# Corporate Governance in

# Banking Organizations in China

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## Abstract

In contrast with conventional economic, political and institutional studies of corporate governance, the present thesis brings together varieties of capitalism (VoC) and discursive institutional approaches in order to analyze how corporate governance is constituted in Chinese banking organizations. The discursive institutions which produce and reproduce national arrangements of corporate governance in banking are analyzed as operating across three related levels; namely, legitimacy, paradigm, and frame. By comparison with the existing national models of corporate governance in banking, the thesis holds that the corporate governance of Chinese banks has a hybrid form that combines elements of the Continental stakeholder model, the Anglo-Saxon shareholder model, and the State-affected model. The thesis finds that the Chinese discursive institutional configuration largely shapes bank governance and is thus crucial to establishing a governance structure that is clearly distinguishable from other models.

Specifically, the thesis demonstrates that the embedded discursive institutions that legitimate relations between banking and the national economy, forms of financial regulation and legal provisions in the Chinese context also legitimate a particular form of corporate governance in Chinese banking organizations. In terms of paradigm, the thesis shows how the legitimacy discourse is manifested in the competing paradigmatic shareholder and stakeholder models which are combined and integrated in the Chinese context. At the frame level, the present study elaborates on the key practical discourses in bank corporate governance in China - the board of directors, regulation of executive pay, risk management, and legal obligations, and finds that they are broadly consistent with the distinctive national discourses of the legitimacy and paradigm. For instance, implicated by the enhanced shareholder model and the stakeholder model, the bank board is oriented towards sustainable profitability to the shareholders, active support for economic development, and balance of interests of various stakeholders. The composition of the bank executive pay and specific regulatory measures, on the other hand, reveals the influence of close financial regulation and the state as the controlling shareholder in Chinese context. In risk management, echoing the paradigm of the stakeholder theory, Chinese banks have moderate risk appetites and concentrate on long-term profitability, real economic investment and sustainable development, which also represents the concerns for the financial stability by the regulators and their close supervision of the banks. For legal duties, which include the compliance duty and the fiduciary duty, the manifestation of a strong financial regulation is present, typically exemplified in shaping various standards and qualifications of legal duties.

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**Acknowledgement**

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## Declaration

Hereby I declare that the present PhD thesis complies with the guidance and regulation on plagiarism and academic misconducts by the University of York. The thesis is an original work of my own, which has not been written wholly or partially by other people. Due credentials and acknowledgements are adequately made to authors of the works referred.

# Part I Theoretical Framework in Corporate Governance

## Chapter One Introduction

*"I started from my sleep with horror; a cold dew covered my forehead, my teeth chattered, and every limb became convulsed: when by the dim and yellow light of the moon, as it forced its way through the window shutters, I beheld the wretch - the miserable monster whom I had created."*

---MARY SHELLY, FRANKENSTEIN

### 1.1 Background and research problems

As the post-2007 global financial crisis has unfolded, renewed attention is being paid to the defects and deficiencies in corporate governance of banking organizations. Such attention is, to Mary Shelley's phase, part of a wider questioning of how these man-made financial giants have turned into the monster of *Bankenstein*. Scholars, regulators and the public alike start to review and reconsider key issues in banking, such as the role of the bank in modern society, the function of the bank's boards of directors, the regulation on bank executives' pay, risk management and legal obligations, along with the arrangement of macro prudential financial regulation. And, various changes and reforms are actively proposed and promoted worldwide to re-enhance corporate governance in banking organizations (U.K. Walker Review, 2009; U.S.A. Blueprint, Department of Treasury, 2008; US, Dodd-Frank Act, 2010).

However, before all these proactive measures can be effectively implemented, a more fundamental understanding of corporate governance in banking organization is needed. And, it is in this context that the present thesis offers an institutional analysis of corporate governance issues in banks. Specifically, it aims to analyze the changing face of corporate governance in banking organizations in China. To this end, the key questions to be addressed range from the general and broad to the particular and specific. How is corporate governance in Chinese banking organizations initiated and developed? In what ways does corporate governance in Chinese banking organizations conform to the principal models that circulate in academic analysis? What are the key factors contributing to Chinese distinctiveness, and how might we distinguish it from other model countries? But before answering these questions in the specific Chinese national configuration, a few fundamental questions need our attention. For instance, how is corporate governance in banking organizations conceptualized? How is corporate governance in banking organizations constituted and changed? What are the main models of corporate governance in banks? And how do variances in bank governance develop in different national institutional settings?

## 1.2 Theory and Concepts

### 1.2.1 Extant theories on corporate governance

In the extant literature, a great variety of theories are elaborated by scholars on the study of corporate governance. Typically, an economic theory is employed, which focuses upon the ownership structure, maximization of shareholder interests, and elimination of agency problems (Jensen and Meckling, 1976; Shleifer and Vishny, 1997; Becht, 2002). Based upon the famous separation of ownership and management (Berle & Means, 1932), the well-known shareholder primacy model is developed and actively promoted, arguing for maximizing the shareholders' rights and interests while subordinating interests and claims of other stakeholders. Its major concern is how to eliminate agency problems and achieve best returns to the investors (Shleifer and Vishny, 1997). In contrast, the stakeholder model, which is said to typically prevail in continental European countries, argues for sufficient protection for the stakeholders' interests in addition to maximizing the shareholders' returns (Cochran and Wartick, 1988). And, instead of being troubled with the principal-agent problem, more attention is given to the principal-principal conflict, where the majority shareholders may exploit the minority ones due to their overwhelming power in the ownership structure (Shleifer and Vishny, 1997).

Within the economic analysis of corporate governance, La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998, 1999, 2000) further develop a financial-legal theory, which focuses upon the legal protection for investors, especially the minority shareholders. According to their survey across a wide range of countries, they find that common-law countries have the strongest protections for investors while French-civil-law provides weakest legal protection, leaving Scandinavian-civil-law countries located in the middle (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1998). In this context, they argue that 'the legal approach is a more fruitful way to understand corporate governance and its reform than the conventional distinction between bank-centered and market-centered financial systems' (La Porta, Lopez-De-Silanes, Shleifer and Vishny, 2000, p3).

In contrast with economic and financial-legal theories, Mark Roe (2003) applies political analysis to corporate governance issues. He argues a concentrated ownership structure may result from major political determinants which prefer stakeholder interests rather than pure maximization of shareholders' values. In contrast, weak political forces always favor a dispersed ownership structure rather than concerns for the stakeholders' interests. Countries that 'fit' the Anglo-Saxon model, especially US, fear the existence of influential economic powers - the concentrated shareholders - and respond with bans on the formation of such ownership structures through various legal mechanisms, even if this adversely affects the rights of shareholders (e.g. restrictions on solicitation of votes by shareholders, or burdensome procedures required on shareholders in derivative suits). Such worries are rare in the Continental model countries. However, although political forces may contribute to the existence of different models, there are problems with simply regarding political forces as a singular causal variable. For instance, it is quite possible for a dispersed ownership structure to co-exist with a political orientation and policies which favor the general welfare of stakeholders (Brian, 2001). Other scholars employ an institutional approach, explicitly or implicitly, in addressing institutional settings for the status quo of corporate governance, its continuity and changes (Jackson, 2003; Lane, 2003, 2005; Bebchuk and Roe, 1999). For instance, by applying the concept of 'path dependence', a core notion in historical institutionalism, Bebchuk and Roe (1999) stress upon the significance of the initial ownership structure in corporate governance and its subsequent impacts on the present one (the structure driven path).

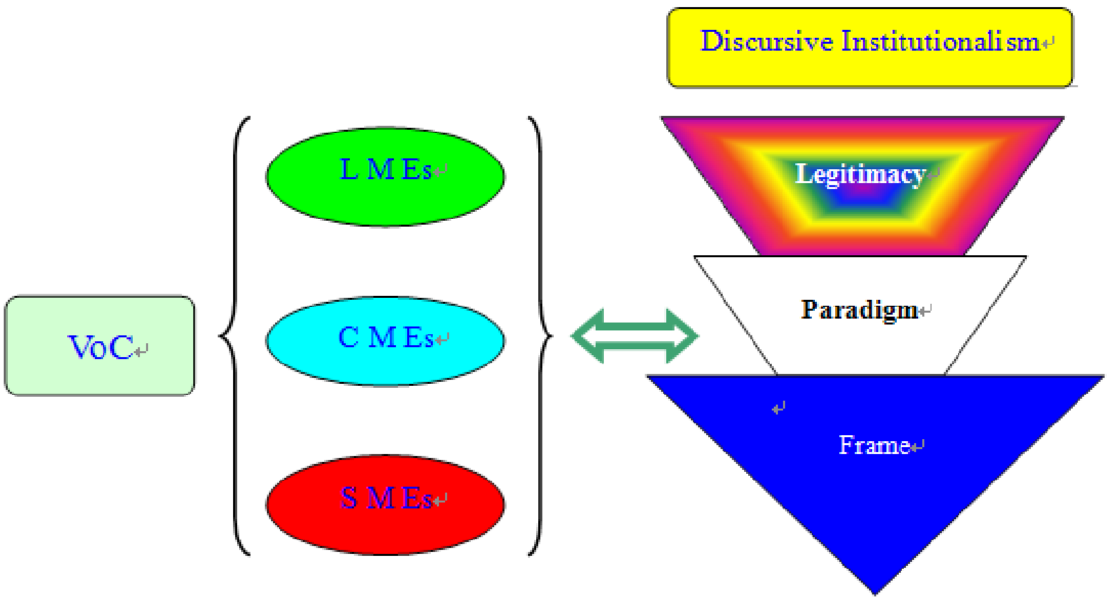
Such theories seem inadequate, however, when explaining the diverse arrangement of corporate governance in banking organizations. Their focuses on particular aspects of corporate governance - economic, legal or political - seem to both separate out and overlook other factors which also play significant roles in the development of corporate governance. Meanwhile, these theories understate the way in which the governance arrangement in a certain institutional setting is a consequence of joint forces by many factors, though with different weights. Moreover, with excessive concentration on shareholder issues and performance of the firm, the theories tend to neglect what happened to the stakeholders of various kinds in the recent financial crisis. Furthermore, the lack of detailed analysis on how institutions and orientations affect and are represented in the business practices and activities in the framework of corporate governance may limit the empirical significance of these theories.

### 1.2.2 Discursive institutional approach

Seeking for a wider and in-depth understanding of corporate governance in banking organizations, the present research brings together the institutionalization of the variety of capitalisms (VoC) approach with a discursive institutional approach. This combination advances knowledge of why corporate governance is divergent in different national configurations, and how such distinctions are formed, oriented and applied in various institutional settings. Figure1.1 provides a summary of the theoretical approach taken by this thesis.

