'Trial Administrative Measures on Fund Management Companies Owned by Commercial Banks', the national commercial banks are permitted to establish or acquire fund management companies upon approval by the CBRC and the CSRC, the regulator of the security industry.

6.3.2 Conduct regulation

Conduct regulation in China can be further classified as economic, allocative and prudential oriented.

6.3.2.1 Economic regulation

Economic regulations include reserve requirements, credit and deposit ceilings, and interest rate controls. In China, economic regulations currently comprise reserve requirements and interest rate controls.[40]

Reserve requirements on China's banking institutions are imposed on the deposit liabilities. The deposited reserve is the fund held by financial institutions for meeting requirements of fund settlement and for customers drawing from savings deposits. It is widely used by central banks in various countries as an important tool of their monetary policies to regulate money supply. China established the deposited reserve system in 1984. The central bank reformed its deposited reserve system in March 1998 by reducing the legal reserve requirements from 13 percent to 8 percent following the establishment of policy-oriented banks and the improvement in the management of commercial banks. Afterwards, the required reserve ratios have been continuously adjusted depending on the conditions of investment and credit, which remain between 6 percent and 9 percent, until now.[41]

Interest rates had been officially set by the PBOC until October 2004. Despite the significant progress of interest rate liberalisation, until very recently, the lower limit on lending rate and the upper limit on interest rate of deposit have been remained. The full liberalisation of interest rates is expected to take longer. While the PBOC officially no longer sets the upper limit for loan interest rates, nor lower limit for deposit rates, Commercial banks are required to set interest rates on loans and deposits within permitted bands of the benchmark rates set by the PBOC. There are currently different PBOC benchmark rates set for different types of business. Commercial banks are allowed to set their own interest rates within the ranges.

6.3.2.2 Allocative regulation

Allocative regulations include selective credit programmers, compulsory investments, and preferential interest rates. The allocative regulations control the directions of credits, either to ensure that a particular industry or activity receives as much funding as the government desires or to prevent banks from financing activities that the government considers undesirable.

'Policy loan' had been the most important credit allocation instrument of the Chinese government until late 1990s.[42] With the ease of the direct interventions of the government, commercial banks are required to take into consideration government macroeconomic policies in making lending decisions under the Commercial Banking Law.[43] Accordingly, commercial banks are encouraged to improve or restrict their lending to borrowers in certain industries in accordance with relevant government policies. Several guidelines and measures have been issued since the establishment of the CBRC concerning real estate loans, automobile loans, and loans to small and medium-sized enterprises. For instance, in order to promote and direct banks to provide financial services to small enterprises, The CBRC issued the 'Guidelines on Banks' Lending to Small Enterprises' in July 2005, which provides specific guidance on bank's lending to small enterprises in terms of lending policies, procedures, and approaches.

6.3.2.3 Prudential regulation

From the late 1970s to the early 1990s, a large number of rules on banking business management were enacted. Some of them dealt with the operational requirements.[44] However, prudential regulations were nominal during this period, since allocative control (i.e. policy loans) was prevailing, and the government controlled every aspect of banks' operations. Even after the Commercial Banking Law was enacted with the explicit provisions to control banks' credit risks, prudential regulations remained nominal until late 1990s when the government direct interference had been gradually eased.

The current regulations mainly include single borrower lending limits, a system of ceiling on the credit extension to group customers. The limit on loans to a single borrower has been in place since the promulgation of the Commercial Banking Law in

1995. This limitation prohibits banking institutions from lending to any single individual or juridical person amounts in excess of 10 percent of their equity.[45] Commercial banks are also subject to a similar lending limit with respect to the ten largest borrowers of the banks. Loans to these borrowers taken as a whole should not exceed 50 percent of a bank's equity.[46] In addition, commercial banks are restricted from extending additional credit to a group customer if the total credit granted to the group customer accounts for 15 percent or more of the bank's equity.[47]

Commercial banks are not allowed to extend unsecured loans to related persons, and must not extend secure loans to related persons with more favourable terms than other borrowers of equal ranking.[48] Transactions with related parties are also subject to limitations. Commercial banks may not grant unsecured loans to related parties or extend credit secured by the bank's own equity.[49]

To ensure sound management of banks, banking institutions are subject to industry standard. First, banking institutions should maintain a minimum 8 percent risk-weighted capital ratio. Second, they are required to maintain a ratio of loans to deposits of less than 75 percent. Finally, they are required to maintain a liquidity ratio of more than 25 percent of their deposit liabilities.[50]

6.4 Evolution of institutional structure of banking regulation and supervision

A regulatory process is usually initiated by legislation and then delegated to a regulator who performs the actual implementation of the regulatory statute through rule-making and decisions. Within this process, a body capable of effectively setting in motion the regulation must be identified. According to a survey to the IMF member countries, the institutional arrangements for the banking regulation and supervision vary between countries.[51] In general, they can be divided into two categories: central banks which have a unified function of monetary authority and banking regulatory and supervisory; and system providing for a separation of banking regulatory and supervisory authority from the central banks.

There has been increasing debates over the institutional structures of banking regulation and supervision in recent years, in particular with the trend that many countries have moved towards the separation of banking supervision from central banks, for instance, the UK, Japan and Korea, among others.

The arguments for the integration of banking supervisory authority can be summarised as follows: First, the goals of monetary policy, as an essential function of a central bank, and banking regulation and supervision are closely related. While the primary goal of monetary policy is to ensure stability of the currency, the banking regulation and supervision focuses on the safety and soundness of the banking system. They can not be attained independently (Tuya and Zamalloa 1994). Second, information problem leads to the involvement of central bank and the regulation and supervision of banking systems (Pasley 1990). The main responsibilities of a central bank, such as formulating and performing monetary policy, maintaining systemic stability and the smooth working of the payments system, are largely subject to macro level of economy. In the conduct of these responsibilities, a central bank needs adequate micro level information on the structural state of the major banks in its country in order to fulfil its duties adequately. A single integrated banking regulator may provide the central bank with much better and more rapid access to information (Goodhart 2000).

The counter arguments are rested on two perspectives: first, there could be a number of potential conflicts of interest when the banking regulatory and supervisory powers are vested in the central bank. In particular, a conflict may arise from the objectives between the monetary function and the regulatory and supervisory function. The health of the banking system, which is the concern of the regulatory and supervisory authorities, needs a 'judicious laxity', while the monetary policy requires strict measurement (Lawson 1992). In such a conflict, regulatory and supervisory action may be delayed or not implemented so as not to aggravate the impact of monetary policy. Second, financial deregulation has thoroughly blurred the previously clear boundaries between categories of financial intermediaries. Universal banking has become more popular and common. Banking has increasingly involved in many non-banking activities, e.g. fund management through insurance and bank assurance. This means that the attempt to supervise separately by function, such as commercial banking, investment banking and fund management, would involve a multiplicity of separate supervisors in the same single institution. This is hardly efficient or cost effective (Goodhart 2000).

Are these issues the same in China? The answer is 'no'. The rationales of the arguments certainly have some merit for the case in China. However, the change process and reforms of banking regulation and supervision in China are more complex. It entirely hinges on its unique national conditions, for instance, the stage of economic and financial development, and the political and social circumstances. The evolution of institutional structures of banking regulation and supervision in China can be divided into three periods based on the development stages.

6.4.1 Bank regulatory and supervisory structure between 1984 and 1998

This period can be classified as the creation stage of China's banking regulatory and supervisory system. In this stage, all financial institutions and their businesses were under the unified supervision by the PBOC. The regulatory and supervisory system and detailed bank regulations however had not yet been fully developed.

This stage began with the issuance of the 'Decision Concerning the Specialisation of Central Bank Functions by the People's Bank of China' by the State Council on 17 September 1983. The PBOC became the central bank, and independent from the Ministry of Finance effective on 1 January 1984.[52] Its commercial functions was separated form the administrative functions of the banking system. It was authorised to supervise the overall banking activities of specialised banks and other financial institutions. Although the PBOC assumed the responsibilities of a central bank, it required the formal legal authority to exercise these functions only gradually. The 'Interim Regulation on Administration of Banks' of 1986, two years after the bank began operating, provided a legal base for the central role of the PBOC in the banking system in China and further defined its functions. However, the independence of the PBOC and its principal duty to maintain the stability of the national currency were not emphasised until 1995 the promulgation of the Central Banking Law.

The independence of the central bank in carrying out monetary policy and prudently regulating financial institutions were greatly improved in the mid-1990s. In July 1993, in order to bring the accelerating inflation back under control, Zhu Rongji who already was vice premier in charge of national economic affairs, assumed the additional role of governor of the PBOC, which marked a turning point. Zhu's position gave him the authority to appoint and remove the heads of the central bank's branches in each province and municipality, who had previously been in the jurisdiction of local governments. The head office of the central bank was also able to centralise the authority for the allocation of both credit quotas and central bank loan quotas.[53]

Another unprecedented move is ending the practice of extending loans to the state. Beginning in 1994 the central bank stopped lending money to the MOF to cover the state's budget deficit. Initially this refusal was an administrative decision. It was subsequently embedded in the provisions of the Central Banking Law of 1995.[54]

An institutional breakthrough occurred in November 1998 when the PBOC was restructured toward greater vertical control. A new organisational and administrative structure with nine trans-regional branches replaced the old structure with 32 branches. The heads of the branches were no longer appointed by the local government, consequently the local intervention it caused faded into history ever since.

In addition, in a relatively long period, the central bank's supervision of financial institutions focused on the administrative procedures, in particular the approval for business entrance, and financial management. This was significantly at the expense of establishing the mechanism of effectively supervising the whole process of financial business. However, since 1993, the PBOC had made gradual progress in building supervisory capacity and developing supervisory techniques in line with international norms. The bank had increased supervisory departments, and clarified responsibilities for financial supervision. The focus of the branches had been shifted from credit allocation to financial supervision, which covered market access and exit, business operation, risk monitoring and control. The bank also set rigid rules for assessing and controlling the supervisory responsibility by issuing the 'System of Job Responsibility for Financial Supervision'.[55]

Despite this progress, the central bank system still fell short of the level necessary for the bank to effectively regulate and supervise the rapid developing financial markets. Although the Central Banking Law of 1995 states that the PBOC 'shall independently implemented monetary policies and be free from any intervention', its exercise of this power is 'under the leadership of the State Council'. Thus the bank was not the final authority on fundamental issues, such as major movements in interest and exchange rates or sale of the state-owned share in the stock market have to date been decided at the highest decision-making level.[56] The PBOC's 12-member Monetary Policy Committee (*huobi zhengce weiyuanhui*) is supposed to be the key decision-making body,[57] equivalent to the US Federal Reserve's Open Market Committee, but in practice, the group, comprising ministerial officials, regulators and economists, is just for advising the State Council.[58]

The PBOC also had difficulties in supervising banks, in particular the Big Four, which still functioned as quasi-government agencies. While aware of the need to enforce prudential regulations, regulators and supervisors, who were also government officials, had other considerations, such as the need to keep SOEs functioning in order to support employment and social welfare. In the same vein, the bank lacked the means of sanctioning banks that breached laws or regulations, or failed to conduct safe and sound operations, because they were protected by the local government or the Party interests.

The effectiveness of the PBOC as banking supervisor was further limited by the weaknesses in the legal framework. A major deficiency was that it was, in varying degrees, inconsistent with international standards and best practices. For instance, with respect to capital regulation, in many situations, bank management had discretion for determining its capital adequacy. Even after the Commercial Banking Law of 1995 adopted the 8 percent minimum capital adequacy requirement, discrepancies with international standards still existed (see Section 5 below). Other deficiencies such as non-transparency also impeded the effectiveness of the supervision.

Moreover, there was lack of integration of the central bank's external regulation and financial institution's internal controls. Over a long period of time internal controls had been neglected in the China's banking sector. At the level of both supervisors and bank management there was a perception that the stability and soundness of banks are the responsibilities of supervisors other than that of bank management.[59] As a result, internal controls were not in place, internal audit departments were not established or were understaffed, and the bank governor often override the board of directors. Even after the PBOC issued the 'Guiding Principles for Strengthening Internal Control in

Financial Institutions' in May 1997, many banks still failed to establish an internal control committee and internal audit department.[60]

6.4.2 Bank regulatory and supervisory structure between 1998 and 2003

The key feature of the reforms during this period was that the Chinese banking sector came under tight control directly by the CCP. In mid 1997 the Asian financial crisis began to unfold, it gave immediately a shocking demonstration about the risks of a mismanaged financial sector. In order to strengthen the control over the Chinese financial system and prevent the spill-over of the crisis, Zhu Rongji, who was the premier of the State Council, pushed through a centralisation of financial supervision.[61] Against this backdrop, a Communist Party Central Financial Work Commission (CFWC, *zhonggong zhongyang jinrong gongzuo weiyuanhui*) was set up in June 1998. The establishment of the CFWC was a move designed to primarily to give the CCP greater dominance over the government apparatus in the finance sector. The real supervisory power was moved to the CFWC.[62]

The CFWC was an interim organ of the Party's Central Committee, which was ranked above ministerial level, since it was headed by Wen jiabao, who concurrently served as a member of the Politburo and as vice premier of the State Council. Commissioners of the CFWC consisted of 15 members, who were predominantly party organisation specialists rather than financial professionals, including deputy party secretaries of the PBOC, the CSRC and the major state-owned financial institutions.[63] It thereby put the committee into a more independent position to monitor financial executives. The main responsibilities of the CFWC were ensuring adherence to financial policies and directives of the Party's Central Committee and the State Council; strengthening ideological work; regulating the cadre institutional structure in the financial sector; integrating financial system reform; combating corruption and undertaking field investigation and research.[64]

In practice, the management framework of CFWC was bringing together heads of key regulatory bodies and national financial institutions, including the PBOC, the CSRC, the CIRC, the state-owned commercial banks, and the policy banks. The CFWC controlled directly thirty most important financial institutions. A new vertical administrative system (*chuizhi guanli tizhi*) was adopted in the entire financial system, which allowed the CFWC to exercise effective downward personnel as well as professional management over every level in the Party hierarchy. This led to the removal of all Party core groups (*dangzu*) of subordinate units and creation of Party committees (*dangwei*) in every institution. Party committees, which answered directly to the central Party leadership, were more influential over any organisation than Party branches that answered only to the local Party apparatus. In the past, each institution had only a Party branch. The Party committees also set up organisation departments, and created a system-wide discipline inspection committee to assist the Party's supervision work on all financial institutions. This aimed to ensure continuity of policies and to maintain effective monitoring the entire financial system.

The CFWC also centralised authority over personnel appointments in the key regulatory bodies and financial institutions down to the provincial level. Before the establishment of the committee, the appointment of senior members of the financial firms had been under the jurisdiction of the Central Organisation Department of the CCP. Managers in local branches had been jointly appointed by the head office of the financial firms and the local Party committee. The CFWC was also in charge of appointment and management of board of supervisors.[65] It appointed a supervisory board for each of sixteen key financial institutions.

The CFWC was indeed powerful, it was once characterised by insiders as a 'super regulatory body',[66] but it was not created on legal basis either by the National People's Congress legislation or by the State Council regulation, since it was founded by way of Communist Party documents. However, Communist Party organs such as CFWC whose organisational set-up and functions are formally regulated by a series of the Party documents can not be regarded as informal or irregular in China. Instead they must be recognised as the core institutions of policy making and supervision in China's political economy. The exceptional powers of the CFWC actually derived from the ultimate authority of the ruling party. Therefore, although seemingly the CFWC did not have formal authority in formulating financial regulation and interfering in the management decision of financial institutions, the Party control over 'leadership cadres' (*lingdao ganbu*, i.e. senior executives) by means of appraisal, appointment, discipline and removal, created incentives and constraints which fundamentally influenced and shaped the behaviour of key decision makers in financial institutions[67]. In a sense, the CFWC is an outstanding example for the understanding the role of the Party in the banking governance and in economic regulation as a whole.

The practice of 'the party taking the place of the government' (*yi dang dai zheng*) in China was not uncommon during the period of 1998-2003 after twenty years of the economic reform. The installation of the Party organ in the financial system did make significant achievements in centralising financial supervision and restoring financial order within a short time.[68] What are the issues are that first, to what extent such Party control mechanisms adapt to the emerging new corporate governance regime, and the rapid increasing activity of foreign investors after the nation's WTO entry. This issue still makes difference in the ongoing banking reforms, since the Party is unlikely to relinquish the control over personnel decisions before its demise. Second, how efficient the work of the CFWC would be if it contrasted to a purely regulatory agency which is subject to much stricter rules and transparency.

There seem no easy answers to these issues. Nevertheless, the new Wen Jiabao government tried a different approach to the reform of the financial system by shifting the Party's oversight functions to government regulatory agencies. The CFWC was disbanded as a result of the government reshuffle in March 2003. Its supervisory functions in the banking sector were transferred to the newly established CBRC.

6.4.3 New bank regulatory and supervisory system since 2003

China established a separated banking regulatory and supervisory system in April 2003 with the creation of the CBRC.[69] Under the reformed system, the new ministerial-level state agency assumes the responsibilities for banking regulation and supervision, including the promulgation rules, issuing license and authorisation of the business activities and operations of the financial institutions. Its supervisory responsibilities focus upon the soundness and safety of financial institutions, and the restructuring of the banking sector. At the same time, the PBOC is designated as the monetary authority under the revised Central Banking Law of 2003, which concentrates on monetary conditions and financial system liquidity with objectives to promote the country's economic growth and price stability. As a lender of last resort, the PBOC still remains a very influential situation in the regulation and supervision of the banking institutions.

This new reform reflected the prevailing view in many countries that the central bank should focus on monetary policy and the systemic stability while supervision of banking institutions should be performed by a separate agency. Some Chinese scholars argued that the conflict between the aim of monetary policy and the targets of supervision on banks might be more acute, given the fact that commercial banks in China is predominant in the financial system, this may add additional difficulty to ensure that the central bank may not ease the supervision of banks when an easy monetary policy is needed.[70] In this sense, the revamped system seemed plausible. Concerns, however, were also raised that the separated supervision in the financial system may segregate regulatory powers among various agencies, and consequently it might adversely affect the efficiency of regulation and supervision of the system as a whole. Insiders pointed out that the CBRC may just play a interim role, from long term, a new agency, assembled the British model (Financial Service Authority), that integrates various agencies would be likely the final choice for the China's financial regulatory system.[71]

Despite the debates, the CBRC has seen significant improvements in 'specialisation of business' during the short period of operation since its establishment.[72] The CBRC has issued a series of rules and guidelines covering a wide range of issues related to banking supervision, which are largely drawn upon the international best practices. These can be divided into two categories, as discussed in the following sections. First, prudential standards, such as asset quality and capital adequacy. Second, supervisory methods, i.e. monitoring and enforcement. The CBRC has also made efforts in improving banks' internal control through the creation of risk management system.[73]

The establishment of the CBRC seems to indicate that the Wen Jiabao government has taken the upgrade of banking supervisory standards seriously. However, the ability of the CBRC to achieve effective prudential supervision remains questionable. The main reason is that the CBRC, like its predecessor the PBOC, is under the jurisdiction of the State Council rather than being legally independent. For instance, the recapitalisation programme of the Big Four started in late 2003 is not a thing that the PBOC and the CBRC can decide. The systematic action includes some intentions that may not be recognised by the market. In other words, only the highest level has the final say over the issues concerning the safeguarding financial stability.[74] The new structural arrangement therefore can not ensure that the possibility of undue governmental and political interference is removed. In this sense, the new reform does not make a fundamental change. Past experiences in both China and other economies, such as Japan and Korea, have shown that a government controlled banking system provides weak bank regulation and supervision when the government pursues goals that are inconsistent with the 'safe and sound' banking regulatory and supervisory objectives.

6.5 Prudential regulation and supervision

One of the most important policy initiatives in reforming China's banking regulatory system is the adoption of prudential regulation and supervision. The standards and practices are generally in line with international norms, while China's banking supervisory and regulatory realities are carefully assessed.

6.5.1 Prudential standards

Since the late 1990s, a series of accounting regulations were issued in China, these include the Accounting Law in 1999, the 'Regulations on Financial Reporting of Enterprise' in 2000, the 'Accounting Systems for Business Enterprises' (ASBE) in 2001, and 'Accounting Systems for Financial Institutions' in 2002. The ASBE sets out the fundamental accounting framework and is more in line with IAS. The Chinese commercial banks are now adopting financial statement definitions and balance sheet criteria, include accuracy, completeness, consistency, timeliness, accrual basis, prudence, matching, that reflect international practices. The areas of improving prudential standards include loan classification, capital adequacy, and loan loss provisions.

6.5.1.1 Loan classification

There is no international uniform system for classifying loans. Determining the appropriate category for a loan is a subjective process, a loan with the same characteristics might be classified differently from one banking system to another, and it primarily depends on the structure of the banking system and socio-economic conditions. Many countries, however, have adopted, mainly through regulatory and supervisory framework, a five category loan classification system, i.e. 'pass', 'special mention', 'substandard', 'doubtful' and 'loss'.[75] In April 1998, China began to use this system, the old four category system, i.e. 'normal', 'overdue', 'doubtful', and 'bad',[76] was gradually phased out in 2004. The two systems are distinct in principle with the internationally applied standards more prudent and forward-looking than China's four category system. This is particularly salient in defining non-performing loan (NPL), the sizes of NPLs measured under the two systems are not comparable,[77] while it appears that the NPL size with China's definition is less than that with international definition. For instance, evidence from comparison of the NPL numbers of the Chinese listed banks that have disclosed their NPLs in accordance with both methods, suggested that the old system understated NPLs by an average of about 15 percent against the new system.[78] This is one of the reasons why the credibility of that data related to the historical NPLs released by the government agencies has been greeted with considerable scepticism both within China and abroad.

The introduction of new loan classification system has dramatically pushed the Chinese banks to upgrade their measurement and reporting standards. The PBOC instituted new disclosure requirement in 2002, all the Chinese banks were required to issue reports based on the new system from 2002. During the experimental stage from 1998 to 2002, a dual system of reporting was adopted, which allowed the banks to fix tracking and reporting system and re-grading the massive loan portfolio. The pace of completing these works was varying in all banks, among which the Big Four were completed by July 1999. The BOC, the CCB and the ICBC started issuing financial report under the new system from 2000.

The new classification category has been further applied to non-credit assets. The PBOC issued the 'Guidelines on Risk-Based Loan Classification' in December 2001. All banks were required to classify their off-balance sheet items according the five categories, with the latter three classified as NPAs.

6.5.1.2 Provisioning requirement

Loan loss provisions are a critical tool for maintaining the solvency of the banks. The practices of provisioning differ among countries, following the asset classification system adopted. Most of the countries have adopted the standard requirements of provisioning — two types of loan loss provisions are allocated. The specific provisions consists of funds set aside against loans that are classified as non performing with specified weights attached to each of the categories — 20 percent of the outstanding balance in respect of 'Substandard' category of asset; 50 percent in respect of 'Doubtful' category, and 100 percent in respect of 'loss' category. The general provisions consist of reserves put aside as insurance against general portfolio risk, but not ascribed to any particular assets.

In China, the loan loss provision was not classified in this manner prior 2001. Banks made provisions for NPLs based upon the volume of total loans outstanding rather than that of classified loans. Banks thus did not have to raise their loan loss provisions as the quality of the loans declines. In addition, lower percentage of loan provisioning was imposed by limiting to 1 percent of total loans, and actual reserves were very low.[79] Such a practice of loan loss reserves was therefore less likely adequate to preserve the solvency of banks.

Since 2001, the percentage of reserves may be as high as 100 percent of loan balances according to the 'Regulation Governing Bad Loans Provisioning and Writing Off of Commercial Banks' issued by the MOF. The PBOC further specified a detailed standard for provisioning in the 'Guidance on Provisioning for Loan Losses' pronounced in April 2002, and brought the loan loss provisioning in line with international practices.

Under the provision guidelines, commercial banks in the PRC are required to make provisions based on a reasonable estimate of the probability of loss on a prudent and timely basis. Loan loss provision consists of general provisions, specific provisions and special provisions. Banks are required to make provisions on a quarterly basis. The general provisions should not be less than 1 percent of the total loans. The specific provisions includes that the provision is set aside for 'Special mention' loans by 2 percent, 'Substandard' loans by 25 percent, 'Doubtful' loans by 50 percent, and 'loss' loans by 100 percent. Among them, provisions for losses of 'Substandard' and 'Doubtful' loans may be set aside with a floating range of 20 percent depending on the banks' own assessment of the risks relating to the relevant loans. Commercial banks may also make special provisions in accordance with special risk factors, such as risks in association with certain industries and countries, probable loss rates and historical experience.

Financial institutions are not allowed to make after-tax profit distribution to shareholders until adequate provisions for losses have been made. A deadline for making provisions on this standard was set.[80] If a financial institution can not meet the requirement of maintaining adequate provisions as of 1 July 2005, the financial institution is required to take necessary steps to ensure that such requirement can be met in approximately three years but not more than five years from 1 July 2005.

6.5.1.3 Capital adequacy requirement

Capital adequacy serves as a strong cushion to withstand adverse impact of various exposures of banking operations. Although there are a series of norms to measure Capital adequacy, the 1988 Capital Adequacy Accord (Basel I) has been recognised internationally.[81] The purpose of the Basel I intended to reduce risk exposures of banks by linking the financial structure of banks to the risk structure of their investment portfolio. It prescribed a uniform classification of the calculation of capital.

Banks' assets include both the on-balance sheet assets and off-balance sheet assets, are divided into four categories based on their perceived risk characteristics with specified risk factor weights attached to each of the categories. This is done in order to get the total amount of risk-based assets of the banks. What is then done is to add up all of the risk-based assets from the four categories. Banks shall then meet two equity capital requirements. The first is that tier 1 capital, defined as common stock, retained earnings, and perpetual preferred stock, must equal at least 4 percent of the total risk-based assets. The second capital requirement is that tier 1 capital plus tier 2 capital, defined as fixed maturity preferred stock, general provisions, and subordinated debt, must equal at least 8 percent of total risk-based assets.[82] The Basel I proposed that internationally active banks could be considered to be adequately capitalised if these institutions could maintain capital level at minimum of 8 percent, otherwise they could be considered to be undercapitalised.

Although there have been some deficiencies in the Basel criteria,[83] over 100 countries have adopted the standards since 1998, especially the Basel Accord I remains the most notable source of reference for most emerging markets. China first introduced the capital adequacy requirements in March 1994 when the PBOC issued a notice requiring the banks to comply with the standards of the Basel guidelines,[84] and it was further reaffirmed in the 1995 Commercial Banking Law.[85] The standards adopted some essential essence formulated by the Basel Accord I. Capital adequacy requirement was set as high as international standards with the purpose of regulating and improving the quality of banking asset and limiting the credit risks involved. However, there were discrepancies in defining capital, assessing of risk-weighted assets and market risk, thus the Chinese banks tended to overstate their capital levels.[86]

In order to bring China's practices in line with the international standards, the CBRC revised the existing capital rules in the 'Regulation Governing Capital Adequacy of Commercial Banks' issued in February 2004. Under the new regulation, for instance, the calculation and measurement of capital adequacy ratios are on the basis of adequate provisions for various losses, including loan losses. Specific provisions should be deducted from the book value of loans when calculating risk-weighted assets. These would generate direct impacts on capital adequacy ratios of the Chinese commercial banks. The new regulation also adopts some features of the new Basel Accord (Basel II), incorporating Pillar II and III (enhanced supervisory review and disclosure),[87] though China will remain on the Basel I at least for a few more years after G10 implementation date of 2006.[88] The regulation provides a transition period ending on 31 December 2006, which enables commercial banks to meet their capital adequacy requirements progressively.[89]

6.5.2 Monitoring

The major measures of monitoring banking institutions include public disclosure, off-site surveillance and on-site examinations. Public disclosure, as a market disciplinary mechanism, has significant benefits in promoting safety and soundness in the banking system. Public disclosure helps prevent the occurrence of problems in banks by allowing market discipline to work earlier and more effectively, thereby strengthening the incentives for banks to behave in a prudent and efficient manner. Public disclosure can also reinforce specific supervisory measures designed to encourage banks to behave prudently by requiring banks to disclose whether or not they are in compliance.[90]

In evaluating the financial performance and condition of banks, a combination of off-site surveillance and on-site examinations is normally used by the banking supervisory authorities. Off-site surveillance provides early warning of actual or potential problems of banking performance. Based on timely, accurate, relevant and sufficient information, the supervisory authorities may assess the condition of individual banks and the banking system as a whole. On-site examinations allow the most extensive review of a bank's financial condition. During an on-site examination, supervisors visit a bank's offices to evaluate its financial soundness and compliance with laws and regulatory policies, to asses the quality of its management team, and to evaluate its systems of internal control.

The monitoring practices in China initiated as early as in the mid-1980s. However, the real progress in building a monitoring mechanism in line with international best practices has only been made since the late 1990s. In particular, the PBOC, and its successor the CBRC, have gradually moved from the earlier compliance-based methods to the new risk-based system. The CBRC has developed new supervisory concepts of conducting consolidated supervision with great importance attached to the overall risks of each institution, the identification, the early warning and the control of systemic risks.

Public disclosure was first made mandatory in May 2002, Under the 'Interim Measures on Information Disclosure of Commercial Banks' issued by the PBOC, the Commercial banks in China are required to publish an annual report within four months after the end of each fiscal year, in which the banks' balance sheets and income statements as of the end of the preceding fiscal year must be provided. Furthermore, the annual report must also disclose, among other things, audited financial statements prepared under the Chinese GAAP, material related party transactions and capital adequacy ratios, risk management performance, corporate governance and other significant events such as any increase or decrease in registered capital during the year.[91] In addition, given the importance of the problem of NPLs, the CBRC has improved the disclosure standards for such loans by issuing NPLs data for the banking sector on a quarterly basis.

The Chinese regulatory and supervisory authorities carry out banking supervision through both off-site surveillance and on-site examinations. In conducting off-site statistic activities, banking institutions are required to submit operation reports to the PBOC or the CBRC as applicable on a regular basis. The reporting requirements are broad and the supervisory authorities can acquire any reports and data from the banks if they are necessary. In general, the reports include balance sheets, income statements, capital adequacy ratios, liquidity ratios and loss provisions, other financial and statistical reports, information concerning business operations and management, and the audit reports prepared by certified public accountants.

On-site examinations in China can be divided into two categories: periodic and special examination. The scope of the periodic examination covers all activities of the banks. The special examination is carried out when there are impeding policy issues or other serious problems. In relation to the risk-focused examination approach, the CBRC introduced a new risk assessment system to evaluate the shareholding commercial banks in February 2004. This system is similar to the CAMEL system used in other countries.[92] Shareholding banks are scored based upon capital adequacy, asset quality, management competence, liquidity and profitability on an annual basis.[93]

6.5.3 Enforcement

Prompt Corrective Action (PCA) as an enforcement measure has been adopted in many countries as a consequence of banking crises since the 1980s.[94] PCA is a device designed to minimise or prevent the risk of regulatory forbearance by intervening earlier in troubled banks and by encouraging banks to become better capitalised. It prescribes specific prompt actions when the book-value capital of a bank falls below certain levels, and gives little discretion for the regulatory and supervisory authorities.

The CBRC implemented the PCA in 2004 followed by the adoption of the new risk assessment system, which is currently applied only to the shareholding commercial banks. Under this approach, the shareholding commercial banks are classified into three categories based on their respective capital adequacy ratios: adequate; inadequate; severely inadequate. Banks provide self-assessment of the quality of loans and the capital adequacy, which is followed by the external audit and the regular examination by the CBRC. If the banks are found inadequately capitalised as a result of such reviews, the CBRC could impose relevant corrective measures according to the severity of the problems. For instance, for the banks with inadequate capital, the CBRC may issue supervisory opinions, which requires the banks to work out a feasible plan to raise its capital adequacy ratios; For the banks with severely inadequate capital, the CBRC may, in addition to the above corrective measures, require the removal of the banks' senior management, take over the banks, facilitate the restructuring of the banks, or revoke the banking licence.

Other enforcement measures in China can be divided into two groups: sanctions against banking institutions and against bank officers and employees. When banking institutions violate the provisions of laws, administrative regulations on banking regulation and supervision; make false supervisory reports or neglect to submit them; reject or obstruct the supervision and examination of the regulatory authority; fail to disclose information to the public; or neglect to take appropriate actions or measures required by the regulatory authority, the banking regulatory authority may impose fines in various amounts depending on the degree of the violation; disqualify or bar the directors and senior mangers concerned from performing their duties; order suspension or revocation of banking license.[95]

When officers and employees of banking institutions neglect their duties in violation of the provisions of the Commercial Banking Law; violate regulations by offering favourite terms to their relatives or friends in granting loans or providing guaranty; engage in conduct in an unlawful manner, such as using their positions to demand, receive or accept bribes, embezzle or misappropriate money belonging to the bank or any client, they shall be subject to administrative penalties or criminal charges.[96]

6.6 Conclusions

The reforms of bank regulation and supervision in China have moved the nation's banks to a system more closely modelled on modern banking operations, with institutional structures and practices increasingly sensitive to international norms. A comprehensive legal framework for the bank regulation and supervision has been established, which has shifted the bank regulation from a discretionary regulatory framework for the administration of financial institutions to a more transparent legal framework. The normative approach of bank regulation through structural regulation and economic controls has been gradually relaxed as part of the liberalisation process. It has provided the Chinese banks with more incentives to act independently in their market operations. Great importance therefore has been placed on prudential regulation and supervision, and the focus of the supervision has moved from the rule compliance to the risk control. The newly created separated banking regulatory and supervisory system that aims at improving the efficiency of the banking supervision has seen a significant progress in upgrading the banking supervisory standards.

The reform programme does not remove the governmental control over the banking system by creating independent regulatory and supervisory authorities. There is no theoretically ideal framework of general application for the institutional arrangement, and it largely depends on the practical detail. Whereas to achieve effective regulatory and supervisory operations, the regulator and the supervisor should be given some degree of independence, free from political interference and especially from governmental objectives, which may be inconsistent with regulatory and supervisory objectives. To this end, it is not completely clear how the newly established banking regulatory commission would ensure that the Chinese banks are 'safe and sound'. This is especially questionable in the areas of the enforcement and the level playing field. For the former, to enforce the laws and regulations has not been an easy task, because society in China is still plagued with the problem of 'rule of man'. For the latter, to ensure a level playing field to all the banks, not only include SOBs but also policy banks and credit cooperatives, the regulatory commission should be sufficiently insulated from political influence.

The current regulatory and supervisory regime reflects the broad views about the role of the government in the Chinese society, in other word, it is in this way that the government may conduct its control over the Chinese financial institutions, and in particular, the state-owned banks after the shareholding reform. This is a drastic policy change that the Chinese government has moved away from direct control over banks towards using prudential regulation.

Chapter 7 Building internal governance systems: the cases of Bank of China and China Construction Bank

7.1 Introduction

The preceding Chapter 5 and Chapter 6 have discussed how the NPLs and the banking regulatory environment have been tackled in China respectively. In short, China has been enthusiastic and aggressive in reforming the SOBs from without. This chapter focuses on how the banks have been transformed from within, i.e. how the banks have established adequate internal governance systems. As discussed in Chapter 2, an effective internal control system is a critical component of bank management and a foundation for the safe and sound operation of banks. Banking systems stability would be impossible to achieve without financial stability among the individual banks. The fundamental purpose of internal control systems is to safeguard the financial integrity of banks (Kinsella 1995). By imposing responsibilities for operating in a more sound and prudent manner, internal control systems require banks to exercise a much higher degree of care.

The direction and goal of the reform of the Big Four was cleared in the 2nd 'National Conference on Financial Work' held by the Central Committee of the CCP in February 2002. A three-step reform strategy in building the banks' internal governance systems was drawn up: strengthening internal management and risk management; transforming into state-controlled shareholding commercial bank; listing on overseas stock markets. At the end of 2003, the BOC and the CCB, because of their relatively better conditions in the Big Four in terms of the financial conditions and asset quality, were chosen as pilot banks to carry out shareholding reform. The other two would closely follow their steps.

The core of the reforms is restructuring the ownership system. By October 2006, three of the Big Four, i.e. the BOC, the CCB and the ICBC,[1] had completed their shareholding restructuring and IPOs. The unprecedented move is a milestone in the evolution of the Chinese banking sector, which marks the end of the 100 percent of the state ownership of the banks. The internal restructuring of the banks, in particular, the issuance of stock, and exposure to foreign capital flows, have expanded their opportunities for the value-adding business strategies. Meanwhile, linked with the new ownership structure, the banks' management structures and reporting lines have also changed.