As a way to understand the institutional diversity of different national capitalisms, VoC is developed in explaining key issues in comparative political economy, such as financial markets and corporate governance (Hall and Soskice, 2001a, 2001b; Streeck and Yamamura, 2001; Yamamura and Streeck2003; Schmidt, 2003; Amable, 2004; Morgan, 2005). The recognized strength of VoC lies in categorizing and explaining how different institutional formations produce variances in economic, financial and political activities. And, it is in this context that VoC will be employed in this thesis for explaining the existing variances of corporate governance of banking organizations in different national institutional settings.

**Figure 1.1 VoC and Discursive Institutional Approach**




According to a three-fold typology, VoC are mainly categorized into liberal market economy (LME), coordinated market economy (CME), and state-affected market economy (SME). Theoretically, LME is said to be characterized with the prevailing ownership of private property, pro-competitive disengagement attitude by the government, and highly developed legal protections for various property and contractual rights (Hall and Soskice, 2001a). In contrast, CME relies on non-market relationships, coordination and collaboration, credible commitments, and deliberative calculation on the part of firms. Specifically, there is a close coordination between the government and the industries, and the government is more actively involved in industrial adjustment process by coordinating the policies across the industrial sectors. Private ownership is less prevalent and often has a strong social nature, and the legal protection, to some extent, is comparatively weaker (Hall and Soskice, 2001b). SME, exemplified by France, prioritizes upon the state's capacity to devise, orchestrate and implement economic policies aimed at modernizing industries and achieving macro policy objectives (Scmidt, 2002, 2003; Coates 2000; Boyer 1997; Weiss 1999). Such self-legitimized state intervention in industries and economic process may well enfeeble the private ownership while over-prevailing the 'public ownership' by the sovereign. Moreover, even the legal protection may have a strong flavor of pubic interests, though there are hidden 'rent-seeking' scheme by dominant interest group who maximize their own interests in the disguise of 'public good' (Hall and Soskice, 2001a).

Though VoC is advantageous in explaining how corporate governance may be differentiated due to varied national institutions, it is less powerful in illustrating how the specific orientation or governance arrangements are constituted in corporate governance across different categories of capitalisms. And, it is in response to this deficiency that this thesis draws upon discursive institutionalism. Traditionally, institutionalism is widely used in political science and social science as an analytical approach, and institutional explanations remain popular in policy and governance studies as well as individual-level behavior analysis. Institutionalism, theoretically, is divided into the old institutionalism school (Broderick, 1970; Wilson, 1898; Bates, 1998) and the new institutionalism school (Peters, 2004; March and Olson, 1989; Steino, Thelen and Longstreth, 1992). And, within the latter, more precise categorizations are made distinguishing between historical institutionalism, rational choice institutionalism, sociological institutionalism, and discursive institutionalism (Schmidt, 2010).

As the newest of the 'new institutionalisms', discursive institutionalism focuses on the substantive content of ideas and the interactive processes of generating and communicating them to the public (Schmidt, 2000). Closely connected to sociological institutionalism (Campbell, 1995; Peter and Thomas, 1996) and the historical institutionalism (Pierson and Skocpol, 2002; Pierson, 2000), discursive institutionalism pays more attention to discourses which illustrate the ways in which actors engage in the process of generating, deliberating and/or legitimizing ideas about social activities.

As the core of discursive institutionalism, ideas/discourses are regarded as foundations for the formation and change in institutional arrangements. Defined as causal beliefs which are products of cognition and connected to the material world via interpretation of the surrounding environments, ideas are said to provide guides for actions and specific ways to address problems and challenges (Emmerij, Jolly and Weiss, 2005). Not infrequently, ideas can take many forms, such as high profile public frames, discourses and ideologies at the foreground of the cognition (Schon and Rein, 1994; Campbell, 2004), or a lower profile assumptions and paradigms that remain at the backgrounds of the arena (Hall, 1993). Similarly, this thesis seeks to categorize ideas as operating at three levels that can be analytically distinguished. I will call these three levels or layers of ideas legitimacy, paradigm, and frame.

First, as the broad foundations of institutions, ideas take the form of legitimacy which comprises public sentiments and assumptions, and this takes into account various social entities, actors, factors and extends to the political, economic, legal institutions. Typically, legitimacy may embrace the relationship between citizens and the state, the rights and obligations in political, social and economic institutions, and public sentiments based upon the common language, culture and historical identity (Hay, 2001). However, there is an intricate relationship between the legitimacy and the actor. On one side, the actor is bound by legitimacy if he or she intends his/her activities to be regarded as institutionally acceptable and publicly desirable. On the flip side, due to broadness and lack of clarity, legitimacy in general cannot provide a specific option or solution to a problem. Meanwhile, it may be played on or even maneuvered by powerful actors, like political leaders, influential businessmen or public figures, such that legitimate ideas are revised and promoted to the public (Hay, 2006).

In the context of corporate governance, legitimacy varies in different national institutional settings. In the Anglo-Saxon countries, which largely fall under the LME variety of capitalism, the legitimacy of corporate governance lies in the prevailing ownership of private property, a pro-competitive hands-off posture by regulators, and strong legal protections for property and contractual rights. In contrast, in the Continental European countries which approximate to the CME variety of capitalism, legitimacy is characterized by the coordination between the government and the industries, banks and enterprises, active involvement by the regulator in industrial adjustment process, and comparatively limited judiciary protection for private property rights. In the State-affected countries, which are largely consistent with SME variety of capitalism, legitimacy is characterized by the state's controlling ownership and active intervention in industries and economic process, the regulator's strong orientation for promoting national economic development, and comparatively weak legal protection for private investment.

Secondly, ideas take the forms of paradigms. In social activities, paradigms produce opportunities for actors in the process of forming their own ideas, and in pursuing the solution to problems. These may be a totally unconscious process, as paradigms are generally rooted in actors' cognitive backgrounds and underlying theoretical and ontological assumptions about how the world runs. For instance, they may be formed through textbooks and case studies in schools and universities, seminars and influential publications by master scholars in the fields, or one's experience from his family, working place and increasingly powerful social media (Campbell, 1998).

In the context of corporate governance, different paradigms are distinguished by varied models and theories in various national institutional settings, based upon the legitimacies as discussed above. In the Anglo-Saxon countries, paradigmatic ideas in corporate governance are categorized as the Anglo-Saxon model and said to be dominated by the shareholder primacy theory, which is characterized by maximizing the interests of the investors, mitigating agency costs, and enhancing the performance of the corporation. Such paradigm well echoes the legitimacy of prevailing of private ownership, disengagement by the government for competition, and strong legal protection of private interests. In the Continental countries, however, the paradigm in corporate governance is labeled as the Continental model and characterized with the stakeholder theory, which contends for equally protecting the interests of the stakeholders of the corporation, such as the employees, creditors, suppliers, etc., while limiting the maximization of the interests of shareholders. This largely resonates with the legitimacy of coordination of interests of different players by the state, limitation on the priority of private ownership, and weak legal protection in CME. And for the Sate-affected countries, which is classified as the State-affected model and said to be the hybrid of the shareholder primacy theory and stakeholder theory, the paradigm lays specific emphasis upon the national economic development and endeavors to harmonize the interests by the shareholders, the stakeholders, and the national economic growth. This is consistent with its legitimacy of preference for the state intervention and active involvement in corporate operation and governance structure, with the pursuit of national economic objectives.

Thirdly, ideas operate at the level of frames, which include norms, codes, and rules of thumb in routine practices, and are designed to diagnose specific problems encountered in social life, sort out most efficient solutions, and achieve certain objectives. Not infrequently, a frame is expected to be clear, concise, and behave as efficient 'short-cut' among a great variety of options and ideas (Campbell, 1998). In corporate governance context, frames mainly constitute the key practices on the specific governance arrangement, such as the ownership structure, the organization and behavior of the board of directors, code of corporate governance, and legal duties of relevant parties. Effectively, frames resonate strongly and are nested within the aforementioned levels of legitimacy and paradigm, and are analytically significant as they often illustrate the impacts of 'taken for granted' ideas.

For instance, despite its general function as 'the brain and heart' of the corporation, the board of directors varies in different models regarding its organization, practice and duties. In the Anglo-Saxon model, the board of directors is oriented towards the best performance of the corporation, effective monitoring over the management, and higher standards of fiduciary duties. These frames are broadly representative of the paradigm of corporate governance in the Anglo-Saxon model, especially as it stresses the shareholder primacy and the legitimacy discourse of the prevailing private ownership. In contrast, the board of directors in the Continental model stresses on the relational role with the shareholders, strong connections with the stakeholders such as mandatory labor participation, and less burden of legal obligations. These well reflect its paradigm of protecting the stakeholders' interests and the legitimacy of coordinating interests among various parties in the framework of corporate governance. The board of directors in the State-affected, similar to that in the Continental model, is distinguished by the state's influence in the board of directors, its strong political connections, and orientations for promoting the national economic development. These are consistent with the paradigm in the State-affected model (the hybrid of shareholder primacy theory and stakeholder theory) and legitimacy of strong state intervention and concerns for national economic growth. Similar dynamics can be observed in other practices of corporate governance, such as the ownership structure, code of corporate governance, and legal duties.

As in Figure 1.2, a general path, spiraling from legitimacy, paradigm and then down to frame, is illustrated for better understanding of different levels of ideas in the cognitive background and foreground. Meanwhile, dynamics between and among these different levels of ideas abound and are more complicated than they first appears. On one side, there is a logical order of ideas, funneling down from legitimacy, to paradigm and then to frame, from the cognitive background to the cognitive foreground. For instance, the paradigm is mainly built upon what is legitimate in the sense of being widely accepted by the public as socially desirable. And the frame, oriented by the paradigm, may directly integrate the paradigm in the form of norms like specifically designed documents, guidance or codes.