This chapter makes an in-depth investigation into the process of establishing internal governance systems in the SOBs through a case study of the BOC and the CCB. It first provides a brief background of the two banks. This chapter then explores the banks' ownership restructuring, including the incorporation, the introduction of foreign strategic investors and the public listing. The features of the reforms are discussed. The next section examines the banks' organisational restructuring, which focuses on the compositions of the board rooms and executive management. The issues related to management accountability under the new system are addressed. In the following section, the reforms on internal risk management systems are examined. It focuses on three aspects: organisational structure, management processes, and administration procedures. Finally, conclusions are presented.

7.2 Backgrounds of the banks[2]

The BOC was established in 1912. Before the founding of the PRC in 1949, the bank served as the central bank, foreign exchange bank and international trade bank. The BOC was reconstituted in 1949, and became subordinate to the PBOC. The bank was separated from the operation of the PBOC following the reform of the banking sector in 1979, and became a wholly state-owned specialised bank, responsible for foreign exchange and international settlement. The BOC was converted into state-owned commercial bank in 1994. In August 2004, the bank was incorporated into shareholding bank and known as the Bank of China Limited (BOC Ltd.), before listed on the Hong Kong Stock Exchange (HKEX) in May 2006 and the Shanghai Stock Exchange (SSE) in July 2006.

The bank is the first and the only Chinese bank that has a strong international presence with its global network covering 25 countries and regions. In HK and Macao, the BOC is one of the local note-issuing banks. At the end of 2005, the BOC had 11,018 domestic branches and outlets as well as 627 overseas branches with 209,000 employees. Its total assets amounted to US$587,348 millions. The BOC was ranked 17 among the world's largest 1,000 banks in terms of core capital by *The Banker* in July 2006.

The CCB was established in 1954 as the People's Construction Bank of China (PCBC), which operated as a subsidiary of the MOF. The PCBC was reconstituted to a state-owned specialised bank in 1979, mainly handling the nation's fixed asset investment and infrastructure development. In 1994, the PCBC was transformed into a state-owned commercial bank. In March 1996, the PCBC officially changed its name to the China Construction Bank. The CCB was restructured into a shareholding bank in September 2004 called the China Construction Bank Corporation (CCB Co.) In October 2005, the bank was listed on the HKEX. It was the first bank in the Big Four that completed initial public offering of shares overseas.

At the end of 2005, the CCB maintained 13,977 domestic branches and outlets across the country; the bank also had six overseas branches and two overseas representative offices. The bank had 300,000 employees. Its assets totalled US$568,228 millions. The CCB was ranked 28 among the biggest 1,000 banks in the world by *The Banker* in July 2006. Table 7.1 summarises major financial indicators of the BOC Ltd. and the CCB Co.

Table 7.1 Financial highlights of the BOC Ltd. and the CCB Co.

(RMB million)

	BOC		CCB	
Financial indicators	2005	2004	2005	2004
Total assets	4,742,806	4,270,443	4,585,742	3,909,920
Total liabilities	4,480,186	4,037,705	4,298,065	3,714,369
Owner's equity	233,842	205,351	287,579	195,516
Total core capital	252,970	228,447	284,209	194,744
Operating profit before provisions	64,744	57,841	128,714	113,976
Profit before tax	55,140	34,576	55,364	51,199
Net profit	27,492	20,932	470,961*	490,401*
Return on assets (ROA)	0.72%	0.61%	0.9%	0.92%
Return on equity (ROE)	12.62%	10.04%	17.7%	17.99%
NPL ratio	4.62%	5.12%	3.84%	3.92%
Cost to income ratio	39.3%	40.02%	45.13%	46.87%

Sources: 2005 Annul Report of the BOC Ltd. and the CCB Co.
Note: * This includes the impact of income tax exemption expired on 30 June 2005 relating to the bank's restructuring.

7.3 Ownership reform

As discussed in Chapter 4, it is a prevailing view in China that the underlying premise of the poorly performing of the SOEs is the lack of identifiable owners. According to this logic, once policy makers provide a clear and decisive answer to the question of who owns, enterprise performance will then almost certainly improve. Shareholding system therefore has been given the status of the main form of state-ownership in China since late 2003.[3] The appeal of corporatisation lies precisely in its ability to specify ownership. A least in theory, corporatisation, by designating shares in the firm and then allocating those shares to a contained group of holder, creates clearly defined owners who have a true interest in maximising efficiency.

The ownership reform of the BOC and the CCB was carried out in line with this principle. The entire process of the reform was designed to include three steps: incorporation; introducing foreign strategic investors; and initial public offering. The main purpose of the scheme was to change the ownership structure of the banks fundamentally from solely state-owned one to diversified one involving the state, the domestic and foreign institutional investors, and the public. By doing so, on the one hand, this would rule out the possibility of re-injection of large scale capital by the government on a legal basis, as the Chinese government has apparently no appetite for repeated bank bail-outs. As a consequence, it may eliminate the moral hazard arising from the banks' expectation for further bailouts by the government. On the other hand, this would lay the ground work for continuing viability on the two banks after the capital injection by establishing an internal governance system in line with the international best practices.

7.3.1 Incorporation

Following the capital injection of US$22.5 billion by the central government on 30 December 2003, the BOC counted the capital as its owner's equity, and issued 186.39 billion shares to China SAFE Investments limited (SAFE Investments, previously known as China Central Huijin Investment Co.), which made the investment on behalf of the state. At the same time, the bank assigned all of its owner's equity prior to 2003 (including the net profit for 2003), a total of RMB 219.4 billion (US$26.4 billion), to its provisions for future write-offs of bad loans.[4] On 23 August 2004, with the approval of the State Council, the BOC was restructured into a shareholding company, and was renamed 'Bank of China Limited'. The new BOC assumed all assets, debts, and business of the original BOC. There was only one founding-shareholder in the new company, i.e. China SAFE Investments limited, which held 100 percent equity of the new BOC, and became the owner of the bank on behalf of the central government immediately after the incorporation.

In contrast to the BOC that had been restructured as a whole company, in policy terms, the old CCB was divided into two parts, one of which became a wholly state-owned company and the other a shareholding company. On 17 September 2004, a formal division was made creating the China Jianyin Investment limited and the China Construction Bank Corporation.

The CCB Co. had an aggregate capital of RMB194.23 billion (US$23.4 billion), with a total of 194.23 billion shares. It assumed all the main business of the CCB as a commercial bank and its relevant assets. The trade name, trademark, internet domain name, and branch establishments remained unchanged, and to be continually used by the CCB Co. There were in total five founding shareholders in the CCB Co., all of which were state-owned companies. China SAFE Investments limited became the controlling shareholder with an 85.23 percent stake. Jianyin Investment Limited held a 10.65 percent stake. Shanghai Baosteel (Group) Corporation, the largest steel conglomerate in China, and State Grid Corporation, the largest enterprise in China's power industry, each held a 1.54 percent stake. Yangtze Power Corporation Limited, the largest hydropower generator in China, owned a 1.03 percent stake.

Jianyin Investment limited assumed all other assets and liabilities outside of the main business of the CCB. Its core was the more than RMB70 billion ($8.46billion) non-credit asset loss, which was peeled off entirely from the historical burden of the CCB.[5] It operates the non-banking business mainly involving in investment in enterprise and asset management.

The partial organisational transformation effected by breaking up existing enterprise has become a persistent model for shareholding reform of large-scale state-owned enterprises in China. This practice can effectively make the enterprises becoming independent from the government, shifting bad debts and over-employment burdens onto their parent or holding companies, and undertaking new business opportunities without losing existing connections to and benefits from the state. As far as the CCB is concerned, the main reasons for adoption of such arrangement were twofold: firstly, the bank was not fully bailed out by the government due to the limited public funds, the historical burdens had become a hurdle for the bank to carry out further reforms. Whilst through its separate establishment, it immediately created favourable conditions for accelerating the process of system reform and public listing. Secondly, as a polite reform, by remaining some portion of bad assets in the bank, it was hoped that it would alleviate moral hazard problem and motivate the management to achieve better performance.

The separation indeed resulted in significant improvement of asset quality and enhancement of the financial transparency of the CCB Co., there was no longer much suspense for its successful public listing. However, in the process of separation, to certain extent, the shareholding reform of the CCB had become the shareholding reform of the CCB Co., in particular, the requirements of the 'Guidelines' (see discussion below) had become tasks and targets of the CCB Co. rather than the entire CCB. In this sense, the public listing of the CCB Co. is not equal to success of the shareholding reform of the CCB, because at least the historical burden left to its holding company still needs to be solved.

7.3.2 The foreign presence

Given the closed nature of the Big Four historically, the foreign presence in the two banks' reform is worthy of paying special attention. It had been an official policy that encouraged the banks to introduce foreign strategic investors.[6] Foreign strategic investors clearly helped to strengthen the banks' capitalisation, while the motivations behind the policy decision to a large extent stemmed from the desire for improving managerial techniques of the banks by introducing international state-of-the-art practices, and for diversifying equity structure. This was evident in, as discussed below, the limited nature of the foreign ownership and the agreed cooperation projects between the two parties. The motivations could also partly explain why the Chinese government gave the high priority of participation to foreign commercial banks other than domestic financial companies during the ownership restructuring of the banks,[7] which has been criticised for obstructing the development of strong domestic financial firms.[8]

At the time when each bank was deemed to have made sufficient progress, i.e. it was restructured into a shareholding company, the bank was allowed to begin negotiations with potential foreign strategic investors. During the process of negotiation, the two banks had been in a very difficult position. One reason was that the banks had few options. Although foreign investors were eager to get a foothold in China as the fastest-growing major economy in the world, concerns over taking a large risk by acquiring shares in the state banks really held some back. This reflected in the common worry among foreign investors about mismanagement and corruption in the banks, as well as how lingering bad loans from the past would affect the banks' performance, even after its restructuring.[9] Moreover, some of the major foreign banks such as the HSBC that had already entered the China market by buying stakes in smaller commercial banks, had to drop out the negotiations, either because they had signed non-competition agreements, or because their involvement with multiple Chinese banks would be deemed restraint of competition by the bank regulators. Another reason was that the banks were under enormous pressure to conclude the negotiation process as early as possible. The introduction of foreign strategic investors was deemed as a crucial step for the subsequent public listing. Although there was no explicit timetable for it, the government had been stepping up pressure on the banks, due to the concern that the longer the process prolonged, the more likely it would be that the capital injected in the banks could be as quickly consumed by the recurring bad debts as it had happened in the previous bailouts.[10] It would undermine the government's costly attempts to reform the once-bankrupt banks. This pressure had pushed the banks to chase too few potential foreign partners.[11]

Table 7.2 Foreign ownership of shares in the BOC Ltd. pre-IPO

Name	Date of announcement	Shares (%)	Value (USD billion)
RBS China	8 Aug 05	9.609	3.048
AFH	8 Aug 05	4.805	1.524
UBS AG	27 Sept 05	1.55	0.49157
ADB	10 Oct 05	0.23	0.07374
Total		16.194	5.13731

Source: Global Offering Prospectus of the BOC Ltd.

The BOC Ltd. finally concluded the negotiations with its foreign strategic partners on 17 October 2005. The bank sold a combined 16.2 percent stake to four foreign investors at the rate of 1.17 times the book net assets on 31 December 2004, valued at US$5.14 billion (see Table 7.2). As a part of the strategic arrangements, the BOC Ltd. and its foreign partners also agreed to cooperate on various areas related to business and management (see Table 7.3).

Table 7.3 Strategic cooperation between the BOC Ltd. and its foreign partners

Name	Potential cooperation areas
RBS China	wealth management services, credit cards, corporate banking, risk management, information technology
AFH	information technology, legal and compliance, human resources
UBS AG	investment banking, fixed income products and services, asset and liability portfolio management, market risk management
ADB	internal control, project finance in the infrastructure sector, anti-money laundering, environmental impact assessment

Source: Global Offering Prospectus of the BOC Ltd.

The process of the negotiations had been very complex. On 18 August 2005, the BOC Ltd. announced the agreement with its principal foreign strategic investor, Royal Bank of Scotland Group (RBS), that the RBS would invest US$3.1 billion to acquire 10 percent of total shares. But the RBS then claimed that it would invest only US$1.6 billion and control 5 percent stake. The other 5 percent of shares would be taken by its subsidiary the BRS China, and split among five shareholders of the BRS China[12] Shareholder pressure at the RBS was the main reason for the change to its initial commitment. Shareholders at RBS did not understand why they should invest several billion dollars in a state-owned bank with substantial exposure to China's legacy of poor lending decisions, for just 10 percent of voting rights. Some were even concerned about that the RBS would probably have to invest more capital in the BOC Ltd. in the future just to maintain its shareholdings.[13]

Another controversial case was the role played by Temasek Holdings (Private) Limited, an investment company controlled by the government of Singapore. According to an agreement signed on 31 August 2005, the Temasek would invest US$ 3.1 billion for a 10-percent stake in the BOC Ltd through Asia Financial Holdings (Private) Limited (AFH), a wholly-owned subsidiary of the Temasek. But the CBRC overruled the proposal, because of the concerns that the AFH had already acquired a 4.55 percent stake in the Minsheng Bank Co. and 5.1 percent stake the CCB Co., this would lead the Temasek to own an unacceptably large stake in China's banks. The board of directors of the SAFE Investments limited also vetoed the plan, since the Temasek does not have the obvious bank management expertise that could be directly transferred to the BOC Ltd. However, considered that the Temasek had been a constructive partner during the toughest part of negotiations, and the Temasek does have significant experience and access to expertise, its stake in the BOC ltd. was approved by cutting in half to 5 percent.[14]

Compared with the BOC Ltd., the negotiation process of the CCB Co. seemed much smoother. The bank finally completed share sales to two strategic investors on 1 July 2005. On 17 June 2005, the CCB Co. signed an agreement with Bank of America (BOA) to sell a 9 percent stake for US$3 billion to the US bank, at the rate of 1.19 times the book net assets of the CCB Co. on 31 December 2004. According to the agreement, the BOA would have the option to buy additional shares to increase its ownership in the CCB Co. in the next five and a half years to 19.9 percent, the maximum percentage allowed for individual foreign investors currently under Chinese law. Under the agreement, the BOA would also provide expertise in risk management, credit cards and consumer banking. By the end of February 2006, the BOA had provided 40 personnel to advise the CCB Co. in such areas as retail banking and electronic banking business.[15]

On 1 July 2005, the CCB Co. reached a similar agreement with the Temasek on a strategic partnership. Through the AFH, the Temasek paid US$1.47 billion for a 5.1 percent stake in the CCB Co. The agreement also included that the Temasek would purchase stocks of a total value of US$1 billion at the price that the CCB Co. would issue in the IPO of the bank. The Temasek would provide strategic cooperation in corporate governance, funding trading, SME and international financing.

7.3.3 Public listing

On 27 October 2005, the CCB Co. took the lead among the Big Four to get listed on the HKEX. The bank had earlier sold 26.5 billion H-shares through the global offering, the price was set in the range of HK$1.90-2.40 (US$ 0.24-0.31). Among them, 1.32 billion shares were earmarked for retail investors in HK, with the rest for international offering, including some to the bank's strategic investors. After its sponsors issued an additional about 3.97 billion shares, the bank offered in total approximately 13.5 percent of its expanded equities, and raised HK$ 71.58 billion (US$9.18 billion) from foreign investors. The stock's IPO price was HK$ 2.35 (US$0.30) per share, which put the ratio of the IPO share price and net asset per share at 1.96. The post-listing ownership of shares in the CCB Co. is shown in Table 7.4.

Table 7.4 Post-listing shareholding structure of the CCB Co.

Name	Shares (%)
China SAFE Investment	61.48
Jianyin Investment	9.21
Shanghai Baosteel	1.34
State Grid	1.34
Yangtze Power	0.89
Bank of America	8.52
AFH	5.88
Shares held by investors under the Global Offering (other than strategic investors)	11.35
Total	100

Source: 2005 Annual Report of the CCB Co.

The IPO of the BOC Ltd. took place seven months after that of the CCB Co. The delay was caused by the debate over whether to sell shares in the mainland China or HK stock market between the SAFE Investments and the CSRC.[16] The former intended to push the bank to follow the lead of CCB Co. and convert its entire stake in the BOC Ltd into shares tradable in HK (H-shares). This can turn stocks into cash smoothly,[17] but the latter wanted portions of the bank's shares to be sold in the mainland market to boost sagging market volume and improve market asset quality. After the bank's shareholders agreed a proposal to launch a dual IPO in the two markets, a move known as 'A+H', the plan had been further delayed by the slumping performance of the mainland's stock markets, in particular when the Shanghai Composite Index hit its low of 1146 in 2005, the CSRC was once forced to give up the idea of approving the bank's plan.

It was not until 1 June 2006, that the BOC Ltd.was eventually listed on the HKEX. A total of 25.57 billion H-shares were offered in its global offering, including initially 1.28 billion shares for the HK public offering and 24.29 billion shares for the international offering, with 22 percent or US$2.16 billion earmarked for 12 corporate investors. The bank priced the shares at between HK$2.50-3.00 (US$0.32-0.39), which equated to 1.89 to 2.17 times its 2006 book value. The offering was well received. The retail portion was 75 times oversubscribed, while the international tranche was oversubscribed 20 times by the institutional investors. The Over-Allotment Option was then exercised in full on 9 June 2006. A further of 3.835 billion shares were sold, which raised the total value of its IPO to HK$87.37 billion (US$11.2 billion). Post-listing shareholding structure of the bank is shown in Table 7.5.

Table 7.5 Post-listing shareholding structure of the BOC Ltd.

Name	Shares (Percent)
China SAFE Investment	69.265
RBS China	8.467
AFH	4.765
SSF	4.576
UBS AG	1.366
ADB	0.205
Shares held by investors under the Global Offering (other than strategic investors)	11.356
Total	100

Source: Announcement regarding excise of Over-Allotment Operation on 6 June 2006

On 5 July 2006, the BOC Ltd. successfully made the largest IPO in mainland China, by offering 6.49 billion A-shares on the SSE, or RMB20 billion (US$2.5 billion). Twenty percent of the shares, or some RMB 3.96 billion, were earmarked for 14 select domestic corporate investors, thirty-two percent were open to other institutional investors, with the remainder going to retail investors. The shares were listed at RMB3.08 (US$0.385) per share in contrast to that of H-shares priced at HK$2.95 (US$0.378) on the HKEX.