**Figure 1.2 Dynamics of Three Levels of Ideas**

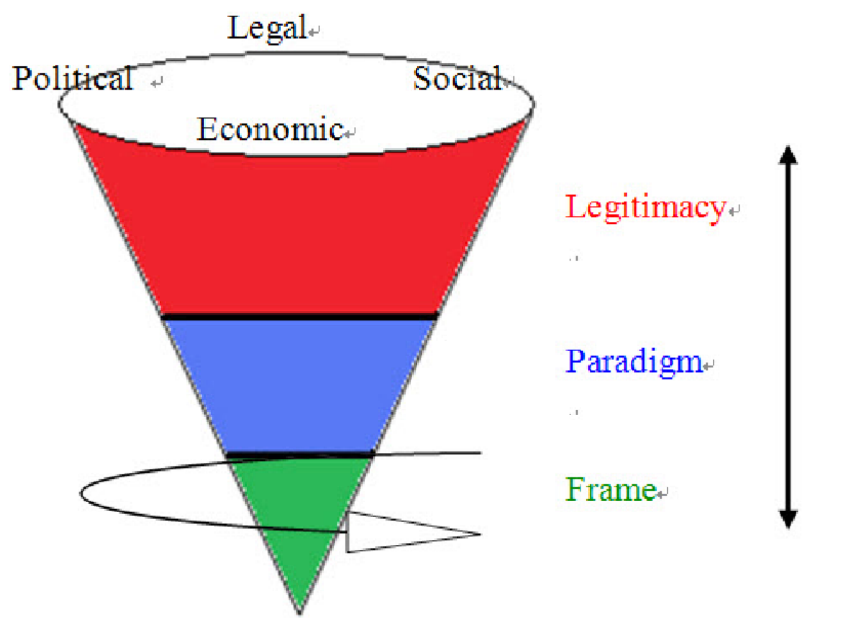
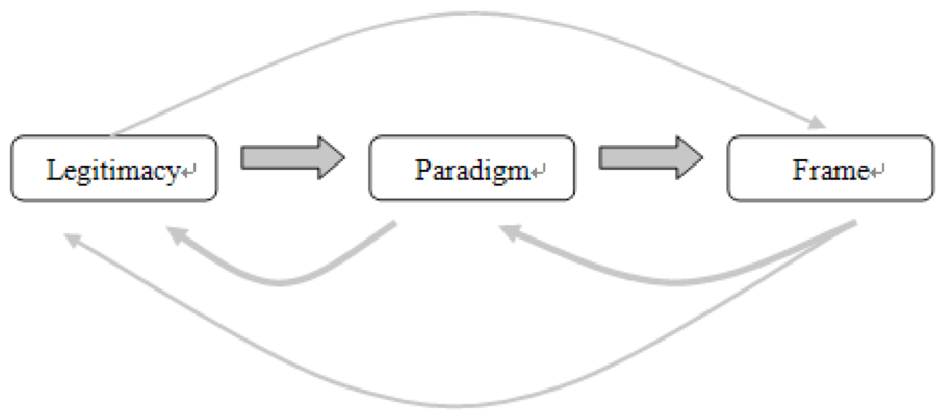



**Figure 1.3 Three Layers of Discourses and Interactions**




On the flip side, however, such logic may deviate or even be reversed, as illustrated in Figure 1.3. A paradigm may divert from what is widely seen as legitimate due to its aggressive promotion by policy makers, think tanks and academia. Frames can deviate from the paradigm and legitimacy to a larger scale. First, there is some cognitive 'distance' between the frame and the paradigm and even farther the legitimacy, which enables the frame to be fairly independent and stretch away from the bounds of the paradigm and legitimacy. This typically happens when the frame is maneuvered by certain interest group for the sake of its own benefits. Secondly, it may happen when the frame is more about specific practices and technical issues, like developments of mathematic models, patterns or equations targeted at certain business. In a more drastic form, there will be a 'rebel' of the frame when, under the powerful influences of certain interest group, it can defy against the present paradigm and legitimacy and even reshape them. Nevertheless, when this happens, there may already have been some changes going on in paradigm and legitimacy which are consistent with the changing frame.

### 1.2.3 New understanding of corporate governance with discursive institutional approach

With the VoC and discursive institutional approach as the analytical tools, the present thesis, distinguished from the extant literature, summarizes corporate governance into the following three views, the micro/microscopic, meso/telescopic and macro/kaleidoscopic (Preda, 2009), which resonate with the three levels of discursive institutionalism, the frame, the paradigm, and legitimacy. The microscope view of corporate governance, the discourse of frame, observes mainly the endogenous and micro aspects of the corporation while intentionally isolating other entities, actors or elements, such as the protection of returns of the financial investment by the investor/shareholders (Shleifer and Vishny, 1997), mitigation of the agency problem (Jensen and Meckling, 1976; Fama and Jensen, 1983), and various specific governance issues like ownership structure, the board of directors, the legal duties. The kaleidoscopic view of corporate governance, or the discourse of legitimacy, observes the corporation in its relationship to broader economic, social and political institutions (Dignam and Galanis, 2008). And, this view often highlights the divergence of corporate governance in different countries which have their own specific political, economic, legal, social and cultural arrangements (Herme, 2007; Okike, 2007; Aguilera and Cuervo, 2009). A meso or telescope view of corporate governance, categorized as paradigm in the present discursive institutional analysis, observes the relationship between corporation and other entities and actors like creditors, regulators and employees. It defines corporate governance as a set of rules or a mechanism regarding the relationship among shareholders, management, stakeholders and the society. And a good governance structure should provide an efficient framework to achieve the corporate objectives, monitor the corporate performance (Williamson, 1984), and consider the overall interests of different stakeholders apart from the shareholders (Freeman, 1984; Donaldson and Preston, 1995).

The present thesis, instead of favoring any of the afore-said conceptions of corporate governance, argues that corporate governance is a composite of the 'three scopes' views. First, from the micro perspective, the corporate governance is a set of well designed structure 'through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined' and it is expected to 'provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders, and should facilitate effective monitoring' (OECD, 2004, p11). Secondly, illustrating the meso view, corporate governance involves a set of complicated relationship 'between a company's management, its board, its shareholders and other stakeholders' (OECD, 2004, p11) and is greatly influenced by the dynamics between these diversified participants. Thirdly, corporate governance is also shaped by the macro factors, such as the economic, legal, and regulatory environments, which can be further categorized into macroeconomic policies (OECD, 2004).

### 1.2.4 Theories of Corporate governance in banking organization

Corporate governance in banking organizations is not, however, merely constituted through the same discursive institutions of legitimacy, paradigm and frames that operate in corporate governance more broadly. It is certainly the case that distinctive country-level governance arrangements legitimate both financial and non-financial sectors, especially considering increased competitions and higher threats from the market for corporate control in the financial industry. And these force banks to take more effective governance structures for the sake of maximizing shareholders' interests and improving banks' performance, and push the bank's governance structure to evolve towards the general governance system used by generic unregulated firms (Belkhir, 2008). Yet, although 'Sectoral orientation will generally reflect national orientation', it may also present some distinctive features and 'reflect the bias of the dominant agency or agencies in the sector and this may reflect the agencies' particular history, mission, or jurisdictional responsibilities' (Vogel, 1996, P22). Hence, while the discursive institutions of corporate governance in banking organizations are largely consistent with those of generic corporate governance at the country level, specialties abound in banking sector due to its specific characteristics and business activities. These specifics may be more significant in the constitution of some aspects of governance issues in banking organizations (Adam and Mehran, 2003, 2005, 2009). The specific discourses on banks may cover issues such as the bank's role as an unique financial intermediary providing liquidity services, its highly leveraged capital structure, more opaqueness and lack of transparency compared with the generic corporations, vulnerability to bank run and hence causing possible systematic financial risk, and being heavily regulated.

Referring to the specialty of the banking industry and the three-level perspectives of generic corporate governance, the research summarizes corporate governance of banking organization as a composite of micro, meso, and macro views. At the micro level, corporate governance of the bank 'involves the manner in which the business and affairs of banks are governed by their boards of directors and senior management, which affects how they set corporate objectives; operate the bank's business on a day-to-day basis; meet the obligation of accountability to their shareholders' (Basel, 2010, p7). In the terms we set out in discussion in discursive institutionalism, this is what we have called the specific 'frame' of the governance structure of the bank. Meanwhile, corporate governance in banking organizations demarcates an emphasis on the arrangement of various stakeholders' interests, such as the protection of the interests of the depositors, creditors, and the state. This boundary of corporate governance goes beyond the profitability of the bank and the maximized return to its shareholders, and takes into account of the bank's influences upon its constituencies. In our terms, the meso view leads to the construction of 'paradigms', which focus on how the bank's governance structure should be oriented towards the protection of its various stakeholders, typically the depositors, creditors, and the economy (Basel, 2010). The macro view, moreover, emphasizes that corporate governance in banking organizations should 'align corporate activities and behavior with the expectation that banks will operate in a safe and sound manner and in compliance with applicable laws and regulations' (Basel, 2010, p7). And, in doing so, it concentrates more on the functions of the banking sector for the sake of economic growth and stability, and addresses the macroeconomic implications of the bank's governance structure, such as contagion risk, impacts on payment systems, liquidity problems and bank runs. For us, this macro view is a question of producing the 'legitimacy' of corporate governance arrangements at work in banking organizations.

Integrating the micro, meso and macro perspectives in conceptualizing corporate governance in banking organizations, the discursive institutional approach, along with the implicit VoC analysis, develops a dynamic three tier canvass of governance structure in banks, proceeding from legitimacy, paradigm, to frame. At the legitimacy level, the VoC analysis is specifically used to approach different institutional settings for the bank's governance in varied models. It pertains to how corporate governance in the bank is legitimized by the discourse on the relationship between the bank and the economy, especially as this is manifested in financial regulation and the role of legal interventions. For instance, the government plays a significant role in 'creating and shaping' the banks' behavior and activities, and, apart from its prevalent regulatory and supervisory function, the government actually 'creates and constitutes what banks are and what banks do' (Rethel and Sinclair, 2012). In relation to the other levels of our analysis, the different paradigms and models of corporate governance in banking organizations, summarized as the shareholder primacy model, the stakeholder theory model, and the state-affected model, can thus be seen to appear as socially and economically appropriate. Moreover, the discursive institutions of legitimacy also contribute to the shaping of the specific governance frames in the bank, such as differences in the organizational structure of the board of directors, the extent of regulation on executive pay, risk management arrangements employed, and legal obligations.

At the paradigm level, and referring to different models in generic corporate governance, the thesis explores different models in the context of the banking industry. The shareholder primacy model takes on some industrial specialties for banking organizations, such as the acuteness of agency problems and intensive conflict of interests between residual claimants and fixed claimants. For the stakeholder model, an umbrella of social responsibility for the bank comes into the analytical picture, especially as that covers the interests of various stakeholders. And, for the state-affected model, as a hybrid of the shareholder primacy model and stakeholder model, the paradigm for corporate governance in banking is marked by the state's positioning of the bank as playing an active role in support of national economic development.

At the level of frames, manifesting the varied legitimacies and paradigms, specific corporate governance structures in banks are developed in different national institutional settings and models. Though there are a great variety of frames to be studied for bank governance, four pivotal issues are selected in the present research. These embrace the organization and behavior of the board of directors, regulation on executive pay, risk management, and legal duties. The discussion of the board of the bank illustrates how different paradigms and legitimacy discourses are manifested in framing the orientation of the board of directors, the size of the board, and the board's independence. The regulation on executive pay, on the other hand, presents the implication of varied paradigm and legitimacy on the composition of the executive remuneration and differentiated regulative measures. The analysis of risk management, as the pivotal issue in the banking industry, manifests how the converged international influence and divergent national legitimacy and paradigm co-function to constitute the conceptions of different risks, the overall risk management framework, and the specific risk management arrangement. The legal duties of the bank, mainly the compliance duty and fiduciary duty, represent the influence of different paradigm and legitimacy in shaping the boundary of the bank's responsibilities and the liabilities by the bank board directors and managers.

### 1.2.5 Theories of corporate governance in banking organizations in China

Applying the discursive institutional approach to corporate governance in Chinese banking organizations, along with comparing and contrasting with different models, the thesis explores specifically how corporate governance is constituted in banks in Chinese national configuration. This is achieved from the three-tier discourse analysis of legitimacy, paradigm, and frame. At the level of legitimacy, corporate governance in Chinese banks will be shown to be a hybrid of the Continental Model, the State-affected model, and the Anglo-Saxon model, which is apparent in the discourse on the Chinese banks' integration into the national economy, their close relationships with industries, and intertwining with enterprises. Regarding discourses of financial regulation, running in parallel is continued close control and administration by the government and an increasing orientation for opt for deregulation. In terms of legal intervention, meanwhile, the courts in China are legitimated as playing a paradoxical role of passivism and activism and frequently influenced by political discourses. Meanwhile, the discourse of international influence is increasingly significant in the legitimating particular corporate governance arrangements in China, especially as it refers to China's active presence in international economic organizations, competitions from foreign banks, and increasing overseas expansions by Chinese banks.

Understanding the specific form taken by this hybridization of legitimacy in corporate governance in banking organizations in China requires, however, that we pay attention to the ways in which the broader discourses and institutions that legitimate banking practices in Chinese context are manifested in many deviations from the aforesaid paradigms. As such, an enhanced shareholder primacy model will be shown to develop through the specific concerns of the Chinese state as a majority shareholder of the banks, and that this leads to attempts to balance the maximization of the shareholders' investment returns with the protection of the stakeholders' interests, and to a specific agency problem. The diversified stakeholder model, on the other hand, highlights banks' serious concerns for the interests of a great variety of stakeholders, for general economy to individual employees, from the regulators to the clients, and from the environmental protection to the social welfare at large.

Echoing the legitimacy and paradigm as so discussed, a specific set of corporate governance frames will be shown to have developed in Chinese banks, especially pertaining to frames for the organization and behavior of the bank board, regulation on executive pay, risk management, and legal duties. The organization and behavior of the bank board pertains to the orientation of the board directors, its composition, the board size, and its independence. Manifesting the hybrid of the paradigm discourses of the enhanced shareholder primacy and the diversified stakeholder model and relevant legitimacy discourses, for instance, the board of directors in Chinese banks is oriented towards sustainable profitability to the shareholders, active support for economic development, and balance of interests of various stakeholders. Similar hybrid manifestations can be observed in the board composition, the board independence and impediments, and arrangement of supervisory board of directors. The exploration on regulation on executive pay in Chinese banks embraces the composition of the compensation, and the specific regulatory measures and mechanisms. It reflects the embeddedness of the legitimacy discourses of close financial regulation on executive pay, exemplified by mandatory requirements on the composition, proportion, and terms of payment of different components in the compensation package. Meanwhile, it illustrates the implication of the paradigm discourse of the stakeholder model by the high proportion of performance related bonus, adequate fixed salary, and generous welfare package for the sake of the long-termism by the bank executives. Also, it presents concerns for the stakeholder interests by setting the social indicator as a compulsory standard for assessing the executives' performance.

As a key issue of corporate governance in Chinese banks, risk management focuses on the analysis of the discourses from international influence and regulators in shaping the general framework of risk management, the risk appetite, and the specifically developed risk management mechanisms. Reflecting the paradigm discourse of the stakeholder model, the dominant role of the state as the controlling shareholder, and the legitimacy discourse of strict financial regulation, for instance, Chinese banks set moderate appetites for their risks. Meanwhile, due to the legitimacy of Chinese bank's intimate relationship with economic development, industries and enterprises, credit risk management takes a specific place in Chinese banks and is targeted in particular at issues like lending to financing platforms by local governments, industries like real estate and environmental protection, and the small and micro enterprises (SMEs). Last but not the least, legal duties in Chinese bank governance embrace the compliance duty and fiduciary duty expected of the board directors and management. The compliance duty of the bank is more a public law obligation and closely connected with risk management and internal control. The fiduciary duty of the bank, frequently rooted in private law terrain, pertains to the board directors, senior management and shareholders, and embrace the duty of care, duty of loyalty, and duty of disclosure. Due to limited roles of the judiciary in China, many of the standards and requirements come from various regulations and rules by financial regulators. The legal obligation in Chinese banking organizations reveals strong regulatory discourses while limited role of the court.

## 1.3 Research Methods

### 1.3.1 Selection of research method

'Give me the place to stand, and I shall move the earth', said Archimedes once in his assertion in demonstrating the *Principle of the Lever* (Heath, 1897). Though social scientists are not interested in lifting the world, they are surely interested in 'looking at the world' and henceforth need 'the place to stand', their standpoints, to understand and explain how the world runs. And in general, the quantitative method, qualitative method and mixed method are such key standpoints, which enable social scientists to logically study things happened, happening and to happen in the social world.

Quantitative method contends that 'social observations should be treated as entities in much the same way that physical scientists treat physical phenomena' and hence argue for absolute objectivity of the research, total separation of the observer from the observed, context-free generalizations for reliability, and viability of the social scientific research (Johnson and Onwuegbuzie,2004, p15). Simplified as an objective process of deduction (Morgan, 2007), it is purported to seek the singular or universal truths or approaches to viewing the world, pursuing the single reality, and henceforth sorting out the causal relationships by means of objective measurement and quantitative analysis (Firestone, 1987). In contrast, qualitative research method argues for the merits of constructivism, idealism, relativism (Lincoln and Guba, 2000; Schwandt, 2000; Smith, 1983, 1984). It contends that social science research abounds in multiple-constructed realities and it is value-bound, impossible to differentiate fully causes and effects, intertwined between the subject and the object (Johnson and Onwuegbuzie, 2004; Guba, 1990). As a subjective process of induction and emphasis on relative context (Morgan, 2007), the qualitative method favors much the constructivism and relativism and contends for multiple realities with different interpretations which are created and shaped by particular circumstances (Appleton and King, 2002).

As the third research paradigm, and something of a middle way, is the mixed method approach. This is 'the class of research where the researcher mixes or combines quantitative and qualitative research techniques, methods, approaches, concepts, or language into a single study', which is expected to achieve 'complementary strengths and non-overlapping weaknesses' in contrast with exclusively use of either qualitative or quantitative method alone' (Johnson and Onwuegbuzie, 2004, p17-18). Targeted at the compatibility of the two schools, it argues for some harmony and merits in mixing these two methods (Johnson and Christensen, 2004; Newman and Benz, 1998; Tashakkori and Teddlie, 1998, 2003). As a utilitarian worldview, the mixed method values more for the consequence than the process, which favors eclecticism and 'a needs-based or contingency approach to research method and concept selection' (Johnson and Onwuegbuzie, 2004, p17). In contrast with the qualitative or quantitative method, the mixed method research is the process of abduction which enables the researcher to move back and forth between induction and deduction through the process of inquiry instead of being bound by a certain theory or data exclusively (Morgan, 2007).

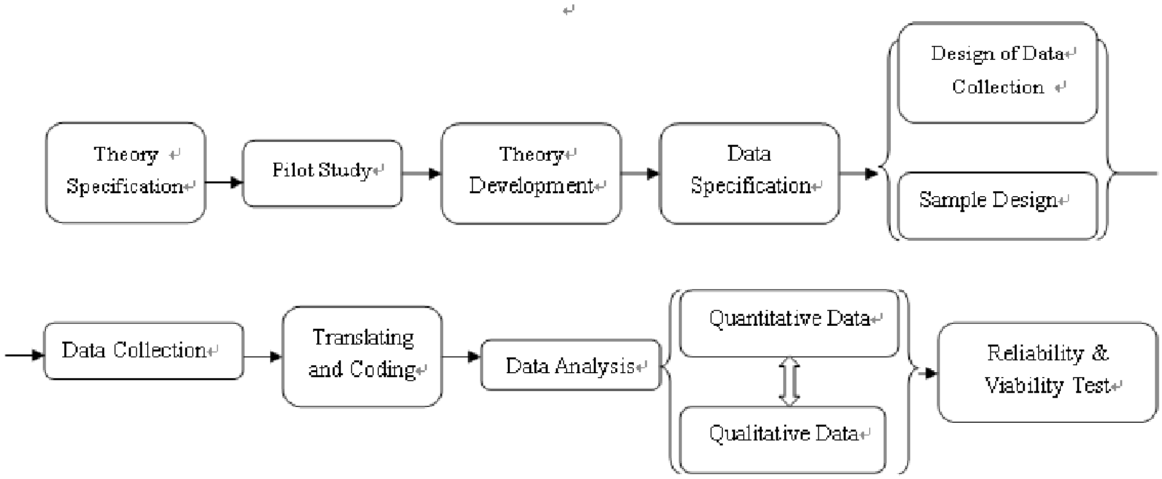
Considering the nature and needs of the present research, which are descriptive, exploratory, and explanatory, the qualitative method is mainly used to understand how corporate governance of banking organizations is constituted and changed in Chinese institutional settings through examining carefully selected sample banks. Meanwhile, with concerns over the limitation of generality of the qualitative method, a complementary quantitative method is applied as well. It helps bring in more data regarding corporate governance in banking organizations industrial wide and enhance the validity of the present study. Meanwhile, in the research process, a mix of study methods is employed such as the comparative method and case method. Comparative method, as an important method in the present research, pertains to the study of foreign countries, study of more than one case, and study with specific methodologies (Mair, 1996). It is valuable in 'observing and comparing carefully selected cases on the basis of some stimulus being absent or present' (Burnham, Gilland, Grant and Layton-Henry, 2004, p60) and in better conceptualization of knowledge, enhancing classification, helping test and reformulate hypothesis, and making efficient predictions (Hague and Harrop, 2011). By comparing and contrasting the differences and similarities of corporate governance in banking organizations in different models, henceforth its divergence and convergence, the present research aims to figure out how the specific governance arrangement in banks is constituted in different national institutional settings. Based on such wide comparisons, the researcher can take a better position in comparing 'Chinese model' with existing models and theorize how corporate governance in banking organizations in China is shaped and changed.