7.3.4 Features of the ownership reform

There are two particular features which can be observed in the ownership reform of the BOC and the CCB.

One of the features is that the reform did not lead to a substantive change in the nature of ownership. Through partial privatisation, the original state ownership of the banks indeed has been broken, and the diversified ownership has achieved clear 'property rights'. However, ultimate control through ownership has not been fully transferred from the state. The foreign ownership of each bank is less than 20 percent, with a single investor less than 10 percent. Even after listing, only a small portion of the equity in the banks was sold to private investors. By doing so, the state preserves the control over the major lenders, while allows non-state investors to contribute to the banks with minority shareholding, it is possible for the state to control more social assets with relatively less state assets. In this sense, the ownership reform of the banks is essentially not different from that of other SOEs.

The government as the dominant shareholder of the banks would have significant implications on the role of foreign strategic investors. The participation of the foreign investors had certainly lent credibility to the listings of the banks, but they were more solicited in the long term, as discussed above, for helping strengthen internal controls and develop management system of the banks. However, uncertainty has remained whether their participation can be effective under the new ownership structure. Because low ownership shares of the foreign strategic investors and their limited management involvement could weaken the incentives for foreign investors to take an active interest in overall bank performance and make them focusing on creating value only in narrow areas of cooperation. This situation is unlikely to change in the short term. According to the country's 11th five-year program (2006-2010) on foreign investment utilisation, Chinese banks must hold the majority of shares of such ventures.

A question arises as to why such foreign investors as the RBS and the BOA would spend billions for just a less than 10 percent non-controlling equity stake in the banks? There seems no simple answer to this question. However, if we looked at the case of China Petroleum & Chemical Corporation (Sinopec), Asia's largest refiner, in which three strategic investors of the company, the ExxonMobil Co., the BP plc and the Royal Dutch/Shell, each won a double investment profit by cashing out of its stake in the company,[18] it would become clear that foreign investors' original share purchase suggests a certain level of investment confidence.

Another feature is that the ownership restructuring of the banks was carried out predominately by top-down administrative directives other than by market rules. This, as part of the planned economy mindset, became evident when the Chinese authorities imposed fixed timetables for fixed targets on the reform processes. Various decisions had been made by the Standing Committee of the State Council, the National Committee on Banking Reform, and the CBRC to ensure the success of the reform. The most important one was the 'Guidelines on Reform and Supervision of Corporate Governance for Bank of China and China Construction Bank' issued by the CBRC on March 2004, in which ten guidelines were set with either qualitative or quantitative targets. It stipulated that the objective of the shareholding reforms of the two pilot banks is to transform, within three years, the banks into modern and internationally competitive shareholding commercial banks.[19] Since public listing was deemed as the vital step to achieve this goal, the 'Guidelines' made requirements in detail on major financial indicators to push the banks to be qualified for flotation as early as possible (see Table 7.6).

Table 7.6 shows a comparison between the targets of the CBRC and the performance of the two banks. It illustrates that the two banks basically met the quantitative targets for 2004 and 2005. The completed financial restructuring under the assistance of the government as discussed in Chapter 5, including the capital injection and NPL write-off and sales, helped the banks meet these targets. However, compared with the strong

Table 7.6 Performance assessment indicators for the BOC Ltd. and the CCB Co.

	BOC			CCB			CBRC targets		
Financial indicators	2004	2005	2006	2004	2005	2006[1]	2004[2]	2005	2007
Return on assets (ROA)	0.61	0.72	0.96	0.9	0.92	0.95	--	0.6	--[3]
Return on equity (ROE)	10.04	12.62	14.06	17.7	17.99	15.67	--	11	>13
Cost to income ratio	47.35	47.95	46.32	46.87	45.13	41.65	--	35-45	35-45
NPL ratio	5.12	4.62	4.04	3.92	3.84	3.51	3-5	3-5	3-5
Capital adequacy ratio	10.04	10.42	13.59	11.29	13.57	13.15	≥8	≥8	≥8
largest exposure to a single customer	3.6	4.7	2.2	10.1	n. a.	n. a.	--	≤10	≤10
NPL provisioning coverage ratio	68.2	88.55	91.34	61.64	66.78	71.73	--	60-80[4]	≥60-80[5]

Sources: 2004 and 2005 Annul Report, 2006 Interim Report of the BOC Ltd and the CCB Co.
The 'Guidelines' of the CBRC.

Notes: 1. Interim figures.
2. There were only two targets set for 2004.
3. The target is 'a level required for an internally competitive bank'.
4. The target was 60 percent for the BOC Ltd. and 80 percent for the CCB Co.
5. The target is 'further increase is required by 2007'.
n. a.: Not available.

technical solutions to the financial restructuring, the banks' operation mechanisms have not seen a significant improvement. Some qualitative issues related to the underdeveloped credit system and credit culture in particular, which have plagued the banks for over decades, are unlikely to be resolved overnight. Important concerns arise, both within China and abroad, whether the banks had actually achieved the target of each stage, and even if it rushed to move to the next phase.

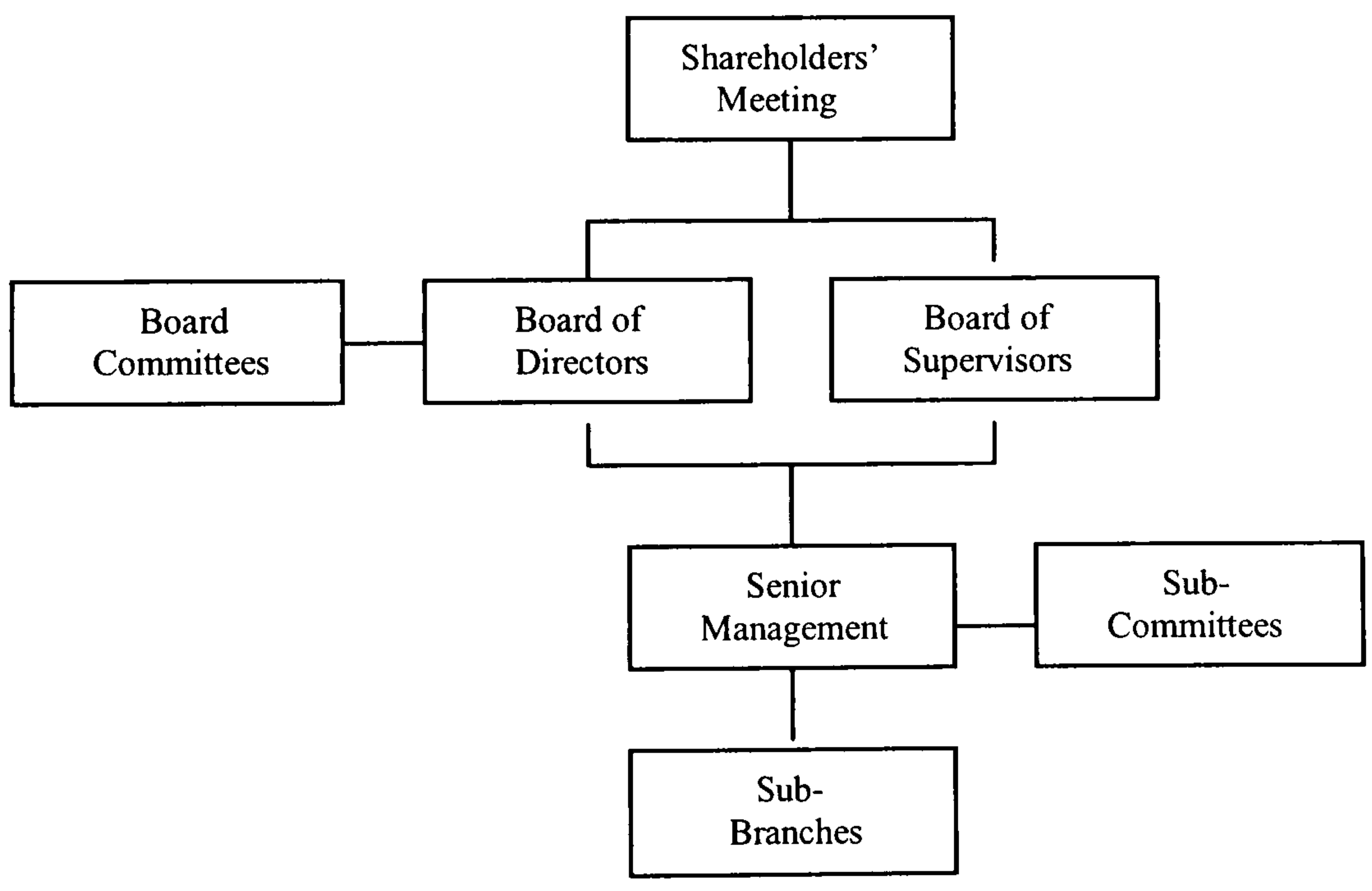
NPLs provide a clear example. In order to meet the government's target, the banks usually tried to increase the amount of such medium and long-term loans as individual housing loans or government-financed infrastructure projects to bloat the loan base, thereby lowering the percentages of their NPLs. By doing so, although the percentage of NPLs naturally goes down as the loan base swells, the risk of creating new potential

NPLs also increases. This is evident that the old NPL-generating mechanism is still an issue. It is, therefore, not surprised that debate about the banks' true financial health has never stopped.[20]

7.4 Organisational restructuring

The internal governance structure of a corporation mainly consists of three administrative levels, i.e. shareholders' meeting, board of directors and executive management. There are unique variations in the major developed economies, as discussed in Chapter 1, such as the German system and the Anglo-American system. In China, a two-tier board structure is adopted. Mandated by the Company Law, one more level in the governance structure is added, i.e. the supervisory board, which is to supervise the activities of the board of directors and senior managers.[21]

Figure 7.1 The internal governance structure of the BOC Ltd. and CCB Co.



Source: Author

In the course of ownership restructuring, the BOC Ltd. and the CCB Co. have put into such a governance structure operating under newly adopted rules (see Figure 7.1). The system had been absent in the past recapitalisation of the banks, which was deemed as a leading cause of the failure in achieving the intended results. A set of accountability procedures has been implemented, which attempted to impose checks and balances among shareholders, the board of directors, the board of supervisors, and top management. This has fundamentally relinquished the past practice of the top manager of the banks calling all the shots.

7.4.1 Composition of the boards and senior management

At the time of listing, the boards of directors of the BOC Ltd and the CCB Co. were comprised of sixteen and fifteen members respectively (see Table 7.7). Among them, majority were non-executive directors, who were appointed by the shareholding entity according to the right of shares of the proportion in the banks. As a majority shareholder, the SAFE Investments owned six seats in each of the boards. The foreign strategic investors, the RBS and the AFH shared the rest of two seats in the BOC Ltd; the BOA took up one seat in the CCB Co. Independent non-executive directors also had a significant presence in both banks. All of them were experts with global prestige.[22]

Table 7.7

Composition of the board of directors of the BOC Ltd and the CCB Co.

	BOC Ltd	CCB Co.
Executive Directors	4	4
Non-Executive Directors	8	7
Independent Non-Executive Directors	4	4
Total	16	15

Source: 2006 Interim Report of the BOC Ltd,
2005 Annual Report of the CCB Co.
Note: Figures show at the time of listing of the bank.

A feature of the new governance system was that the state appointed non-executive directors in the banks by acting as a shareholder. All the twelve non-executive directors in the two banks were employees of the SAFE Investments. They were required to attend a meeting held by the SAFE Investments on a weekly basis. The purpose of the meeting was to discuss issues in relation to the bank in which they were designated. The meeting was held separately in order to build an internal 'fire wall' between the two banks. All these directors worked at their dedicated offices in the banks on a daily basis, while they were not involving the banks' routine management. This bears certain feature of independent director in the Anglo-American system. They, however, were not independent from the shareholder, which makes them fundamentally distinctive from the independent director. Such an arrangement was believed to open a new way in addressing the issues of 'absence of owners' and 'insiders control', which had not been dealt with in the previous reforms of the SOBs.[23]

In both banks, the positions of the chairman of the board were separated from that of the CEO, which represents the changing practice in an attempt to improve the internal balancing mechanism in China. For the BOC Ltd., when the bank was incorporated on August 2004, Xiao Gang, the board chairman and president of the old BOC ceded the presidency to Li Lihui, the former vice-governor of Hainan Province. Xiao retained the position of board chairman. Identically, the former president of the CCB, Zhang Enzhao, assumed the chairman of the board of the CCB Co. Chang Zhenming, the former vice-president of China International Trust and Investment Corporation (CITIC), served as the bank's president.

Under each of the boards, five board committees were set up to assist the board in fulfilling its responsibilities relating to audit, strategy development, risk control, personnel and compensation, and related party transaction. Independent non-executive directors played active role in the board committees, and each board has three committees chaired by the independent directors.

The board of supervisors of the BOC Ltd. consisted of five members, including the chairman and two employee supervisors who came from the bank, two full-time supervisors who had been designated by the State Council before the bank's restructuring. The CCB Co. had seven supervisors, apart from one external supervisor, four of them came from the bank, two from the founding-shareholders. It is noted that the practice of appointment of the supervisors in the banks has been changed, with majority of the supervisors who came from inside the banks, either being appointed by the banks or the shareholders, the central government no longer send outside supervisory boards to the banks.[24]

The top management teams of the BOC Ltd and the CCB Co. were composed of six and seven members respectively, including the presidents, the vice presidents and assistant presidents. Under the executive body, the BOC Ltd. set up four committees responsible for internal control, asset-liability management, asset disposal and anti-money laundering. The CCB Co. formed nine committees responsible for corpoarte banking, personal banking, treasury, asset-liability, information technology, general administration, compliance and risk control.

After corproate restructuring, the top management in the two banks remained largely unchanged. Apart from the presidents, five senior managers in the BOC Ltd. and six senior managers in the CCB Co. retained their positions. This could indicate that, on the one hand, management was experienced, competent and appropriate during industry turbulence. On the other hand, the government retained the power of appointment of senior managers, while it was unwilling to make a drastic personnel reshuffle for some reason, for instance, to ensure a steady business operations during the banks' transformations. Nevertheless, this lack of change in leadership could lead to a bias against change. The experiences of bank privatisation in the former Central and Eastern European countries show that improvement in management did not follow immediately upon the ownership reform due to the retention of the top management who ran the banks. Because these managers were entrenched, they wielded significant power over the affairs of the banks through strength of personality and superior knowledge of banking.[25]

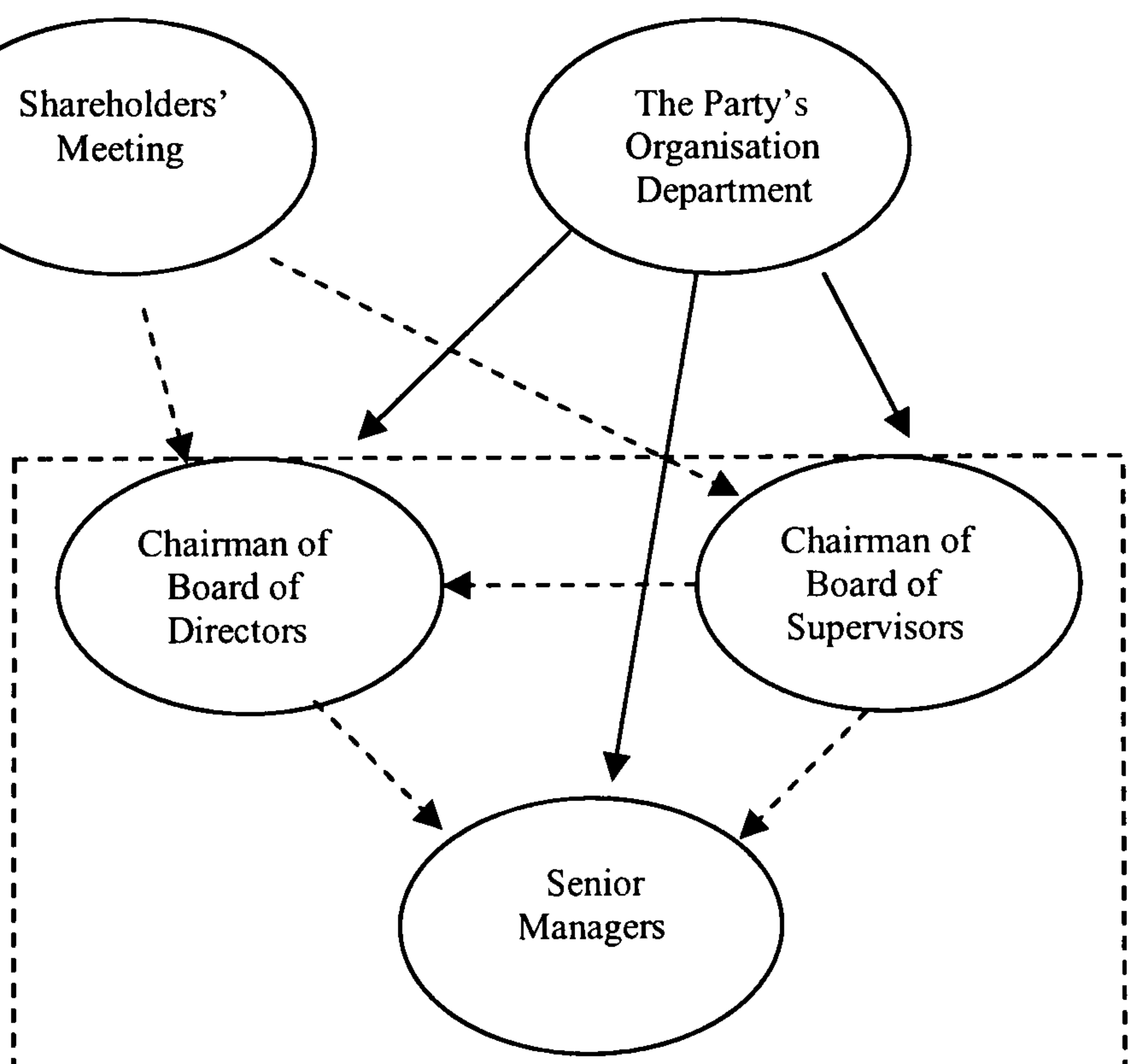
7.4.2 Personnel appointment and accountability under the new system

In theory, the managers of a public firm, should be chosen by a board of directors, a board that would itself be chosen through shareholders' voting. For China, however, control over personnel appointment in the SOEs, even after they become shareholding companies and are listed on stock exchanges, has been the most enduring and effective means by which central leaders retain control over the entire political and economic system. This is essentially concerned with the role of the Communist Party, which has been a major dilemma in reforming the nation's corporate governance. This issue can not be solved by enterprise reform, rather it relies on a radical political reform, whilst such political reform has been intentionally avoided since the beginning of the economic reform. Under such circumstances, it is inconceivable, at least at the present, that the Chinese government would relinquish its personnel authority in major SOEs to private owners or even foreign investors.