The case method is also employed in the present research. With its advantages in exploring complex phenomenon in the descriptive, exploratory and explanatory studies (Yin, 2009; Looper and Emori, 1995), and in providing description, test and generate theory (Eiberhardt, 1989), the case method enables the researcher to collect rich qualitative data on selected bank cases and achieve in-depth specific study. Moreover, to overcome the limitation of the case study such as it incompetence for generalization (Burnham, Gilland, Grant and Layton-Henry, 2004), the researcher carefully selected multiple bank cases with great significance in national financial system, secondary data on larger bank samples by peer researchers, and macro data on Chinese banking industry by national statistics bureau, financial regulators, banking associations, and international economic organizations.

### 1.3.2 Research design

As illustrated in Figure 1.4, the present research proceeds as a linear progression and embraces different steps. Based on different focuses and needs of the research process, it is divided into 4 stages. The first stage, as a preparation stage, embraces theory specification and pilot study. The second stage progresses to the theory development, data specification (including design of data collection and sample design). The third stage, as the core of the research, pertains to data collection, both qualitative and quantitative. The final stage embraces translating and coding, data analysis, and reliability and viability test.

**Figure 1.4 Research Process as a Liner Progression**




Source: Burnham, Gilland, Grant and Henry, 2004

The researcher is prepared with a good theoretical background and comparatively clear perspectives on the research questions, considering around a decade experience as academic at the top economic and financial university in China and years of teaching, research and engagement in national and ministerial research projects with regard to corporate governance, corporate law and financial law. Meanwhile, in designing the present research project, an extensive preliminary literature review was conducted by referring to various electronic databases, academic works and journals across financial, political and legal disciplines. On this basis, a brief pilot research was taken by consulting and discussing with relevant academics and bank practitioners, who are engaged in or relevant to the proposed research project. For the preparation of the further research, primary networking was initiated by the researcher in Chinese banking industry with connections to alumni and colleagues.

In the present research, two categories of data are designed, primary data and secondary data. The former mainly originates from the qualitative data and the latter focuses on the quantitative data. For collection of the qualitative data, interviews and non-participation observation are designed strategically. However, due to limited access and serious concerns about confidentiality by Chinese banks, non-participation observation had to be given up. Nevertheless, some alternative approaches were used, such as in-depth follow-up non-structured interviews, and involvement in relevant research projects by the sampled banks. With regard to the quantitative data, mainly the descriptive statistics, the researcher refers to a wide range of data from different sources, such as academic database, official statistics, the bank's annual reports, and registration documents in stock exchange.

The sampled Chinese banks for the present research are large-sized commercial banks, which are typical and representative of the present Chinese banking industry, considering their large proportion in the total assets of Chinese banking industry, great influence industrial wide as well as to national economy, and modeling effects for other banks. Due to concerns for confidentiality and requirements from the respondents, the sample banks in the present thesis are referred to as Bank A, B, C and D. Meanwhile, some of the sampled banks are prioritized in the present research due to their significant status, great impact and typicality. Based upon the research questions, a tailored interview plan is prepared for different departments in sample banks, involving the strategic research and development department, credit granting and monitoring department (corporate business department), risk management department, department of compliance and legal affairs. Meanwhile, other key business departments and units are also interviewed, such as the investment banking department, institutional clients department, and pension fund department. All the selected departments are at the head office level and most of the interviewees are middle-ranked bank managers with over 10 years of banking practice and management, and play practically key functions in the department.

Theoretically, there are mainly three categories of interviews, structured-interviews, semi-structured interviews, and non-structured interviews. The structured interview, perceived from the positivism, aims to generate data that are valid and reliable. Frequently, this is achieved by 'random selection of the interview sample and administration of standardized questions' (Silverman, 2011, p168). The semi-structured interviews, based on the constructivism, engage both the interviewers and interviewees to construct the meaning of the event and 'the interviews are treated as topics rather than a research source' (Silverman, 2011, p168). The unstructured or open-ended interviews, according to the emotionism, is purported to gain authentic insight into people's experience (Silverman, 2011). Considering the specialty of the research subject and accessibility to the sampled banking organizations, the researcher chooses the semi-structured interviews as the main tool to collect the primary data, complemented by the non-structured interviews.

*Data collection*

With a clear interview schedule, the researcher proceeds with the interviews in different steps. First, a documentary study on the sampled banks and selected departments is conducted by means of the websites, the annual reports, and official registration documents. Meanwhile, though comparatively limited in amount and value, a brief literature review is taken regarding the sampled banks and departments to be interviewed. Moreover, a general comparative study with other sampled banks and departments is prepared before the interview.

Secondly, emails and phone calls for interviews are arranged in advance. By emails, the researcher briefly introduces the research subject, the wish to interview, the key interview questions, and the time and place for interviews. Frequently, this is done a week in advance. On the day before the interview, the researcher emails and calls the interviewee for reconfirmation of the interviews. After the interviews, the researcher often emails or makes phone to the interviewee for thanks for his/her support for the research. Periodically, the researcher emails to the interviewee for update of the latest development in the bank and the specific departments.

As an efficient way of conducting more extensive qualitative interviews, the snowballing method is used in the present research to access to relevant departments of the bank and other sampled banks. Frequently, after interviewing certain interviewees (the targeted interviewee mainly) whom the research already establishes contacts, the researcher asks for the courtesy from the interviewee to be introduced to key personals in other departments of the bank or same department in other sampled banks. The strategy of snowballing sometimes does not work in the context of Chinese banks and the researcher is refused politely for several occasions.

At the beginning of each interview, the researcher briefly introduces the research subject, the outline of questions for the interview, the proposed use for the interview materials, and the confidentiality policy and document regarding the interview. For interview questions, there are mainly two categories, general questions and specific questions. The general questions relate to the general function of the interviewed department, the conception of corporate governance by the interviewee, the factors affecting the formation of corporate governance, and the role of the department in the bank's governance structure. The specific questions involve the particular role of the department in corporate governance of the bank, key factors in shaping such functions, and comparisons with counterpart departments in other banks.

There are 22 interviews accomplished for the sampled Chinese banks, which were mainly accomplished between April 2012 and August 2012. Apart from 4 interviews which were conducted by telephone, all the interviews were conducted face to face. Taking into account of the different typicality and significance of the sampled banks in Chinese banking industry and national economy, along with concerns for accessibility, priorities are arranged henceforth. For instance, considering the modeling effects of Bank A regarding corporate governance and the unique status of Bank B in Chinese banking sector, more interviews are arranged, with the former of 10 interviews and the latter of 6 interviews. Generally, the interview takes place in the conference room of the interviewed department of the bank and lasts from 60 to 80 minutes. Sometimes, the interview, typically the non-structured interview, is conducted in a less formal venue, such a coffee or tea bar in the building of the bank and lasts around one hour. Due to the confidentiality policy in sampled banks and sensitivity to recording by the interviewees, all the interviews have to be recorded by note-taking.

*Quantitative data*

'Data are the eyes and ears we use to see and hear what is happening in the financial and economic world' (Cecchetti, Fender and McGuire, 2010, p3). Considering its merits of generality and wider application, the present research also uses the quantitative data to compare and complement the qualitative data, henceforth enhancing the viability of the research. Based on the nature, purpose and specialty of the quantitative data, the present research classifies the

**Table 1.1 Key Sampled Questions for Interviews**

| Categories of Questions | Questions | |
|---|---|---|
| General questions | Would you introduce your department?<br>Would you introduce your role in the department?<br>How do you perceive corporate governance of the bank?<br>How do you perceive the role of your department in corporate governance in the bank?<br>What factors do you think will affect and change the corporate governance of the bank? | |
| Specific questions | Research and Strategic Development Department | What is the corporate governance structure of the bank?<br>What factors play key role in shaping and changing the governance structure of the bank?<br>What is role of board of directors in corporate governance of the bank?<br>The orientation, composition, and specialty of the bank board? |
| | Risk Management Department and Credit Granting Department | What is the risk management framework of the bank?<br>How such risk management framework shaped and developed in the governance structure of the bank?<br>What is the risk appetite of the bank?<br>What is the key risk management of the bank? Are there any specific measures developed for it? |

**Table 1.1 Key Sampled Questions for Interviews --- Continued**

| | | |
|---|---|---|
| | Pension fund business department | What is the composition of the executive pay? How is such composition formed?<br>What measures are employed in the pay regulations for the bank executives?<br>What are responses from the bank executives to the pay regulation? Are there any differences between the senior and middle-ranked management?<br>What other factors may be considered for the regulation on executive pay in banks? |
| | Compliance/Legal Affair Department | What are key legal duties in the bank?<br>What is the role of legal obligation in corporate governance structure of the bank?<br>What are factors to be considered when forming the structure of legal obligations in the bank?<br>What is the specific mechanism developed for monitoring the implementation of the legal obligations of the bank? |

secondary data into three groups, macro, meso, and micro, which echoes the three-tier view of corporate governance in banking organizations and institutional analysis from perspectives of legitimacy, paradigm and frame. The macro data focuses upon mainly the database by the national statistics bureau and financial regulators such as PBC, CBRC, and MoF, along with international organizations like BIS, IMF, and the World Bank. The meso data is mainly collected from academic related databases and sometimes intertwines with the macro and micro data. The micro data is mainly obtained from the stock exchange (Shanghai Stock Exchange and Shenzhen Stock Exchange, for instance), the annual and temporary reports by the bank and the banking association, and the bank's websites. Used in different parts of the thesis and for different aspects of corporate governance in Chinese banking organizations, arrangement of the quantitative data in this way may facilitate a better understanding of the studied subject, and help cross-examine, compare and adjust the data for better viability of the research.

*Data analysis*

For better accuracy, the interview materials are transcribed immediately after the interview is completed, and the transcription is then translated into English as interviews on sampled Chinese banks are recorded in Chinese. Key nodes are developed to code all the transcribed interview materials, which facilitate comparing data from different interviewees. These include corporate governance, risk management, compliance, legal obligations, the board of directors, bank and real economy, financial regulation, international influence, legal guidance. Meanwhile, software like Nvivo 8 is used for efficient processing and analysis of data from the interviews.

Different groups of secondary data are collected and processed in the present research. Some data is more 'prepared', such as data collected and analyzed by other researchers, provided in official statistics, or from analytical reports by public or private sectors. Other data, however, is less obtainable. By hard working and time-consuming data-mining, the researcher hand collects significant data on specific governance issues in different banks, comparative data on same issue across different banks in different countries, and data hidden deeply and randomly in the website of relevant banks. Software like SPSS and Excel are employed to process with the data analysis and illustration in the research.

### 1.3.3 Reliability and validity

To enhance the reliability and validity of the present research, the researcher employs some specific approaches, such as the triangulation method, update of the data, and relevant personal research experience.