In the cases of the BOC and the CCB, despite the public share offerings, the managerial appointment system has seen little change. The Communist Party has essentially retained the rights of appointment. Although the senior executives of the corporatised banks are appointed formally by the board of directors, the decisions of appointments are actually still made by the Party's personnel departments as before. All senior managerial positions of the banks, including the chairman, the president and the vice president are still determined by the Organisation Department of the Party's Central Committee. All senior line managers are appointed by the Party Committee in the head office and filed in the Organisation Department of the Party's Central Committee.[26] Figure 7.2 illustrates the role of the Party under the new internal governance system.

Figure 7.2

The relationships among the party and other governance bodies of the banks



Source: Author

While each bank has a corporate board, which, in theory, represents shareholder interests, each bank also has a Party Committee. The responsibilities of the board and the Party Committee are overlapped. Although the board focuses more specifically on 'economic' issues whereas the Party Committee has a more 'political' function, in reality, the Party Committee in both banks that are headed by the the chairman and the president (serve as deputy secretary), and staffed with handpicked top managers, essentially run the banks and channel state policy into corporate practice.[27] Let alone that the majority directors nominated by the SAFE Investments represent the state's interest as an investor. The outside directors do not have effective veto power over key decisions, and hence they are unlikely to provide adequate counterbalance to the government's authority.

A case in point, between September 1994 and March 1995, the Party Committee in the CCB Co. had held over 20 meetings to make decisions on issues which involved in almost every aspect of the bank's operations, including personnel, finance and sales, and remuneration. In contrast, the board, as a strategy-making body of the bank, only held three meetings during the same period.[28] Such a role of the Party seems little understood outside China. It is noted that both banks' publications, i.e. its listing prospectuses and annual reports, have avoided mention of the Party when referring to appointments. Yet internal documents of both banks have made absolutely clear about the Party operations.

It is evident that the newly established governance regime in the BOC Ltd. and the CCB Co. is hybrid, which is, to a large extent, distinctive from any other prevailing models in the major economies of the world. Such a model acknowledges that the Party-government in China looks at the banks' broader social and economic impact, it is a broader set of stakeholders, this may not be necessarily inimical to shareholders' interests. However, two important points are worth emphasising with regard to the personnel situations at the banks.

The first is that although the new system has provided a new twist on the traditional checks and balances in the banks, given the continuity of the Party's personnel policy, the underlying issue of changing the old patterns of accountability of the senior management, as discussed in Chapter 4, remains uncertain. Top managers are likely to continue to conduct business in a way that places priority on their own interests rather than those of ordinary investors and stakeholders alike. This is evidenced by the series of high profile corruption scandals involving the senior executives of the two banks.[29] In particular, the most recent one in which Zhang Enzhao, the former chairman of the CCB Co., was convicted of taking bribes and sentenced to 15 years imprisonment in November 2006, nineteen months after he resigned as chairman of the bank.[30] The scandal surfaced just before the public listing of the bank, though it was taking place in the early stage of the bank's restructuring, this incidence has cast serious doubt on the effectiveness of the changes to be introduced. More specifically, after Zhang's resignation, the appointment of the new chairman and the Party's secretary of the bank, Guo Shuqing, the former vice governor of the PBOC and the director of the State Administration of Foreign Exchange (SAFE), was announced by the chief of the Organisation Department of the Party's Central Committee in a meeting held by the Party Committee within the bank.[31] This reveals that the Party's bureaucracy, which is deemed as the root cause of corruption of the top executives, remains.

The second point is linked to that fact that compared with the magnitude of the financial restructurings, the BOC Ltd. and the CCB Co. have done relatively little restructurings in the personnel system, and also the restructurings have been largely limited in the banks' head offices, and have not been born down on the lower tiers of the banks. Early in 2003, the BOC worked out a human resource reform program with the assistance of PricewaterhouseCoopers, an American consultancy firm. According to the bank's document, the reform has 'thoroughly broken the traditional official standard system of the SOE' by replacing the old position system characterised as single administrative office with a new one including three position serials. The new system would obviously have positive effect on strengthening the internal management of the bank, it, however, has made little difference in changing the situation of the entrenchment and override of the management at various levels of the bank. For majority employees, the new position system is nothing more than a change of the title name.[32] Under this situation, it is hard to imagine that the management of the bank could change the ways of thinking overnight. While it is essentially for reshaping corporate culture of the bank, perhaps it is as important as or more important than the systems themselves.

Just before the listing of the bank, the bank's chief credit officer, Lonnie Dounnue, the former senior official of the HSBC, resigned after one year of serving the bank. Dounnue's departure may result from his being unable to adapt to the new working environment, but it may also reflect the fact that the bank's old system dies hard.[33] The corruption cases revealed between 2001 and 2005 in the bank's Guangdong, Heilongjiang and Beijing branches, in which US$737 million of bank funds had been misused or embezzled,[34] have further shown that the accountability system is still an issue that the bank has to address.

7.5 Establishing internal risk control and management systems

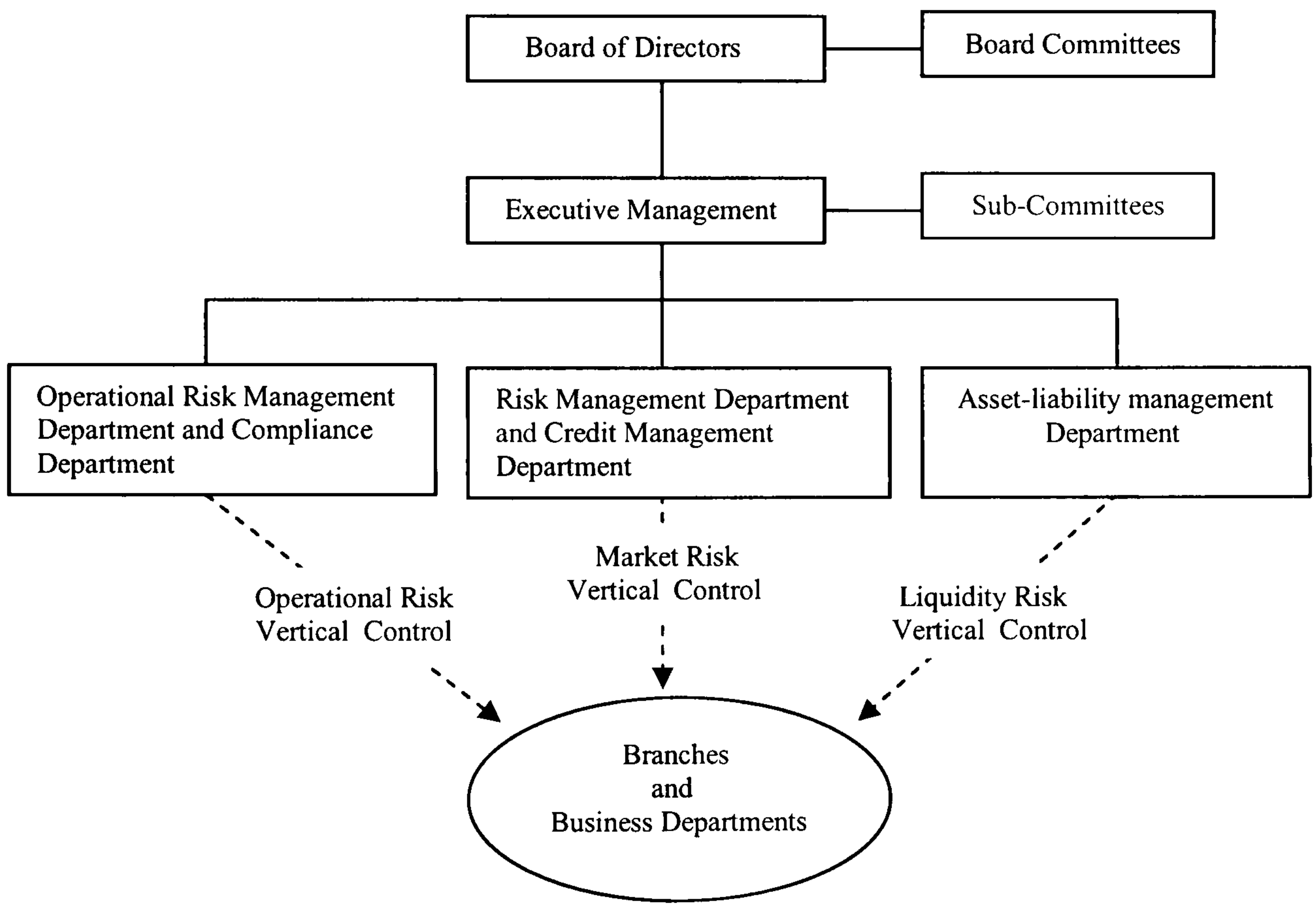
In recent years, the BOC Ltd. and the CCB Co. have put significant efforts towards changing their risk control and management systems to address the different types of risk, including credit risk, market risk and operational risk. Considerable progress has been made. Although the depth and pace of the reforms of the two banks are slightly uneven, the reform programs are almost identical, which attempts to establish a new framework by mainly focusing on three aspects: organisational structure, management processes, and administration procedures.

For the organisational structure, both banks have established a risk management committee and an asset-liability management committee, which directly report to the board of directors, and assist the board in developing the bank's risk management framework, and controlling liquidity risk as well as interest rate risk, foreign exchange risk, capital risk, credit risk. A risk management department has also been in operation under the executive management at the head office of each of the banks, which is responsible for analysing the bank's risk profile and developing risk management polices. In the CCB Co., a market and operational risk management sub-department has been set up within the risk management department in order to strengthen the management of operational risk.

The management process has been transformed, the BOC Ltd. and the CCB Co. have adopted a 'vertical management' model since 2004 and early 2006 respectively. Major management functions of the banks, such as risk management, credit approval, audit, accounting, fund clearing and financial management have gradually centralised at the head office (see Figure 7.3).

Controls over loan operations have become of paramount importance in the banks, because loans typically comprise most of the bank's asset and involve significant risk. The loan lending function and loan approving function have been clearly separated in the banks, with the establishment of the credit examination and approval committees or units at different levels that consist of those independent from relationship managers. The new credit management process in both banks can be basically divided into three stages: credit origination and assessment; credit review and approval; loan disbursement and post-lending management.

Figure 7.3 Risk management under new system



Source: Author

The BOC Ltd. relies on its established 'three-in-one' mechanism of the credit decision making process, which includes an independent due diligent investigation, an assessment of credit applications by an independent credit review committee, and a follow up evaluation. The mechanism has been gradually evolved. Before 2004, the branch offices at different levels of the bank, including tier-one branches, tier-two branches, sub-branches, etc. were granted different degrees of loan-approving power with different single loan lending limits. Since 2004, the bank has centralised all corporate lending approval authority at the head office and tier-one branches. Approval of personal loans has also been retained at the same levels since 2005 after the establishment of consumer lending centres at tier-one branches.[35]

In the CCB Co., corporate loans are generally approved at tier-one branches in accordance with the required credit authorisation limit. The credit limit is reviewed by the head office at least once every year. Personal loans are generally granted at tier-two or lower level branches.[36]

Internal auditing in the two banks has also been centralised. Efforts have been made to increase the independence of the internal auditors from the operational management and strengthen the authority of the internal audit function. Auditors at the banks' local branches report auditing results directly to the head office, at which involves the board of directors, the board of supervisors, the audit committee and the president. The management of internal audit personnel, including remuneration, performance appraisal and monitoring has been retained at the head offices. Auditors rotate across the banks to ensure that they work independently. For instance, in the CCB Co., 10 percent of the auditors exchange positions every year.[37]

Both banks started to improve their IT governance process in 2005, though they are currently still much behind the world's leading banks in this regard. The BOC Ltd., for instance, between the end of the 1990 and early 2000, the bank had over 70 disparate IT systems. In 2005, the bank implemented a plan to establish a new advanced core banking system (operation centre), which would cost RMB 8 billion (US$1 billion). The collection of data across the bank will be completed between 2007 and 2008.[38]

Appropriate administration procedures have been in place in the two banks to ensure that the established policies and process are followed. These procedures largely rely on well documented and communicated organisational structure that clearly shows lines and of reporting responsibility and authority. All levels of personnel in the bank will understand and any policy violations or illegal actions are noticed and the responsibilities are located. For instance, the BOC Ltd. has issued a series of rules and guidelines involving the operational risk management, the compliance requirements and responsibilities of each job position;[39] The CCB has established internal reporting and monitoring procedures for employee misconduct that adversely affects its business. Policies have also been implemented for holding officers accountable for the misconduct of employees under their supervision.[40]

7.6 Conclusions

The cases of the BOC and the CCB have illustrated that in building the internal governance systems in the banks, the reform programme does constitute radical change. Both banks have been transformed from fully state-owned banks into public companies. With new ownership and governance changes, the boards and management of the banks would have to respond to the interests of their owners rather than act as agents of state policy. By going public and enhanced transparency, the banks should ultimately rely less upon the guarantees of the government and more on their own standing with the market. The banks would be under great pressures to meet the expectations of financial markets, especially as they will be seeking to raise large sums in the capital markets both domestically and internationally.

A hybrid model has emerged in terms of the structure and practices of the new regime. On the one hand, this model captures some of the features of the prevailing models in the world, for instance, the majority of directors being non-executive or independent in the Anglo-American model; the supervisory board with participation of employees in the German model. However, important difference exits, which lies in the personnel policy of the CCP on the directors and the senior management. This would have major implications on the role of those non-executive or independent directors as well as the accountability of the senior management, which may lead to divergence from that of its Western counterparts. On the other hand, compared with other SOEs reforms in China, the new regime has no difference in this regard, whilst a new initiative has been taken by sending non-executive directors to the boards via the state-holding company, which makes the board governance distinct from that of other SOEs. In addition, much importance has been attached to the establishment of internal risk control and management systems, which directly link to the unique features of the banking business. These have added new elements in the past practices of the checks and balances in the SOEs.

It is evident that the Chinese government is not likely to relinquish control over the banks. But a large state ownership stake needs not necessarily mean government control of the overall affairs of the bank. So far as each of the banks is concerned, whether the government chooses to intervene as owners or using its power as regulators and supervisors has depended on the particular issue and the particular political circumstances. For instance, the government's policy on the restructuring of the banks; and the government's control over the senior personnel of the banks, in either case is the government apparently acting in or using its capacity as owners of the banks. This is because these issues directly concern the dominant positions of the government in the banks. While in other cases, such as the banks' management, specifically the banks' performance and risk management, which are more technically oriented, the government is keen to act as regulators and supervisors and allow shareholders regimes to develop.

Chapter 8 Conclusions

8.1 The findings of the study

The specific subject of this study is the evolution of corporate governance in the context of the Chinese banking sector, with particular reference to the reforms of the SOBs since the late 1990s. A systematic and comprehensive study of these issues has been made from a descriptive perspective. The research questions addressed are how the change in systems of corporate governance in the banking sector occurs, and why China is engaged in such a process. It should be pointed out that the system of corporate governance in China' banking sector is still in the process of evolution, any conclusions drawn about this dynamic process are necessarily intricate and tentative.

This study has demonstrated that the SOBs have undergone a profound transformation since 1998 from a qualitative point of view. A new governance structure of the SOBs has been established through institutional reforms, which have mainly focused on three aspects aiming at addressing the issues of ownership, asset quality and governance of the banks.

The first aspect is the financial restructuring. A set of measures combining flow and stock solutions had been adopted, including strengthening the bank's capital base through cash injections with foreign exchange reserve, and approval of issuance of subordinated bond. On the other hand, resolving bad assets by debt write-off and creation of AMCs. The second aspect is the instituting regulation and supervision framework. This has reflected in the regulatory improvements, in particular, the adoption of international best practices in accounting, loan classification and provision, disclosures and transparency, and also in the supervisory strengthening by creating a new independent agency. The third aspect is the building internal governance mechanism in the banks. The major efforts have been placed on the creation of new ownership structures and checks and balances regimes through shareholding reforms, and institutional strengthening in the form of credit management, risk and financial management.

The reforms in the three aspects are indispensable and complementary. Financial restructuring creates favourable conditions for the SOBs to conduct business on the pure commercial principles, which is the prerequisite for the corporate governance reforms. While it constitutes only one step of the whole process, this is because the strong balance sheets would not necessarily guarantee the future health of the banks. Institutional strengthening of credit and risk management capabilities must build within the banks to prevent new NPLs occurring and achieve lasting effectiveness in the lending process. There is also a need for a strong regulatory and supervisory framework for the smooth operations of the banks, for helping to improve efficiency, safety, liquidity, for increasing efficient transfer of information and adding to financial discipline.

This study has also demonstrated that the Chinese government has emerged as still in control of the SOBs, which has seen little change throughout the reforms process. First, the reform programme does not create independent regulatory and supervisory authorities. This, therefore, can not ensure that the possibility of undue governmental and political interference is removed. Second, the shareholding reform does not lead to a substantive change in the nature of ownership. The ultimate control through ownership has not been fully transferred from the state. The domestic private investors have not been allowed to participate in, and the role of foreign strategic investors is more limited in improving managerial techniques of the banks. Third, the government retains control over management appointment. By means of appraisal, appointment, discipline and removal, incentives and constraints are created, which fundamentally influenced and shaped the behaviour of key decision makers in the financial institutions.

The reform efforts, however, have made significant changes in the ways that the government conducts its control over the SOBs. This has seen shifting from a system of direct influence and control of management to control through indirect forms. The government, on the one hand, has abandoned its administrative control by abolishing the credit plan system and deregulating interest rates. The banks have been given full autonomy to make decisions for the business in terms of pricing loans according to risk assessment and being responsible for their lending decisions.

The government, on the other hand, has strengthened the control more indirectly through new institutions. First, a comprehensive legal framework for the bank regulation and supervision has been established, which has shifted the bank regulation from a discretionary regulatory framework for the administration of financial institutions to a more transparent legal framework. The normative approach of bank regulation through structural regulation and economic controls has been gradually relaxed as part of the liberalisation process. It has provided the banks with more incentives to act independently in their market operations. Great importance has been placed on prudential regulation and supervision, and the focus of the supervision has moved from the rule compliance to the risk control. The newly created separated banking regulatory and supervisory system that aims at improving the efficiency of the banking supervision has seen a significant progress in upgrading the banking supervisory standards. Second, a new internal governance regime in the banks has been established through shareholding reforms. In particular, the creation of the SAFE Investments Ltd, a state holding company, makes a breakthrough in reforming the governance of the SOBs, because the company has replaced the government agencies to fulfil the role of a commercially-oriented owner (shareholder) in disciplining and monitoring the banks. The company, therefore, has been used as a means to lessen administrative intervention in the SOBs by the government.

This study has shown that corporate governance reforms of the SOBs have all been a strategic choice in the whole process of the Chinese economic reform. The forms, approaches and pace are all subject to the country's dynamic political and economic institutions.

Banking reform generally lags behind other sectors, because systemic reforms of banking sector, in particular the SOBs, are undoubtedly difficult, costly and potentially destabilising, so it is no wonder that the Chinese policy makers had avoided it assiduously. Inconsistencies appear in the reform path, which are not only caused by incomplete information, but also the sense of transformation in the banking sector is underlined by the multiple and often conflicting objectives of the government's reform plan. Since the Chinese government has to strike a proper balance between the banking restructuring and the sustained economic development.

The overall approach of the reform since the late 1990s has a clear objective and has been implementing gradually. Among the government's more aggressive governance reforms has been the ownership restructuring, which fundamentally replicates the initiatives of the SOE reform. The aim of the reform is to address the principal-agent problem of the banks, a fundamental issue of the state ownership, which is presumed to result from the ambiguity and inevitable splitting of control and cash flow rights in the banks. Like the reforms in other large SOEs, the Chinese government has pushed through the partial privatisation of the banks with little interest in changing the dominant position of state ownership in the banks. Given the centrality of the banks to the Chinese economic development and growth, such channels by gripping on decisions and capital in banks enable the government to ensure that its interests are still taken into account.

In dealing with asset quality of the banks, China faces its own unique challenges. The magnitude of the problems and the inadequate budgetary resources, appear to be the driving factors in China's choice of approach to the financial reform and the bank restructuring methods. The methods chosen allow some deferral of the budgetary cost of bank restructuring. This is evidenced by using foreign exchange reserves to recapitalise banks. This is also the case with the use of the AMCs, which are, in many ways, an arm of the government. The longer-term aim of the AMCs is to rehabilitate the loss making large SOEs. Therefore, unlike conventional practice of AMC that merely overhauls banks, this policy leads to restructuring of enterprises, not only banks, and hence, restructuring borrowers, not only creditors.

The major steps of the reform have targeted the efficiency of state ownership and interference. These are evidenced in the banks' regulation and supervision reforms and building the banks' internal governance mechanisms. The SOBs have become more prudent in operations by adopting prudential regulation and supervision which are generally in line with international norms more transparent. The banks have also become more transparent by using International Accounting Standards (IAS) and reputable external auditors. The banks have improved board practices by setting up various committees and appointing independent directors to chair some of these committees. The great deal of improvement in their corporate governance, however, has been achieved without fundamentally changing their ownership structure. It is clear that the Chinese government has attempted to introduce new governance regime into the SOBs without substantially diminishing the role of government as owner. It is unlikely that the government would play its role as a passive shareholder. However, the government has become increasingly aware of the importance of what interventions would be appropriate in what contexts. For instance, as discussed in Chapter 7, whether the government chooses to intervene as owners or using its power as regulators and supervisors has depended on the particular issue and the particular political circumstances.

8.2 The limitations of the study

There are two limitations of this study that need to be acknowledged and addressed. The first limitation has to do with the extent to which the findings can be generalised beyond the case studied. As with any case study, the results need to be interpreted in light of the small sample-in this case the SOBs. Yet, given the state of knowledge concerning corporate governance in China, case studies are an appropriate research methodology (as discussed in Chapter 3). Nevertheless, caution should be exercised when interpreting the findings. Although the SOBs case represents rather significant aspect of the development of corporate governance in the banking sector, given the fact that the SOBs have remained dominant position in the sector as mentioned earlier, differences in governance practice do exist to vary degree in individual banks, which is determined by the diversified forms of banks in the sector. The findings in this study thus, as in any other, have their contextual aspects. The sample is not representative of all banks in China's banking sector.

Another possible criticism of this study is the limited scope of the governance issues that has been studied. This study has focused on such a phenomenon as evolution of banking governance in a transitional economy that is rather extensive. Clearly, this represents a challenging task for research regardless of the more specific interests that the study may have. In this study, this extensive and complex phenomenon has been studied from a relatively narrow empirical perspective, which concentrates on the most dramatic and significant transformations. It has not addressed issues such as the role of capital market and the role of market competition on the banks governance. As essential components of external governance mechanisms of firms, they have been well documented in Western countries.

However, the researcher considers it inappropriate to dedicate the two issues at the current stage of the SOBs in China. The reason is twofold: first, the Big Four had historically been under full control of the government, they had remained monopoly in the financial market and faced little competitive threat. Capital market and product market competition, therefore, were not very much relevant to the governance of the banks. Second, the recent introduction of capital market by listing the SOBs in the international stock markets, as well as the full open of financial market at the end of the 2006 according to WTO agreement, will certainly generate significant impacts on the banks' governance. However, it will likely take time before these market forces take effects and more data becomes available so that an in-depth study of the outcomes can be carried out.

8.3 The need for future research

There is considerable scope for further research on the corporate governance in China's banking sector. As far as this study is concerned, two obvious avenues in which the future work could be extended.

First, based on the current research, more focused qualitative study should be carried out concentrating on the national shareholding commercial banks with non-state-controlled ownership. For instance, the China Minsheng Banking Co. was founded in 1996 and is almost solely owned by private institutional shareholders, making it the largest private bank in China; the Shenzhen Development Bank Co., a national Shenzhen-based listed bank, became the first national domestic bank controlled by foreign investor in 2004, when Newbridge Capital Ltd., a U.S. investor group, acquired majority of 18 percent of the shares in the bank. The governance practices in these individual banks are likely, to some extent, distinctive from that of the SOBs due to the different ownership structures. The study of these banks, therefore, could generate additional understanding of the corporate governance in China's banking system.

Second, longitudinal studies should be conducted to investigate the efficiency effects of the changes of the corporate governance regime. One of the objectives of the banking reform is to improve and banks' managerial capabilities and to enable them to operate in an increasing competitive environment. Whilst the relationship between corporate governance and bank performance remains controversial, some existing researches have demonstrated that there is no clear evidence that changes in corporate governance rules would have had much impact on the profitability. Therefore, the issue that to what extent the better corporate governance is correlated with improved market valuation and optimal operating performance by the banks should be addressed.

Third, the likely future impacts of the IPOs and the full open of financial market on the banks' governance should be put on future research agenda. The international stock market listing offers such a mechanism as the listing banks are now disciplined and regulated by more developed capital markets outside the home jurisdictions, which will move their corporate governance practices closer to globally accepted standards. Future research should be designed to examine how the capital market alters the important factors of the banks' operation, financial information and incentives. Similarly, the increasingly liberalised financial market will intensify the product market competition of the banking sector and consequently have impacts on the banks governance structures, in particular the risk management and controls. These issues should be given further attention.

Fourth, the changing patterns of corporate governance of the SOBs is a complex process, going beyond changes in regulation and supervision and guidelines of good practice. A convincing evaluation of the nature and degree of transformation has to go beyond this and deal with their multiple real consequences for various stakeholders at the level of firm, in particular the SOEs. Future research, therefore, should address the issue in relation to any fundamental changes in banks' strategy and the new configuration of bank-firm relations initiated by them.

Appendix I

Chronology of China's banking governance reform 1979-2006

1979

February	The Agricultural Bank of China (ABC) was re-established, 'mono-bank' began transforming into two-tier system.
March	The Bank of China (BOC) also was separated from the PBOC.
October	The Construction Bank (CCB) was transformed from a department of the Ministry of Finance (MOF) and became a bank under the State Council.

1982

July	The State Council gave the PBOC a central bank-style role in managing the financial system in China.

1983

September	The State Council decided to create a central bank.

1984

January	The PBOC assumed the role of China's central bank; the Industrial and Commercial Bank of China (ICBC) was created to take over the remaining deposit-taking and lending functions of the PBOC.
1986	The bankruptcy law was promulgated in 1986 for a trial implementation.

1989

January	The PBOC adopted a quota system for credit plan management.

1990

December	Shanghai Stock Exchanges was established.

1991

July	The second stock exchanges - Shenzhen Securities Exchange was established.
1992	Banks were given authority to write off loans of up to a half billion yuan; larger amounts still required approval from the State Council.

1993

December	The Company Law was passed by the National People's Congress.

1994

March	Two policy banks – the China Development Bank, and the Export-Import Bank were established to free the four specialised state-owned banks from directed lending.

November	The third policy bank – the Agricultural Development Bank was established
1995	
March	The Central Banking Law was enacted, legally confirming the PBOC as the central bank of China.
May	The Commercial Banking Law was promulgated. This created conditions for commercial bank system formation, and provided legal basis for transforming specialised state banks into state-owned commercial banks.
1996	A floating interest rate system was introduced, which allowed greater flexibility to vary lending rates around the administered level.
January	The first non-state owned commercial bank – the Minsheng bank was established.
October	China established full convertibility of the Renminbi on the current account of the balance of payments.
1998	
January	The PBOC abolished the credit plan system. The commercial banks were given more flexibility to determine the size of loans following the asset-liability ratio management and risk management approaches.
	The PBOC began institutional restructure, nine regional branches were established to replace the previous provincial and municipal branches.
April	The new loan classification system began to be implemented.
June	Communist Party Central Financial Work Commission (CFWC) began operations
August	China injected RMB270 billion in capital to ameliorate the NPL problems in the SOBs.
October	The Guangdong International Trust and Investment Corporation (GITIC) went bankrupt.
1999	Four asset management companies (AMCs) - Great Wall, Cinda, Huarong and China Orient were set up to help clear up the balance sheets of the big four SOBs.
2001	
December	China became a member of World Trade Organization (WTO). As part of its accession commitments China agreed substantially to open the financial market to foreign institutions over five years.
2002	
January	Wang Xuebing, the former head of the BOC and the CCB was investigated for alleged corruption and subsequently jailed.
February	The proposal was made to separate bank regulation and supervision from the PBOC at the Central Financial Work Conference.
2003	
April	The CBRC assumed the functions of banking regulation and supervision

from the PBOC.

December The Central Banking Law and the Commercial Banking law were revised.

The Law on Banking Regulation and Supervision was promulgated.

The BOC and the CCB each received US$22.5 billion capital injection from PBOC's foreign exchange reserves.

The Central Huijin Investment Co. (now known as China SAFE Investments Ltd.) was set up to manage the capital injection in the banks.

2004

March The CBRC issued a guideline for the corporate governance reforms of the BOC and the CCB.

June The CBRC set rules on the issuance of subordinated bonds by commercial banks

Cinda purchased a combined RMB280 billion (US$34 billion) of NPEs from the BOC and the CCB.

August The BOC was transformed into a shareholding bank.

September The CCB was restructured into a shareholding bank.

December Foreign banks were allowed to initiate renminbi business, as agreed for membership of the WTO.

2005

March Zhang Enzhao, the former chairman of the CCB Co., resigned due to alleged taking bribes and subsequently was jailed.

April The ICBC received US$15 billion recapitalisation from the government.

August Bank of Communications, the fifth largest SOB, was listed on the HKEX.

October The CCB Co. was listed on the HKEX.

2006

June The BOC Ltd. was listed on the HKEX.

August The new Bankruptcy Law was promulgated.

October The ICBC completed IPOs in Hong Kong and Shanghai simultaneously, which raised US$19.1 billion of capital, and became the world's largest IPO.

December Under its commitment to the WTO, China lift all geographic restrictions relating to foreign bank offered services in domestic currency to foreign and domestic companies and individuals.

Appendix II

A brief chronology of the shareholding reform of the BOC 2003-2006

2003

July The initial plan for the shareholding reform was made.

30 December The bank received a US$22.5 billion capital injection from the government.

2004

End of June The bank's entire non-performing assets had been resolved. The NPL ratio was brought down from 16.29 percent at the beginning of the year to 5.46 percent at the end of June.

7 July The bank issued RMB14.07 billion (US$1.7 billion) of subordinated bonds in the inter-banking bond market. This was the first sale of this type of debt by the SOB to replenish its capital base.

26 August The BOC was incorporated into shareholding bank, known as the Bank of China Limited (BOC Ltd.).

August Human resource reform at the head office level was carried out.

22 October The BOC Ltd. issued RMB12 billion (US$1.4 billion) of subordinated bonds.

November Pilot reforms were conducted in its two branches in Jiangsu and Zhejiang respectively.

2005

January A fraud was uncovered in a sub-branch in Heilongjiang province. Two managers of the sub-branch had disappeared along with RMB1 billion (US$120 million) of bank funds.

18 February The BOC Ltd. issued RMB27 billion (US$3.3 billion) of subordinated bonds.

21 February Lonnie Dounnue, an American citizen, was appointed as the bank's chief credit office. This was the first time that the SOB hired foreigner at the senior management level.

11 March The BOC Ltd. made an additional issue of subordinate bonds amounting to RMB6.93 billion (US$0.84 billion) of subordinated bonds, which brought the bank's total subordinated debts to RMB60 billion (US$ 7.2 billion).

18 August The BOC Ltd. signed strategic investment and cooperation agreement with Royal Bank of Scotland Group (RBS).

31 August The BOC Ltd. signed strategic investment agreement with Temasek Holdings (Private) limited.

27 September The BOC Ltd. signed strategic investment agreement with UBS.

10 October The BOC Ltd. signed strategic investment agreement with Asian Development Bank (ADB)

2006

1 June The BOC Ltd. was listed on the HKEX.

5 July The BOC Ltd. was listed on the SSE.

Appendix III

A brief chronology of the shareholding reform of the CCB 2003-2005

2003

Early April The shareholding reform began. A special office was set up to arrange and coordinate the bank's overall shareholding reform.

July-August The intermediary agencies involved in the reform, including auditors, assessors, lawyers, the management consulting firm were appointed.

30 December The bank received a US$22.5 billion capital injection from the government.

2004

January Human resource reform was completed. The bank had cut approximately 80,000 employees over the past two years.

June The bank and Xinda Asset Management Company signed an agreement on the transfer of non-performing assets.

4 August The bank issued RMB15 billion (US$1.8 billion) of subordinated bonds.

6 September The bank signed agreements with five sponsors.

17 September The bank was incorporated into a shareholding bank. A formal division was made creating the China Jianyin Investment limited and the China Construction Bank Corporation (CCB Co.).

20 September The CCB Co. issued RMB8.3 billion (US$1.0 billion) of subordinated bonds. The bank's capital adequacy ratio increased to 9.39 percent by the end of September.

21 December The CCB Co. issued RMB16.7 billion (US$2.0 billion) of subordinated bonds. This issue brought the bank's total subordinated debt to RMB40 billion (US$4.84 billion).

2005

16 March Zhang Enzhao, the former chairman of the CCB Co., resigned due to alleged taking bribes and subsequently was jailed.

25 March Guo Shuiqing, the former vice governor of the PBOC and the director of the SAFE, was appointed as the chairman of the CCB Co.

17 June The CCB Co. signed strategic investment agreement with Bank of America.

1 July The CCB Co. signed strategic investment agreement with Temasek Holdings (Private) limited.

27 October The CCB Co. was listed on the HKEX.

Notes

Chapter 1

1. Fama (1980) further emphasised that ownership of capital should be confused with ownership of the firm. Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs.

2. According to agency theory, the share price is an indicator of corporate performance and the stock market is the only objective evaluation of management performance. If a firm underperforms, its price will drop, which provides a chance for outsiders to purchase the firm's share at a low price. The threat of a takeover forces management to make efforts for better performance and maximise shareholders' return in order to prevent it.

3. Agency theory views the managerial labour market as a disciplinary tool on management's misconduct. There exists both internal market (top managers in a firm compete to become the boss of the bosses), and external market (a poorly performing manager will have difficulty in finding a new job).

4. Stakeholder theory differs from agency theory as to the extent of principal-agent relationship, with agency theory restricting this to legal and implied contracts while stakeholder theory takes a broader definition to include social/moral as well as legal and implied contracts.

5. In this respect stewardship theory directly challenges agency theory, where the monitoring role of an independent board and a powerful chairman, who can represent the interests of shareholders against the self-interest of executive managers, is conceived always to have positive effective on performance.

6. This sector focuses on two main approaches to the theory of the firm, i.e. neoclassical economic theory of the firm (i.e. agency theory), and organisational theory of the firm (i.e. stakeholder theory and stewardship theory). There are also some other important schools of thought, for example, new institutional economics (i.e. transaction cost theory) attempts to explain why firms exist (i.e., why economic activities are coordinated through formal organizations rather than simply through market contacts) (Coase 1937; Williamson 1979, 1985). Aoki's (1984) cooperative game theory of the firm attempts to explain internal governance, particularly the balance between owners' and workers' interests. Hart and Moor (1990) view the firm as a collection of jointly owned physical assets. Rajan and Zingales (1998) propose the firm as a nexus of specific investments.

7. For example, the Anglo-American system, the Rhineland system, the Latin system, the Japanese system, the Family-based system.

8. See Hopt, et al. (1998), Keasey, et al. (2005) and Charkham (2005) for a greater detail of corporate governance regimes around the world.