Originating from positioning geometry where 'one position in space is determined in relation to some stable and objectively verifiable reference points' (Modell, 2009, p213), the triangulation method is valuable in its use of multiple theories, methods, data source to enhance the validity of the research findings (Denzin, 1978; Jick, 1979). Specifically, this method is valuable in reducing the bias while affording the researcher complementary strength and non-overlapping weakness (from the qualitative and quantitative method) to better capture some 'unified social reality' (Modell, 2009). The present thesis, by use of the triangulation method, employs a mix of different methods and data to provide efficient means to ensure the viability of the research. For instance, by combing the qualitative and quantitative method and comparing the qualitative and quantitative data, the researcher can have a more unbiased and paramount view of the research questions. This is accomplished by sorting out and comparing related data from interview materials and those collected in the secondary data. By testing the consistency of these two sets of data, the present research can better ensure the reliability of the research output.

Secondly, the present research lays specific emphasis on updating relevant data and information to keep pace with latest developments in corporate governance in banking organizations. For instance, the researcher periodically reviews the websites of related financial regulators, sampled banks, and banking associations to be informed of significant changes in policies, regulations and banking practice. The researcher also keeps in touch with the interviewees and emails or makes phone calls to be updated of the status quo of the sampled banks. In this way, the researcher can largely control the reliability problems caused by outdated information.

The viability of the research is further enhanced by the researcher's personal working and research experience and close ties with Chinese banking industry. With years of teaching and research on corporate governance and financial law in the top university in China, the researcher has a better understanding of corporate governance in Chinese banks. This is further re-enhanced by the research's alumni and research ties to Chinese banking industry, which bring about vivid and diverse pictures through the lens of the banking professionals.

### 1.4 Overview of the chapters

In general, the present thesis is divided into three parts. Part I, including the present Chapter and Chapter Two and Three, aims to introduce the thesis, and set up the theoretical approach to be taken for analyzing corporate governance in banking organizations. Chapter Two explores the extant theories on corporate governance. By presenting a new 'three scope view' on corporate governance, from micro to macro, the chapter analyzes the diverse institutional settings of corporate governance in different national configurations, and summarizes the dominant competing models, which includes the Anglo-Saxon model, Continental model, and State-affected model. Meanwhile, the chapter elaborates on some key practices in corporate governance, such as the ownership structure, the practice of the board of directors, code of corporate governance, and legal duties. Chapter Three reinvigorates the implicit institutionalism of the VoC literature by drawing on the recent development of discursive institutional theory, and analyzes corporate governance by differentiating and exploring three levels of discourses: legitimacy, paradigm and frame. Legitimacy in corporate governance is shown to involve the pubic sentiments and popular cognitions present in diverse forms of capitalisms, which constitute the legitimate roles that corporations are expected to perform across varieties of capitalisms. The paradigm is, as sedimented institutional arrangements in corporate governance, typically referred to as different models of corporate governance. Such models are specifically useful in explaining the constitutive and competing conceptions of how corporate governance can and should be organized, including the so-called 'shareholder model', 'stakeholder model', 'state affected model'. The frame, embedded in routine and mundane practices of corporate governance, includes specific governance structures like the ownership structure, the organization and activities of the board of directors, the code of corporate governance, and legal duties.

Part II, comprising Chapters Four and Five, proceeds to discuss the details of corporate governance in banking organizations through the lenses provided by the discursive institutionalism toolkit. Chapter Four, as the first cut of the theoretical analysis in Part II, focuses on corporate governance in banking organizations at the level of legitimacy and paradigm. At the legitimacy level, the chapter explores how corporate governance in the bank is legitimized by the discourse of the relationship between the bank and the economy, the influence of the financial regulation, and the role of legal interventions. These discursive institutions of legitimacy provide implications for the constitution of the discourses on paradigm and frame. At the paradigm level, this chapter compares and contrasts different models of corporate governance in the context of the banking industry, namely, the shareholder primacy model, the stakeholder model, and the state-affected model. Such paradigm discourse, as constitutive ideas, provides great significance in shaping the frames in the bank governance structure. Chapter Five continues the discursive institutional approach and explores discourse at the level of frames, the specific governance structure in practice, in banks across different models. Discursive frames pertain to four pivotal sets of subjects, the organization and behavior of the board of directors of the bank, regulation on executive pay, risk management, and legal duties. Specifically, as a manifestation of the varied discourses of legitimacy and paradigm, frames are analyzed in this chapter in terms of how they are arranged and differentiated in varied models. The discussion of the board of the bank illustrates how different paradigm and legitimacy are represented in the orientation of the board of directors, the size of the board, and its independence. Regulation on executive pay, on the other hand, presents the implication of varied paradigm and legitimacy on the composition of the executive remuneration and differentiated regulative measures. The analysis of risk management, as a pivotal issue in the banking industry, manifests how the national legitimacy and paradigm co-function to constitute the conceptions of different risks, the overall risk management framework, and the specific risk management arrangement. The legal duties of the bank, mainly the compliance duty and fiduciary duty, represent the influence of different paradigm and legitimacy in shaping the boundary of the bank's responsibilities and the liabilities by the bank board directors and management.

Part III, from empirical perspective, provides in-depth canvass of corporate governance in Chinese banking organizations, and comprises Chapter Six, Seven, Eight, and Nine. The aim is to deepen the understanding of corporate governance in banking organizations in China through a discursive institutionalism framework, which elaborates, from more pragmatic perspectives, the legitimacy, paradigm and frame of the governance structure in Chinese banking industry. Chapter Six focuses upon the legitimacy of corporate governance in Chinese banks based upon the discourses regarding the bank's close ties with macro economy, intimately intertwining with industries and different enterprises, strong policy orientation in the context of administrative control and governance by the regulators, gradual and careful financial deregulation movements, increasing though limited legal interventions, and strong international impacts. Against this backdrop, in Chapter Seven, the paradigm of bank governance in China is found to be a hybrid of the enhanced shareholder primacy model and the diversified stakeholder model. Chapter Eight and Nine, as the finale chapters of the present thesis, focus upon the frames of corporate governance in Chinese bank. By putting together the puzzles from all the previous chapters, these chapters examine the representation of 'ideas' discussed in legitimacy and paradigms in specific organizational arrangement, business operations and financial practices by sampled Chinese banks. Chapter Eight explores the subjects of the board of directors and senior management in Chinese banking organizations, including the organization and practice of the board of directors and regulation on compensation for senior management. Chapter Nine, continuing the frame analysis, explores risk management and legal duties in Chinese banking industry.

**Part I Theoretical Framework in Corporate Governance**

Chapter One Introduction

Chapter Two Extant Theories of Corporate Governance

Chapter Three A Discursive Institutional Approach to Corporate Governance

**Part II Corporate Governance in Banking Organizations**

Chapter Four Corporate Governance in Banking Organizations (I): Legitimacy and Paradigm

Chapter Five Corporate Governance in Banking Organizations (II): Frame

**Part III Corporate Governance in Banking Organizations in China**

Chapter Six Corporate Governance in Banking Organizations in China (I): Legitimacy

Chapter Seven Corporate Governance in Banking Organizations in China (II): Paradigm

Chapter Eight Corporate Governance in Banking Organizations in China (III): Frame (1)

Chapter Nine Corporate Governance in Banking Organizations in China (III): Frame (2)

Conclusion

## 1.5 Contribution

In contrast with the more popular study on corporate governance of generic firms in China, the thesis focuses on the less explored specific governance structure in Chinese banking organizations, which are in many aspects unique due to the industrial specialty and the bank's tremendous influence on the economy and society at large, best represented in the 2007-2009 financial crises. Distinguished from the peer research on corporate governance in Chinese banks, which largely concentrates on certain aspects of the governance structure, the thesis contributes by presenting a rich, in-depth and dynamic study on the key mechanisms in corporate governance in Chinese banking organizations, including the organization and behavior of the board of directors, regulation on executive pay, risk management and the legal duties, all of which are in hot debate by scholars from fields of corporate governance, finance and banking ever since the passing financial crisis. A unique contribution by the present thesis lays in the dynamic analysis of corporate governance in Chinese banks from more paramount institutional angles, which explore the specific Chinese institutional national settings, dominant orientations in Chinese banks, and their manifestation in the key practices of corporate governance arrangement.

Theoretically, the present thesis contributes to the study on corporate governance in banking organizations by applying the discursive institutional approach, which is distinguished from the conventional economic, political or institutional approach. By bring together the VoC analysis with the discursive institutional analytical framework, the present research presents an in-depth reinvigorating on how corporate governance in banking organizations is constituted from three levels of discourses. At the level of legitimacy, the present research innovates an exploration on how corporate governance in banking organizations is legitimized and accepted at large in Chinese national institutional settings, involving the inter-relationship between the bank and the economy, the financial regulation, and the legal obligation. Such legitimacy, as the discourse at the background of cognition, provides a profound implication for the discourses at the level of paradigm and frame as the foreground of ideas. At the next level of ideas, the thesis demonstrates how corporate governance in banks is conceptualized and constituted through the paradigm, which resonates with the legitimacy while providing further implications for the formation of specific governance in Chinese banks. With extensive elaboration on the discourse of frame, the thesis highlights on how the solutions are sorted out for specific corporate governance mechanisms in banking organizations in the context of different legitimacy and paradigm. Meanwhile, the thesis also reflects on the dynamics between these three levels of discourses.

# Chapter Two Extant Theories of Corporate Governance

## 2.1 Introduction

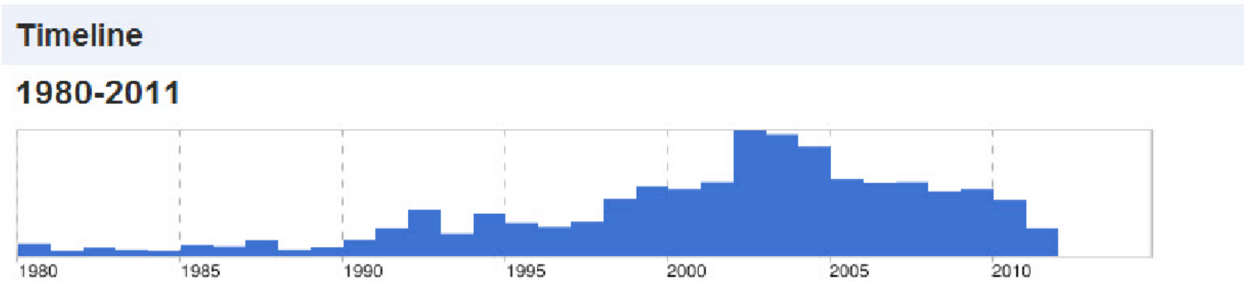
Introducing the academic debate relevant to the thesis, this chapter explores the extant theories on corporate governance. It begins with a new three-level 'scope view' on the conception of corporate governance, from micro level to macro level. On this basis, the chapter proceeds to the analysis of diverse institutional settings of corporate governance in different national configurations, which presents the grounds for the formation of corporate governance. This is followed by a summary of competing models, embracing the Anglo-Saxon model, Continental model, State-affected model and family control model. Next is a brief summary of important and controversial issues relating to contemporary practices of corporate governance, including the ownership structure, the practice of board of directors, code of corporate governance, and legal duties. The chapter lays the foundation for the understanding of corporate governance in banking organizations that is developed in the following chapters in Part II of the thesis.

## 2.2 Conceptions of corporate governance

Even since 1980s, there has been a wide coverage of corporate governance issues, especially in the wave of economic crises, such as the 1997 Asian financial crisis, the 2002 US Enron debacle, and the 2007-2009 financial crises, as illustrated in Table 2.1. And its importance is gaining more and more attention at international, national and firm level. Though the term 'corporate governance' occurs constantly in academic literature, policy documents, and legislations, its conception varies in the context of different national institutional settings, various orientations by different interest groups, and complicated arrangements of specific governance structure. Observing through 'carefully designed scopes', the present thesis summarizes corporate governance into the following three views, the micro/microscopic, meso/telescopic and macro/kaleidoscopic (Preda, 2009), with each embodying distinctive ideas, interests and frameworks.

The microscope view of corporate governance observes mainly the endogenous and micro aspects of the corporation while intentionally isolating other entities, actors or elements, like the laboratory observation of viruses or bacteria though the microscope. This narrowest boundary of corporate governance presents an in-depth 'pure' view of the corporation as an independent 'being'. For instance, many scholars argue that explanation of corporate governance should focus on the protection of returns of the financial investment by the investor/shareholders (Shleifer and Vishny, 1997), and the maximization of their economic interests in the context of separation of ownership and management in the corporation. And, for such scholars, the main concern in corporate governance is the agency problem, i.e. the agent's (the management) entrenchment at the price of the principal's (shareholders) interests (Jensen and Meckling, 1976; Fama and Jensen, 1983). Other microscopic studies pertain to issues such as enhancement in corporate performance, the ownership structure, the organizational structure and activities of the board of directors, and the mechanisms of information disclosure and transparency (Durisin and Puzone, 2009).

**Table 2.1 News coverage of 'corporate governance' from Google news: 1980 - 2011**




Source: Google News Statistics, 25 th March, 2011

Taking another scope, some scholars argue, especially during the 2007-2009 financial crises, that the corporate governance should be an arrangement among a great variety of participants shaped by the general macro political, economic, and legal environments (Dignam& Galanis, 2008). This kaleidoscopic view of corporate governance observes the corporation in its relationship to broader economic, social and political institutions. And, this view often highlights the divergence of corporate governance in different countries which have their own specific political, economic, legal, social and cultural arrangements. Patterns of corporate governance borrowed from other countries, even if in the 'advanced' stage, do not function properly in the borrowing countries as the institutional incompatibility will greatly hinder its subjective cognition and practical implementation. For instance, regarding the shaping of code of corporate governance, Herme (2007) finds that different domestic forces determine the contents of code of corporate governance and the very different national contexts where firms are embedded will lead to a wide diversity of approaches to corporate governance. Specifically, the code of corporate governance must capture the socio-political and economic environment in which firms operate (Okike, 2007; Aguilera and Cuervo, 2009), especially in the developing and transition economies where there are abundant national and development-stage specialties (Reaz and Hossain, 2007).

A meso or telescope view of corporate governance, meanwhile, observes the relationship between corporation and other entities and actors like creditors, regulators and employees. Such boundary of corporate governance is like the observation of relationship between different planets and stars through the astronomical instrument. It defines the corporate governance as a set of rules or a mechanism regarding the relationship among shareholders, management, stakeholders and the society, and a good governance structure should provide an efficient framework to achieve the corporate objectives as well as effective monitoring on the corporate performance (Williamson, 1984). In this sense, the corporation should take into account the overall interests of different constituent groups apart from the shareholders, including but not limited to employees, creditors, suppliers and customers (Freeman, 1984; Donaldson and Preston, 1995). The participation of such wider interests groups in the governance process will not only help protect their interests, but help the corporation enhance its governance structure to survive and succeed in the rapidly changing environment (Collier and Esteban, 1999). Also, such meso level corporate governance arrangements may motivate the managers, in their roles of stewardship and entrepreneurship, to improve the business of the corporation (Keasy and Wright, 1997), resist short term pressures from the corporate financial market, and encourage the long-term investment decisions (Biswas and Bhuiyan, 2008).

The present thesis, instead of favoring any of the afore-said conceptions of corporate governance, argues that corporate governance is a composite of the 'three scope' views. First, from the micro perspective, the corporate governance is a set of well designed structure 'thorough which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined' and it is expected to 'provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders, and should facilitate effective monitoring' (OECD, 2004, p11). Secondly, illustrating the meso view, corporate governance involves a set of complicated relationship 'between a company's management, its board, its shareholders and other stakeholders' (OECD, 2004, p11), and is greatly influenced by the dynamics between these diversified participants. Frequently, the divergence in any of these participants may lead to some different governance pattern while a specific pattern may influence the roles by different participants in shaping a new governance structure. Thirdly, corporate governance is also shaped by the macro factors, such as the economic, legal, and regulatory environments, which can be further categorized into macroeconomic policies (OECD, 2004). This 'three scope' view on corporate governance enables the present thesis to theorize corporate governance from the perspectives of the (macro) institutional settings, the (meso) varied models and theories, and (micro) key practices in different national configurations, mainly categorized into the Anglo-Saxon model, and the Continental model, as illustrated in Table 2.2. Moreover, other models like the state-affected model and family-group control model will also be briefly reviewed.

## 2.3 Institutional settings

Institutional settings of corporate governance vary in different national configurations and pertain to the economic institutions, regulatory environment and legal involvement, as echoing the kaleidoscope view of corporate governance. For corporate governance in what is usually referred to as the Anglo-Saxon countries, there is strong orientation towards economic efficiency, maximization of private wealth under equal situations, pro-competitive deregulation by the government, and strong legal protections by independent court systems. Specifically, it is characterized by an arm's length relationship between different entities, like regulators, corporations and banks (Hall and Sockie, 2001b). Corporate governance in the Anglo-Saxon countries follows from the privileged place of capital markets in corporate finance, and the 'success' of 'good governance' is judged in terms of its capability in maximizing returns for its investors. Although bank relations are also significant, especially in hard times, the bank-firm relationship follows an arm's length pattern and the bank is less powerful in monitoring and controlling the invested corporations. The shares of the corporation are highly dispersed, either held by individual investors or institutional investors, and is actively traded in the capital market (Vogel, 1996; Allen and Gale, 2002). To mitigate the effects of information asymmetry in such decentralized market, a high level of transparency is demanded. For instance, financial reporting are required to be prepared by the auditors and periodically reviewed by the investors and analysts. Fight for corporate control, always in the form of antagonistic merger and acquisition, is fairly active and mainly exercised through the takeover markets. Moreover, the government plays a passive role and seldom intervenes (Hall and Sockie, 2001b; Allen and Gale, 2002).

Table 2.2 Institutional Settings, Theories and Practices of Corporate Governance in Different Models

| Category of countries | Institutional settings | Models | Key practices |
|---|---|---|---|
| **The Anglo-Saxon Model** | Dominant market institutions and arm's length relationship between different market participants;<br>Economic efficiency for investors in pursuit of maximized interests;<br>Pro-competitive deregulation by the government;<br>Strong legal protection for property and contractual rights. | Shareholder supremacy theory;<br>Agency theory and solutions for principal-agent problems;<br>Sub-current stewardship theory. | Dispersed ownership structure and bias against concentrated ownership, with key role by capital market instead of banks, and shareholding by management;<br>One-tier board of directors focusing upon corporate performance, with emphasis on independence and professional qualifications;<br>Significant role of the self-regulatory code of corporate governance with 'comply or explain' rule;<br>Sophisticated and workable judicial framework for key issues in corporate actions, and more specific and higher standards for legal duties. |

**Table 2.2 Institutional Settings, Theories and Practices of Corporate Governance in Different Models ---Continued**

| Category of countries | Institutional settings | Models | Key practices |
|---|---|---|---|
| **The Continental Model** | Coordination of different interests groups for a balanced outcome;<br>Active orchestration and guidance by the government in economic activities and relatively close relationship between market participants;<br>Limited legal protections. | Stakeholder theory;<br>Principal – principal problems. | Favoured concentrated ownership structure, with key role by banks instead of capital market;<br>Two-tier board of directors focusing on balancing interests between all stakeholders, with internal coordination and relevant lax independence and qualification requirements;<br>Significant roles by corporate statutes and laws, complemented by code of corporate governance as self-regulatory orientations;<br>Limited judicial functions in corporate actions, with less detailed and workable principles |

In contrast, institutional settings in the Continental countries are characterized by coordination and close relationship between the government, banks, corporations and labor, represented by Germany and Japan (Hall and Sockie, 2001a). Though the government apparently takes a liberal posture and promotes self-regulation by the corporation, it is actively involved in facilitating business activities and guiding industrial development. Capital markets are comparatively less developed and restricted in size, and the corporations are mainly financed by the retained earnings and bank loans. The former may result from institutional and legal incentives, which encourage the corporation to accumulate their own reserves, such as high corporate taxation and allowance for accelerated depreciation. The latter originates from the bank's active lending activities to the generic firms and its unique status in corporate governance of the enterprises (Allen and Gale, 2002). In this context, concentrated ownership, typically in forms of block holding and cross holding, is quite popular in the Continental countries and bank-industrial cross-holding relationship are much stronger. These result from a closer collaborative system where the government bureaucrats, corporate managers, bankers and political parties have some shared aims for the sake of economic development. Targeted at long-term interests and sustainable development, the management of the corporations is encouraged to hold the investors 'patient' and focus on returns of capital gains and collateral business in the long run, rather than paying immediate high dividends to investors (Vogel, 1996; Allen and Gale, 2002). Due to the existence of active and controlling shareholders, there is less need for transparency, and information disclosure is only drawn up to meet tax and reporting obligations rather than informing the public shareholders. Meanwhile, the corporate control market is inactive and takeovers are fairly rare. Even in events of merger and acquisition, the transactions are mainly based on inside information and friendly negotiation instead of the hostile take-over which marks the Anglo-Saxon model (Hall and Sockie, 2001a; Allen and Gale, 2002).