9. The efficacy of takeovers however is questioned on several grounds. As takeovers are often attempted not for the purpose of improving the management of the target firms, but also for the purpose of empire building. Also, the management of the target firms may try hard to thwart hostile takeovers through various measures of anti-takeover defense (Caprio and Levine 2002), for instance, poison pill (see infra note 11)

10. See Cheffins (2002) for a discussion.

11. 'Poison pill' is the term used to describe a broad category of anti-takeover measures which is designed to make a target company's stock look less attractive to a potential buyer. For instance, a flip-in pill allows existing shareholders (but not the acquirer) to buy more shares at a discount. A flip-over pill permits stockers to buy the acquirer's share at a discounted after the takeover, and so forth. Pills often have an extremely dilutive effect, which works against the acquirer's plans. Such tactics are often viewed as protecting management at the expense of shareholders.

12. See Keasey's (1997) myopic market model.

13. See Kaplan and Holmstrom (2003) for a discussion.

14. For the role of banks in corporate governance of other business firms, Macey and Miller (1995) articulated how banks work; Fama (1985) and Mester et al (2001) explained why banks can play the role, i.e. they argued that banks jointly (1) offer access to the payment system and (2) process information and monitoring borrowers.

15. Co-determination refers to the right of employees to be kept informed about the company's activities and to participate in decisions that may affect the workers.

16. See Estrin (1994), Frydman, et al. (1993) and Wright, et al (2005) for a detailed discussion of privatisation process and corporate governance reforms in the Central and Eastern European countries.

17. This does not include Hungary and Poland since 1968 and during the 1980s respectively (see Ellman 1989).

18. Very different views have been taken over the outcomes of the privatisation reforms in Central and Eastern Europe. The debate mainly focuses on the appropriateness of application of neoclassical model. See Aslund (1999), Nellis (1999), Stiglitz (1999), Black and Kraakman (1999), Marangos (2002).

19. See for the advanced economies, Hopt et al. (1998), Charkham (1994, 2005) and Fitzgerald and Abe (2004); for the transitional economies in Central and Eastern Europe, Frydman et al. (1996), Brada and Singh (1999); for Asia in general, Roche (2005); for other major developing economies, Oman (2003) and OECD (2004).

20. See OECD (2004), Lane (2003) for more discussions.

21. See Kaplan and Holmstrom (2003).

22. See Rayton and Cheng (2004).

23. For example, Blair (1995), Fukao (1995), and Porter (1997) recommended that the US firms establish stakeholder associations and networks.

24. See Gordon (2004) and Coffee (2004).

25. See, for example, Clarke (2004).

26. For a detailed discussion of the economics of shareholder value, see O'Sullivan (2000).

27. This argument is actually the part of general neo-liberal argument that holds that economic systems will converge towards market system.

28. Path dependency theory was originally developed by economists to explain technology adoption processes and industry evolution. When it is applied to institutional theory, it means that institutions evolve along path dependent trajectories and heavily shaped by initial starting points and pre-existing conditions.

Chapter 2

1. For a detailed discussion of the role of banks in economic growth, see George (1987) and Levine (1997).

2. See Eatwell and Taylor (2000) for a discussion of the pricing of risk by banks and how systemic risk can arise and undermine financial stability. See Davis (1995) for a discussion of how the negative effects of banks insolvency can be transmitted through the economy.

3. See ibid.

4. For an overview of deposit insurance around the world, see Garcia (1999), Demirguc-Kunt and Sobaci (2001).

5. Other financial safety nets include the lender-of -last-resort function of the central bank, and the solution procedures for insolvent banks.

6. While it is widely acknowledged deposit that deposit insurance is a source of moral hazard, deposit insurance (financed through money creation) is an optimal policy in a model where bank stability is threatened by self-fulfilling depositor runs. See classic work of Diamond and Dybvig (1983).

7. Certainly, even in the absence of deposit insurance, banks are prone to excessive risk taking due to limited liability for their equityholders and to their high leverage. See Stiglitz (1972).

8. The U.S. Savings & Loan crisis has been widely attributed to the moral hazard created by a combination of generous deposit insurance, financial liberalisation, and regulatory failure. See Kane (1989).

9. For a discussion of corporate governance problems of Barings, see Hogan (1997).

10. This includes restrictions on bank ownership for non financial firms or non bank financial institutions and vice versa. See Barth et al. (2001).

11. See Reinicke (1995) for a detailed discussion of American commercial banks and regulatory change.

12. There has been a trend during the 1990s to weaken or remove the limits imposed in the 1930s, e.g., in the US, the Glass-Steagall Act was abolished in 1999, as according to the authorities 'market evolution made it redundant', see Krainer (2000).

13. The issue debated in the literature is whether it is possible to design the corporate ownership structure or charter to limit the power of the blockholder in a way to prevent expropriation (due to conflicts of interest) without phasing out the incentives for him to monitor the company effectively, see Becht et al. (2002).

14. See La Porta et al. (2002)

15. See ibid.

16. See Banerjee (1997).

17. 'Regulation' refers to the set of laws and rules applicable to banking. 'Supervision' is defined as the monitoring by authorities of banks' activities and the enforcement of banking regulations.

18. An alternative school of thought advocates free banking. See, for example, White (1986).

19. See Caprio and Klingebiel (1996) for a detailed discussion.

20. See Coleman (1996) for a detailed discussion of the various national political models and regulatory traditions in banking.

21. In a general sense, prudential regulation and supervision means a conscientious enforcement of banking regulations by banking regulatory and supervisory authorities. This can be seen in the use of recommendations, rather than directives. Prudence as a core value in the UK's banking system emerged for the first time in the 1979 Banking Act's statutory requirement that all banks conduct their business in a 'prudent manner'. In terms of prudential supervision, the Bank of England emphasised bank stability (see *'Banking Supervision, Fact Sheet' of Bank of England,* October 1993).

22. The Basel Committee was established by the central bank governors of the Group of Ten (G10) countries plus Switzerland and Luxembourg in 1974, and was designed to foster cooperation on bank supervisory matters among the member countries. The Basel Committee reports to the Committee of Central Bank Governors that meets at the Bank for International Settlements in Basel, Switzerland, hence the committee's name.

23. In the UK, for example, the new capital ratio was set as always between the Bank of England and individual banks, whereas in Germany, supervisory agencies and leading banking associations determined a norm for the entire banking sector in a corporatist manner.

24. The Basel Committee on Banking Regulation and Supervisory Practices released 'International convergence of capital measurement and capital standards'.

25. In recent years considerable attention has been paid to the topic of market discipline in banking. The new Basel Capital Accord is one manifestation of this evolving approach. It stresses greater risk sensitivity, flexible supervision, and more reliance on market disciplines. Market discipline refers to a market-based incentive scheme in which investors in bank liabilities, such as subordinated debt or uninsured deposits, 'punish' banks for greater risk-taking by demanding higher yields on those liabilities (Nier and Baumann 2006). Apart from Basel Accord II, a number of other policy initiatives also recognise the importance of market discipline in safeguarding financial stability, including initiatives to create internationally accepted accounting standards (IAS) and proposals to make it mandatory for banks to issue subordinated debt (see Evanoff and Wall 2000; Hamalainen 2004).

26. A strand of literature on corporate governance has followed a more general trend in the area of strategic management to consider more closely the 'black box' of the firm, and to see the firm as a bundle of unique resources, which when used effectively can provide the firm with its competitive advantage (Barney 1991; Grant 1996). This has come to be known as the Resource Based View of the Firm. Some scholars argue that it is an error to overemphasise the monitoring role of boards, and that more emphasis should be paid to the skills and other knowledge resources that directors, and particularly non-executive directors, can bring to the firm (Short et al 1999). This coincides with other efforts in recent corporate governance research to increase the focus on firm context and boardroom process (Roberts et al. 2005; Huse 2005).

27. For a detailed discussion of stock-based compensation for corporate executives, see Core, Guay and Larcker (2001).

28. Banking firms or industry can be considered to have characteristics of low-growth firms or industry, see Adams and Mehran (2003).

29. For example, *Principles For the Management of Interest Rate Risk* (1997), and *Principles for the Management of Credit Risk* (2000).

Chapter 3

1. This does not include a large number of informal conversations via telephone and Email had been made throughout the whole research period. The exact number of those interviews was not counted.

2. It should be pointed out that the collection of primary data through interviewing had been supplemented by the gathering and analysis of the banks' documentary material, such as internal reports, memoranda, and regulations. These kinds of documents were a useful source of information from which to understand each bank's business activities and its reform processes. In addition, these documents provided valuable information that may not be accessible by other means. They were less likely to be subject to information distortion in comparison with data obtained only from an interview.

3. See Gronning (1997) for a discussion.

4. This approach was also making economic difference by alleviating the researcher's limited financial resources.

5. Other disadvantages of interview include travel cost, time consumed and interview bias. For this reason, the validity of recorded information can be improved through the use of tandem interviewing (e.g. two interviewers). This type of study is normally conducted as part of a wider team project.

Chapter 4

1. The general experience of China's economic reform will not be reviewed in detail in this chapter (paper), as this has been done by many researchers (e.g. Garnaut and Huang 2001, Lardy 1998, OECD 2000), Instead, this chapter (paper) focuses upon the SOE reform and issues which are more closely relevant the corporate governance reform in the banking sector. In particular, novel arguments are brought in based on the most recent movement, for which there has so far been very little published analysis.

2. See Chapter 7 section 2.1 for discussion.

3. See Su (2003) for a detailed study of China's capital market.

4. For details of SOE reforms in Central and Eastern Europe see Estrin (1994).

5. See discussion in Chapter 1.

6. The term "shareholding company" usually describes a public company that has share which is traded on the stock market. This term in China also refers to a stage in the corporatisation process whereby a state-owned enterprise issues share, but that the

dominant share is owned by the state with next stage being sold to the public. In this sense, the shareholding company in China is essentially distinguished from that in the West, as Fama and Jensen (1983) delineate that the emergence of public corporations, characterised by the separation of ownership and control, is a result of an endogenous, evolutionary process based on voluntary exchanges of private property rights in pursuit of gains from specialisation.

7. MBO is the leveraged buyout whereby the management of a company gains ownership by purchasing its outstanding shares from the parent firm or its owners with his or her own money. The goal of such a buyout may be to strengthen the managers' interest in the success of the company. It is often used as an effective means of reorganising a firm's operations besides mergers and acquisitions or to battle hostile takeover bids. Hired managers usually do not have the necessary funds for an MBO, so in many cases they join hands either with investment companies affiliated to financial institutions or with investment funds that have amassed capital from investors. The key considerations are the fairness to shareholders, the price, the future business plan, and legal and tax issues. Since the emergence of MBO in the US in the 1970s, these issues have remained controversial. For more details see Wright, Thompson and Burrows (2005).

8. The debate has occurred between 'non-mainstream' economists who are anti-privatisation and 'mainstream' economists who actively advocate privatisation. The key arguments of 'non-mainstream' economists are that the problem of the 'absence of owner' often cited when SOEs are discussed does not actually exist; the real problem lies in the lack of supervision over management; privatisation without a proper legal system is leading to 'the capitalisation of power'. 'mainstream' economists argue that if enterprises remain state-owned, there is no chance for their efficiency to improve, privatisation through MBO is the only way that may align the residual control rights with residual incomes claim rights and provide managers with an incentive to improve corporate performance; one must tolerate a certain degree of asset drain as a cost of the transition, as this helps accelerate the transition from the old economic system to a new one by weakening the opposition to reforms by vested interests; entrepreneurs who have made great contributions to China's economic development should be more respected and appreciated. 'non-mainstream' economists have gained overwhelming supports from the public.

9. My interviews with some Chinese academics revealed that China has attached much importance to property rights reforms. The Chinese policy makers' thinking has become closer to that of the neo-liberals. They have done all the experiments based on the neo-liberals' policy recommendations, except massive privatization. However, China has not found the equilibrium between incentives and governance. Many interviewees pointed out that lessons from the experience of other transition economies should be learned. Ownership reform on its own can not ensure the efficiency and profitability of SOEs, which eventually have to go through a fundamental management reform.

10. For instance, privatisation through MBO has made ownership and management integrated with each other, it is against the direction of setting up modern enterprise system and it is likely for the SOEs reform to retrogress to 20 years ago (interview with an economist in Beijing, May 2005.).

11. Hungary has experience of gradual transformation starting in 1968 with the New Economic Mechanism. For more details see Szekely and Newbery (1993).

12. Interview with an economist in Beijing, May 2005.

13. This chapter (thesis) uses the term of 'state ownership' instead of 'public ownership', which has been frequently seen in existing literatures associated with China's economic reforms, as the later one may cause confusion with the term of 'public ownership' in the market economies. Chinese 'public ownership' means that the property belongs to the citizenry, which is fundamentally different from that of free market system.

14. China's 'mainstream' economists regard state ownership as the central cause of poor performance, from their perspective, the transfer of assets to new owners (managers) becomes a focal point for policy recommendations.

15. MBO in China has its political context, in a sense that the managers of China's SOEs are not hired from the market, but are government officials.

16. As a result of privatisation, many Communist Party members are turning into capitalists, According to a report on the fifth nationwide survey of private enterprises (2002), released by the China Institute of Private Enterprise Study, 422 owners of privatised SOEs (out of 833 samples) were members of the CCP. 60.6 percent of the owners bought the SOEs in which they had been the managers. As a result, the percentage of private enterprise owners who were party members rose to 29.9 percent in 2001 from 13.1 percent in 1993.

17. In contrast to other transition economies, for instance, the privatisation approaches adopted by Russia and Poland (i.e. voucher programme and employee buy-out), at least during its designing and initial stage, addressed the needs of the public (e.g. fairness).

18. See *China Daily*, 4 March 2005.

19. The Agriculture Bank of China was firstly established in 1955 and closed in 1957.

20. The China Construction Bank was founded in 1954, and operated as a subsidiary of the Ministry of Finance before reconstituted to an independent entity in 1979.

21. The Bank of China (BOC) was established in 1912 and reconstituted in 1949. It was subordinate to the People's Bank of China before became an independent entity in 1979.

22. Except for the Mingshen Bank, the government had a controlling stake in these shareholding banks, though indirectly via one or several conglomerate or investment company owned by the central government or a provincial government, while the rest of the shareholders being mostly other smaller state institutions. There were very few private investors. Thus the representatives from the governments always had a final say, and other SOE shareholders had small voices and also did not really

have the incentives to exercise their shareholder rights. These shareholding banks were not yet operating like a genuine shareholding company at this stage.

23. See more discussion in Chapter 5.

24. Unlike the supervisory board in systems with two-tier board systems, the board of supervisors in China does not form part of the governance hierarchy. It is an entity that operates outside the decision-making hierarchy and with the major function of overseeing compliance with laws and regulations. The supervisory board is composed of outside supervisors appointed by the government as well as some representatives of the employees. According to the Chinese Company Law, it is responsible for: (1) monitoring compliance with laws and regulations. (2) examining financial statement. (3) inspecting business performance. (4) evaluating the CEO.

25. Interview with a scholar in Beijing, May 2005.

26. For instance, the Chinese government tried to use expansionary monetary policy to stimulate economy but failed. Because of the huge burden of NPLs, the banks were prudent to new loans especially to unprofitable SOEs. From 1994 to 1997, only 80 percent of the credit quota was fulfilled. (Interview with an economist, May 2005)

27. According China's WTO commitments: (1) Upon accession, foreign currency business will be permitted without geographical restriction. Geographical restrictions on local currency business will be phased out over five years. (2) Within two years after accession, foreign financial institutions will be permitted to provide local currency services to Chinese enterprises; within five years, to all Chinese clients. (3) Within five years after accession, any existing non-prudential measures restricting ownership, operation, and juridical form of foreign financial institutions, including on internal branching and licenses, will be eliminated.

28. 'Circular Concerning Improvement of Administration of Loan Scope of State-owned Commercial Banks', *Bulletin of the People's Bank of China*, 41, 1998.

29. PBOC (2004), *China Monetary Policy Report, Quarter Three, 2004.*

    Previously, the Chinese banks were allowed to set their lending rates no higher than 70 percent above the PBOC benchmark rate. With the interest rate ceiling now removed, banks can better price their lending rates to credit risk. The PBOC also intends to eliminate the lower limit on lending rate and the upper limit on interest rate of deposit.

30. The reforms in the three aspects are discussed in details in the subsequent chapters.

31. See detailed discussion in Chapter 6.

32. The creation of the Central Huijin is modelled on the Singapore-based Temasek Holdings, an investment company fully controlled by the Singapore government. At the time of writing, however, the Central Huijin, as the holder of the state-owned financial assets in the SOBs, has not been legally authorised, though it does operate with the consent of the government. Without an explicitly defined position, its

function, business mode and operation mechanism as well as its relationship with the government have been evolving.

Chapter 5

1. Even after the late 1990s when the government has been promoting higher transparency and disclosure as an important element of banking reform certain aspects of Chinese banking are still considered sensitive and remain hazy.

2. See detailed discussion in Chapter 6.

3. This includes RMB30 billion (US$3.62 billion) in 1997, RMB40 billion (US$4.83 billion) in 1998, and RMB23.8 billion (UD$2.88 billion). See PBOC (1998), *China financial outlook.*

4. This is not surprised that without a systemic bank restructuring during that period, the increasing NPLs was unlikely to be reversed by simply disciplining the banks' management.

5. CBRC's internal document.

6. *People's Daily,* 7 March 1998.

7. This include the initial estimate of RBM2000 billion in 1999, and further RMB400 billion was discovered during the examinations of the PBOC in 2000 (See supra note 4).

8. Based on the evidence that the old system understated NPLs by an average of about 15 percent against the new system (see Chapter 6, note 78), the legacy NPLs in the Big Four under the five category loan classification system was around RMB2760 billion (US$333.7 billion), or 41 percent of the total lending.

9. According to the CBRC, the average coverage of disposal for the four AMCs in 2005 was 24.58 percent (see the CBRC website).

10. See detailed discussion of the regulation and supervision of the capital adequacy in Chapter 6.

11. For detailed discussion, see Chapter 6.

12. The SOBs were first allowed to issue subordinated debt in June 2004 (see discussion in Section 3).

13. See supra note 5.

14. See Chapter 6 note 85.

15. See supra note 5.

16. Transitional economies typically face a deteriorating fiscal situation as their traditional tax revenue base, the remitted profits of SOEs, is eroded. China is no exception to this phenomenon.

17. See Kaufman (1993) for more discussion of the economic transition in the former Soviet Union,

18. *China Statistical Yearbook* 1999.

19. Ibid.

20. Ibid.

21. For discussion of systemic banking restructuring across countries, see Dziobek and Ceyla (1997).

22. For discussion of banking restructuring in Eastern Europe, see Saunders and Sommariva (1993).

23. See Deloitte (2005).

24. PBOC, *Quarterly Statistical Bulletin 2001-1.*

25. For instance, the major proportion of the NPLs included RMB600 billion (US$72.6 billion) resulted from the application of the new loan classification system (see supra note 5), and RMB400 billion (US$48.4 billion) represented pre-1999 NPLs that were recognised in 2000 (see supra note 7)

26. See detailed discussion of the shareholding reforms of the BOC and the CCB in Chapter 7.

27. On 23 June 2004, the PBOC and the CBRC jointly promulgated the *Administrative Rules for the Issuance of Subordinated Bonds by Commercial Banks*, providing guideline to recapitalisation of banks by issuing subordinated bonds.

28. *China Daily*, 3 February 2004.

29. The banks' websites.

30. See Peiser and Wang (2002).

31. See the World Bank (2001).

32. See supra note 28.

33. Deutsche Bank Asia Equity Research (2001), *Asset Management Companies: A Tough Job Ahead*, p.2.

34. *Almanac of China's Finance and Banking 2001*, p.49

35. The CBRC's website.

36. For more discussion of how the company works, see Chapter 4 and Chapter 7.

37. See the IPOs of the BOC and the CCB in chapter 7.

38. Interviews with mangers in the banks, in Beijing, June 2005.

39. See detailed discussion of prudential regulations in Chapter 6.

40. See supra note 24.

41. For more details of the bank's ownership restructuring, see Chapter 7

42. See discussion in Chapter 4.

43. PBOC (2005), *Circular Concerning Adjustment of Policy on Housing Loans by Commercial Banks and Interest Rate for the Deposit of Excess Reserves.*

44. 2003 Annual Reports of the BOC and the CCB.

45. Ibid.

46. Ibid.

47. 2005-2006 Zhongguo Shangyieyinhang Jingzhengli Baogao (*Report of the Competitiveness of China's Commercial Banks 2005-2006*), *Yinghangjia Magazine* (*China banker*), 2006 (4).

Chapter 6

1. *Law of People's Bank of China*, Article 2.

2. Ibid., Article 3.

3. Ibid., Articles 2, 5.

4. Ibid., Article 7.

5. Ibid., Article 31.

6. Ibid., Article 32.

7. Ibid., Article 33.

8. *Revised Law of People's Bank of China*, Articles 33, 34.

9. *Commercial Banking law*, Article 1.

10. Ibid., Article 2.

11. Ibid., Articles 4, 39.

12. Ibid., Article 43.

13. Ibid., Article 59.

14. Ibid., Article 62.

15. *Revised Commercial Banking law*, Articles 3, 34.

16. Ibid., Article 43.

17. *Law on Banking Regulation and Supervision*, Article 1.

18. Ibid., Article 2.

19. Ibid., Chapter 3, Chapter 4.

20. Ibid., Article 21.

21. *The Company Law*, Section 2.

22. *The Code of Corporate Governance for Listed Companies*, Chapter 1 Section 1.

23. Ibid., Chapter 3 Section1

24. Ibid., Article 49.

25. Ibid., Articles 60, 61.

26. Ibid., Chapter 7 Section 3.

27. For more details of different types of regulation, see Kay et al. (1988).

28. See supra note 15, Article 12, Clause 1.

29. There are different criteria between nationwide banks and local banks with regard to the amount of the minimum capital requirement. The minimum registered capital for a national commercial bank, city commercial bank and rural commercial bank is RMB1,000 million, RMB100 million and RMB50 million respectively. See supra note 15, Article 13.

30. See supra note 15, Article 24.

31. See supra note 15, Article 12, Clause 3.

32. See supra note 15, Article 19.

33. PBOC (1990), *Measures for Administration of Financial Institutions Abroad.*

34. See supra note 9, Article 28

35. See supra note 15, Article 28

36. CBRC (2003), *Administrative Rules Governing the Equity Investment in Chinese Financial Institutions by Foreign Financial Institutions.*

37. Ibid., Article 8, 9.

38. See Dewatripont and Tirole (1994).

39. It is noted that the small but significant amendment to the Article 43 in the revised law could offer some legal leeway for banks to conduct such business. See supra note 16.

40. China had adopted a credit plan system for as long as half a century before it was abolished in January 1998. See more discussions in Chapter 4.

41. The latest adjustment took place in 15 November 2006 when the PBOC raised the required reserve ratios from 8.5 percent (raised in July 2006) to 9 percent. See www.pbc.gov.cn.

42. The issues related policy loans have been discussed in depth in Chapter 4 and Chapter 5.

43. See supra note 9, Article 34.

44. For example, the *Report on Changing the Budgetary Appropriations for Basic Constructions into Loans* approved by the State Council in November 1980, provided that the SOEs would no longer enjoy free cash injections from the state and had to consider the economic effects of their investment in order to generate necessary cash flow to repay the loans. *The Regulations on Contracts for Money Borrowing* enacted in February 1985 set the general principles for banking loans. It stipulated that neither an organisation nor any individual had the right to force the banks to sign loan contracts. Borrower should repay the loans with their own capital or assets as collateral. The banks' officers should hold responsibility for bad debts.

45. See supra note 9, Article 39, Clause 4.

46. PBOC (1996), *Monitoring Norms and Assessments Methods for the Regulations of Assets and Liabilities Ratios of Commercial Banks.*

47. CBRC (2003), *Guidelines for Credit Extension by Commercial Banks to Group Customers.*

48. See supra note 15, Article 40. Paragraph 1.

49. CBRC (2004), *Administrative Measures on Related Party Transactions between Commercial banks and Insiders or Shareholders.*

50. See supra note 9, Article 39, Clauses 1, 2. 3.

51. See Tuya and Zamalloa (1994).

52. Founded in 1948, the PBOC handled currency issuance and payments clearance. Monetary policy decisions were made by the Ministry of Finance.

53. World Bank (1995), *China: Macroeconomic Stability in a Decentralised Economy.*

54. See supra note 1, Article 29.

55. The PBOC's internal report.

56. Interview with a regulatory official in Beijing, April 2005.

57. When the PBOC was established in 1983, the principal policy advisory body was the bank's council or board of directors (*lishihui*). The Central Banking Law of 1995 called for the creation of a Monetary Policy Commission that appears to have assumed some of the functions of the previous board of directors.

58. Interview with a regulatory official in Beijing, April 2005.

59. Ibid.

60. Ibid.

61. Interviews with scholars in Beijing, May 2005.

62. Ibid.

63. Almanac of China's Finance and Banking, 1999.

64. Ibid.

65. See more discussion in Chapter 4.

66. Interview with a regulatory official in Beijing, April 2005.

67. See further discussion of the Party role over personnel control in Chapter 7.

68. Interviews with scholars in Beijing, May 2005. Several interviewees expressed the same view that the Party control over carders is the most effective way to restrain the behaviour of 'leadership carders'.

69. The establishment of the CBRC marks the formation of the framework of 'separated operation, separated supervision' in the Chinese financial system. The PBOC's supervisory responsibilities for the securities and the insurance sector were already transferred to the separated supervisory bodies i.e. China's Securities Regulatory Commission (CSRC) and China's Insurance Regulatory Commission (CIRC) respectively in 1998.

70. Interviews with scholars in Beijing, April 2005.

71. Interviews with regulatory officials in Beijing, April 2005.

72. Interviews with regulatory officials and bankers in Beijing, April and June 2005.

73. For detailed discussion of the banks' reform in internal risk management system, see Chapter 7.

74. Several interviewees expressed the same view.

75. 'Pass' refers to loan where no problem with repayment of interest or principal occurred or perceived. 'Special mention' refers to loans where though no repayment delays yet, problems that would affect the repayment detected. 'Substandard' refers to loans where the repayment can not be fully made with normal business income. 'Doubtful' refers to loans where the repayment can not be fully made even with securities or guarantees being exercised. 'Loss' refers to loans where the repayment can not be made after taking all the possible measures and necessary legal procedures.

76. 'Normal' refers to loans where no problem with payment of principal occurred. 'Overdue' refers to loans where repayment of principal is in arrears. 'Doubtful' refers to loans where repayment of principal is in arrears for more than one year. 'Bad' refers to loans where repayment of principal is in arrear for more than two years.

77. The four category system defines NPLs as 'overdue' plus 'doubtful' and 'bad' loans. The five category system defines NPLs as loans where repayment of interest or principal is overdue for more 90 days. Thus 'substandard', 'doubtful' and 'loss' correspond to NPLs.

78. See Moody's Investors Service (2002), *China Banking System Outlook.*

79. For instance, the NPL provisioning coverage ratios were only 12 percent and 4 percent in the BOC and the CCB respectively at the end of 2000.

80. MOF (2001), *Notice on Administrative Policy for Financial Enterprises' Provisioning and Write-off of Doubtful Accounts.*

81. See more discussion for Basel Accords in Chapter 2.

82. See the Basel Accord I.

83. For instance, the major deficiency stems from the arbitrary way in which the standards have been formulated. As Greenspan pointed out that adding more and more layers of arbitrary regulation would be counter productive (See Alan Greenspan, *'The Role of Capital in Optimal Banking Supervision and Regulation'*, remarks in the Conference on Capital Regulation in the 21st Century, 26 February 1998.)

84. PBOC (1994), *Notice Concerning Carrying out Asset to Liability Ratio Management by Commercial banks.*

85. See supra note 9, Article 39.

86. According to the CBRC's internal document, the 'Chinese standards' overstated capital adequacy levels by 4-5 percent against the Basel Accord I.

87. See supra note 80.

88. This was declared on 30 July 2003 in the letter written by Liu Mingkang, chairman of the CBRC to Caruana, chairman of Basel Committee on Banking Supervision. It was articulated in the letter that besides a higher capital requirement, the Basel II may have adverse impact on the capital flows of less developed economies and disadvantage banks in emerging markets, particularly for their overseas operations conducted by their local branches and subsidiaries, if not just by market pressure.

89. According to the 2004 CBRC's guidelines (see Chapter 7 note 6), the BOC and the CCB are required to be in compliance with the new regulations from 2004 and to maintain the capital adequacy ratio at 8 percent or above thereafter.

90. Basel Committee on Banking Supervision (1998), *Enhancing Bank Transparency.*

91. These measures are currently largely applied to the listed banks. For instance, the Agricultural Bank of China, one of the Big Four, has not to date publicly disclosed any comprehensive balance sheets and income statements.

92. CAMEL is an acronym for capital adequacy, asset quality, management quality, earning's performance, and liquidity. Banks are scored on a scale of 1 (the best) to 5 (the worst) using this five criteria. The examinations are meant to prevent fraud and to ensure a bank is complying with the various rules and regulations related to its balance sheet and off-balance sheet holdings.

93. CBRC (2004), *A Provisional Risk Assessment System for Joint-stock Commercial Banks.*

94. For instance, the US introduced the PCA in 1991, Japan introduced the PCA in 1998.

95. See *Law on Banking Regulation and Supervision*, Articles 45, 46, 47; Revised *Commercial Banking law*, Articles 77, 78, 80.

96. See supra note 15, Articles 84-89.

Chapter 7

1. The BOC had been perceived as the best in financial conditions, while the CCB had been perceived as the best in asset quality among the Big Four before 2003.

The Industrial and Commercial Bank of China (ICBC) was listed simultaneously on the Hong Kong and Shanghai Stock Exchanges on 27 October 2006.

2. Unless otherwise indicated, the information in this section is from the websites of the two banks.

3. '*Decision on Issue Regarding the Improvement of the Socialist Market Economic System*' adopted at the third plenary of the 16^{th} Congress of the CCP in October 2003.

4. *Annual Report of Bank of China 2003.*

5. See more discussion in Chapter 5.

6. See *Guidelines on Reform and Supervision of Corporate Governance for Bank of China and China Construction Bank*, 2004, Article 5.

7. The National Social Security Fund (SSF) was the only domestic company approved by the Chinese government to participate in the restructuring of the two banks. It is responsible for the management of the National Social Security Fund of China under the direct leadership of the State Council. On 13^{th} March 2006, the SSF invested RMB10 billion (USD$1.2 billion) in the BOC ltd. for 3.91 percent stake.

   China has long been avoiding banks to engage in close relationships with the enterprises, like the Japanese keiretsu or Korean chaebol model, due to the possibility of conflicts of interests between banking and industrial interests. This further explains why China taps foreign investors more than domestic institutions.

8. See for example, Yu, Y. H. and Luo D.M. (2005), 'Yinhang Jianmai Zhenglun Shenxiaochengshang, Shuijiang zhangkong ZhongguodeJinrong?' (The debate over selling stakes in the banks too cheaply reaches a crescendo: who will control China's financial industry in the future?), *Yinhangjia zazhi* (*Banker magazine*).

   There have been massive criticisms over the ways that bank reforms in China. The debates focus on selling stakes to foreigners. Some worry that the nation's economic security and sovereignty could be threatened. More criticisms argue that the banks' stakes were sold too cheaply, and the bank reform has been counted too much on foreigners. The debates have gathered momentum since the IPO of the CCB Co. in Hong Kong in October 2005. Shares in the bank have soared since it was listed. The controversy over the bank stake sales is actually part of a broader debate in China over the state-owned enterprise reform, which reflects the views of different interest groups (see also Notes 8 and 9 in Chapter 4).

9. For instance, the head of the Citibank's investment bank services in China promised to the CCB Co. that Citibank would bid for a strategic stake in the bank, when Citibank sought to act as sponsor to the listing of the CCB Co. However, one year later, the CCB Co. was told that but the promise had not been approved by the board of directors of Citibank. Similar case occurred between the BOC ltd. and the J.P. Morgan Chase & Co., after 6 months of negotiation, and just before signing a memorandum, the BOC Ltd. was told that the proposed investment had rejected by

the board of directors of the J.P. Morgan Chase & Co. See Huan, G. C. (2005), 'Sanwen Guoyouyinghang Zhanglueyinzi' (*Three questions to ask about introduction of strategic investors of the state-owned banks*), *Caijing*, No. 148.

10. See discussion of recapitalisation of the banks in Chapter 5.

11. The banks' weak bargaining situation may well be illustrated by an anecdote, according to which a high-powered team from a Wall Street bank flew into China at the beginning of 2005, to look into investing in two of the Big Four, the ICBC and the BOC. After a week of meetings, as the leader of the team was preparing to leave Beijing, he received a phone call from an official from the CCB asking the foreign bank to consider a potential investment. See Cong, Y. P (2005), 'Jingti Waizi Dui Jinrongzican De Lianjiagoumai' (*Be vigilant of foreign capital purchasing banking asset at cheap price*), *Dongshihui (Borad of Directors)*, No.11.

12. The BRS China is controlled by the BRS Group which owns 51.6 percent shares. The other five shareholders include the Temmurgal Holding Co. AB (an affiliate of Merrill Lynch & Co), the Magnitico Holdings Limited (a subsidiary of Li Kai-Shing Foundation Limited), the D.E. Shaw Oculus Investments (Cyprus) Limited and the D.E. Shaw Composite Investments (Cyprus) Limited (both members of D.E. Shaw Group), the Oaktree Cyprus Principal Investments Limited (a wholly-owned subsidiary by Oaktree Capital Management, LLC.), the OZ Sculptor (Cyprus) Limited (a member of the Och-Ziff Capital Management Group).

13. 'RBS eyes Chinese bank stake' *Financial Times*, 28 July 2005.

14. 'Temasek to buy 5% of Bank of China', *China Daily*, 26 December 2005.

15. The bank's internal report.

16. 'Zhonghang Gonghang Shangshi Jianxingjiannan' (*The IPO of the BOC and the ICBC are running in difficulty*), *Caijing* (*Caijing Magazine*), No.153.

17. There are various types of shares issued in China's Stock Markets. Since the government concerned about the potential loss of state assets if all shares of a restructured SOE were to be freely traded, the ownership of each firm is split into state shares, legal person shares, public shares (A and B shares), and employee shares. State shares is classified that the ultimate owners of these shares is the central government. This type of shares is not allowed publicly traded and exchanged except with the approval of the state authorised institutions or departments.

    The SAFE Investments noted that if after the IPO of the BOC Ltd, its shares remain state shares, it might be problematic for them to transform them into H-shares due to a 'types of shareholder' clause in the securities law, i.e. if the BOC Ltd. also lists some shares in the mainland market (A-shares), the SAFE Investments will have to obtain special approval from HK investors for transactions involving its shares in the BOC Ltd.

18. ‘Sinopec shares drop after Exxon sells out’, *International Herald Tribune*, 3 March 2005.

19. Ibid, Article 2.

20. For instance, the most recent dispute between the CCB Co, and its a former senior risk adviser, who revealed that the bank had hid up to US$3 billion bad loans before listing (‘Rare Look at China’s Burdened Banks’, *New York Times*, 15 November 2006).

21. See also Chapter 4, note 24.

22. For instance, Peter Cooke, former Associate Director of the Bank of England, and Anthony Francis NEOH, former Chairman of the Hong Kong Securities and Futures Commission, served as independent directors in the BOC Ltd; Yashiro Masamoto, former Chairman and CEO of Shinsei Bank, served as independent directors in the CCB Co.

23. Interview with an official in the SAFE Investments in Beijing, June 2005.

24. See discussion of the previous practice of supervisory boards in Chapter 4.

25. See Rostowski (1995).

26. Interviews with managers in the banks, in Beijing, June 2005.

27. This argument corroborates the former view in Chapter 5.

28. The bank’s internal document.

29. Other scandals involving the senior executives of the two banks include, for instance, the former president of the CCB, Wang Xuebing, was sentenced to 12 years imprisonment for taking bribes in December 2003; Liu Jinbao, the former CEO of the BOC’s public traded subsidiary in Hong Kong was convicted of embezzlement and given a suspended death sentence in August 2005.

30. *China Daily*, 3 November 2006.

31. The bank’s internal document.

32. Interviews with managers in the bank, in Beijing, June 2005.

33. Personal communications with mangers in the bank.

34. The bank’s Global Offering Prospectus.

35. Interviews with managers in the bank, in Beijing, June 2005. See also the bank’s 2004 and 2005 Annual Reports.

36. The bank’s 2004 and 2005 Annual Reports.

37. Interview with a manager in the bank, in Beijing, June 2005.

38. The bank's internal document.

39. The bank's 2005 Annual Report.

40. The bank's 2005 Annual Report.

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