In the State-affected countries, typically represented by France, the institutional settings are characterized by the dominant role of the government in controlling corporations by means of national ownership, direct appointment of quasi-official directors in banks and public corporations, and strict regulations (Goyer, 2003). The funding of the corporation is mainly provided by the bank, while the development of the capital market is comparatively limited. In particular, it is always the state that controls the key commercial banks, and a state-controlled pattern is set in place in allocating credit resources to the corporations and determines the price of such credit. Other funding channels, like policy loans, government subsidy and tax preference treatment, are also provided to encourage the development of specific sectors, industries or corporations, which are considered as strategically important for national economy (Chang, 1996; Deyo, 1989; Woo, 1991). Meanwhile, senior managers in the corporation are frequently assigned by the government and initiated by bureaucratic promotion. And, instead of pursuing short-term profit maximization, the corporate managers hold themselves as long-term committed, seek the long-termism of the corporation development, and are accountable for the national economic development (Kang, 2008). In addition, close interconnectivity through informal state networks, based upon state-related education and experience, helps form better inter-corporation coordination, information sharing, and cooperation on corporate strategies (Hanche, 2002; Schmidt, 2002a). The market for corporate control is significantly affected by the government and in the instances of take-over battles, financial regulators frequently play a determining role in the outcome (Hall and Sockie, 2001b).

## 2.4 Different models and theories

Constantly argued in corporate governance literatures, several models of corporate governance can be distinguished based on varied orientations and relationship between multiple participants, which resonates with the telescope view of corporate governance. Traditionally, the Anglo-Saxon model and the Continental model of corporate governance have been dominating this field, although other models have been identified to some extent, such as the state-affected model, family-group control model (in some East Asia countries) and insider control model (in countries of transitional periods).

### 2.4.1 The Anglo-Saxon model

The Anglo-Saxon model, also known as the shareholder primacy model (Jensen and Meckling, 1976; Shleifer and Vishny, 1997; Becht, 2002), originates in America and Britain and is followed by Canada, Australia and some other common law countries. It is oriented towards maximizing shareholders' rights and interests while subordinating other stakeholders' claims. This theory is grounded on the status of the investor as the owner of the corporation, whose private property rights and interests are entitled to protection. Alternatively, the shareholder is taken as the residual claimant who takes the final residual risk in the event of corporate failures (Alchian and Demsetz, 1972; Fama and Jesnen, 1976). Meanwhile, the maximization of shareholder values is viewed as propelling the superior economic performance of the corporation and the economy as whole (Fama and Jensen, 1976)

The major concern in the Anglo-Saxon model is the agency problem, also known as the principal-agent problem, which arises from the separation of ownership from control of the corporation, with the investors owning the corporation while the managers controlling it (Berle and Means, 1932; Jensen Meckling, 1976; Shleifer Vishny, 1986; Demsetz, 1985; Eisenhardt, 1989). It is said to occur when 'one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.' In addition, 'if both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal' (Jensen Meckling, 1976, p 334). This is further aggravated by the differing preferences of the owners and the managers, information asymmetry in the corporation, and different time horizons and risk appetites (Eisenhardt, 1989; Pettigrew, 1973).

Many solutions are proposed for mitigating such agency problem. Some scholars favor general contracts between the investors and the management, the incentive contract for the management's compensation, and the disciplinary reputation mechanism (Shleifer Vishny, 1986, 1997; La Porte, 1997, 1998, 1999, 2000). Other scholars believe in the discipline of efficient market and design relevant market mechanisms to mitigate the agency problem, such as strict monitoring, efficient market for corporate control and management labor, and better transparency (Learmount, 2002). Though these delicately designed mechanisms can alleviate the agency problem to some extent, they can not totally eliminate the problem (Shleifer Vishny, 1997).

Although a concern with the agency problem dominates in corporate governance in the so-called Anglo-Saxon model, a subset of competing theories is developed based upon the management homogeneity, typically represented by the stewardship theory. Instead of focusing the conflict of interests between the management (the agent) and the owner (the principal), the stewardship theory contends that the managers should be positioned as good stewards, and in pursuing the best performance of the enterprise, they can both maximize the shareholders' interests and bring satisfaction to other stakeholders. 'A steward protects and maximizes shareholder's wealth through firm performance, because, by so doing, the steward's utility functions are maximized.' And 'a steward who successfully improves the performance of the organization generally satisfies most groups, because most stakeholder groups having interests that are well served by increasing organization wealth.'(Donaldson and Davis, 1991, p154).

### 2.4.2 The Continental model

In contrast, the Continental model of corporate governance, also known as the stakeholder model (Cochran and Wartick, 1988), is typically said with the extant literature to broadly reflect German corporate governance mechanism. This model is also said to characterize corporate governance in Japan, Austria and other European countries with variances. Alongside the shareholders' benefits, this model takes into account the stakeholders' interests and often balances them in case of conflicts.

As the dominant concern in the continental model, the stakeholder theory argues that the corporation is an organization composed of different groups of stakeholders and its purpose is to manage their interests, needs and viewpoints (Dodd, 1933; Freeman, 1984, Freeman and Reed, 1990; Donaldson and Preston, 1995, Clarkson, 1995, Clarke and Clegg, 2000; Friedman, 2006). The stakeholder is classically defined as any group or individual who can affect, or be affected by the achievement of the organization's objectives (Freeman, 1984). The management is expected to manage the corporation for the benefits of its stakeholders and promote their rights and participation in decision-making process (Donaldson and Preston, 1995). This implies that the managers, apart from acting as the shareholders' agent to ensure the survival of the firm, have to safeguard the long-term stakes of each interest group. In this context, the management is expected to integrate the various relationships and interests of the shareholders and different stakeholders in a way that guarantees the long-term success of the firm (Freeman, 1984).

Another significant characteristic of the Continental model of corporate governance is the existence of large and controlling shareholders, who are either banks or other corporations by way of cross holding or block holding (Barclay and Pontiff, 1993; Becht and RNoell, 1999; Bebchuk, and Kraakman, 1999). As large shareholders are motivated to collect information on the corporation, monitor the managers closely, and impose great pressure upon the management regarding significant decisions, the agency problem popular in the Anglo-Saxon model is said to be less severe. The existence of large investors afford other merits as well, including an effective governing system, better performance by the managers, and less dependence on judicial systems. However, the control by large shareholders causes another problem in corporate governance, namely, the principal-principal problem (Shleifer Vishny, 1997). In contrast with the traditional principal-agent conflict in Anglo-Saxon model, inherent in the Continental model of corporate governance is a principal-principal conflict, which mainly arises between majority (controlling shareholders) and minority shareholders because of the existence of the large and controlling shareholdings (Shleifer Vishny, 1997). Such concentrated ownership leads to imbalanced powers in the corporation, such as appointment and control of the director and management, bias in major policies (investment opportunities, dividend pay-out police), and insider transactions, which results in expropriation much resembling that in principal-agent conflict (Young, Peng, Ahlstrom, Bruton and Jiang, 2008). Typically, such problem can be seen as a product of concentrated ownership and control by the business groups, state, or family structure, where legal protection for minority shareholders is weak.

### 2.4.3 Other models and relevant theories

Apart from the aforementioned models, other types of corporate governance models are identified by the extant literature. These include the state-affected model (in France), family group control model in (South-east Asia), and models in transitional economies like former Soviet Union countries. These models, though less influential in debate in the extant theories than the shareholder or stakeholder model, have their distinctive forms and specific features.

For instance, the state-affected model, which is said to be typically prevalent in France and many transitional economies, is unique in its governance arrangement. Its corporate governance system is by nature a 'hybrid' model, though close to the 'stakeholders' approach (Blazy, Boughanmi, Deffains and Guigou, 2011). Instead of arguing the merits of the shareholder primacy theory or the stakeholder theory, this model is frequently concerned with the state as the majority shareholder of the corporation, which pursues economic policy objectives and specified national development strategies (Schmidt, 2003; Kang, 2006). Interestingly, both principal-agent and principal-principal problems can be found in this model due to the existence of government as the owner and majority shareholder of the corporation. Though it may have merits in coordinating and facilitating the growth and development of national economies in certain periods of time, this model may limit corporate capacity for responding to the dynamics of global market competition.

The family control model, meanwhile, is characterized by the main owner's (family) active and decisive role in the key-decision-making of the firm (Daily and Dollinger, 1992; Melin and Nordqvist, 2000) and the governance structure is primarily targeted at facilitating the owner of the firm to realize their particular vision, goals and objectives (Melin and Nordqvist, 2000). This model is said to overcome agency costs due to the duality of the manager and owner (Randoy, 2003; Schulze, 2003), and is held to provide for long term perspective (Cadbury, 2000) and altruistic behavior and trust (Berghe and Carchon, 2003; De Paola and Scoppa, 2001). On the flip side, however, this model is associated with costs and inefficiencies, such as prioritizing family interests over the firm's interests due to family loyalty (Randoy, 2003; Schulze, 2003), more significant monitoring costs (Berghe and Carchon, 2003), and opportunistic behaviors by the non-family members (Baldridge and Schulze, 1999).

### 2.4.4 Dynamics in corporate governance and convergence

Once identified by the extant literature, the afore-mentioned models provide the basis for analysis of dynamics between the models. For instance, with the presence and increasing power of the institutional investors (typically the pension funds and mutual funds) in the Anglo-Saxon model since 1980s, shareholder activism and concentrated control have come to be viewed as limiting the enormous powers held by the board of directors regarding some significant and controversial issues in corporate governance, such as executive pay, merger and acquisition. Also, protection for the stakeholders has become a feature of this model, observable in increasing legislations which stress on the consideration for the interests of various constituencies of the corporation (US, Frank-Dodd Act, 2010; UK Company Law, 1980). For the Continental model, meanwhile, some scholars argue for the prevailing of shareholder primacy theory, the maximization of shareholders' interests, and the best performance of the corporation (Gordon, 1999)

This brings in the discussion of convergence of corporate governance. In the extant literature on corporate governance, there is a wide debate upon the convergence of corporate governance. The proponents for convergence argue that the convergence of corporate governance is inevitable in the context of globalization, especially the integration of financial markets and product markets. With free flow of capital, the financial markets around the world are closely integrated and is said to become a key drive for the convergence of corporate governance (Nestor and Thompson, 2000; Khanna and Palepu, 2004). The integration of the financial markets takes many forms, such as listings of the firm in multiple stock exchange across different countries (Chemmanur and Fulghieri, 2006; Bell, Moore and Al-Shammari, 2008), massive increase in foreign portfolio investment in both developed and developing countries (Useem, 1998), increasing cross-border merger and acquisitions, and fast expansion of multinational corporations over the world. These drive the corporations, especially those transnational ones, to converge their corporate governance in order to operate legally and legitimately around the world. Another contributory factor for convergence is the integration of the product market against the backdrop of intensifying global competition (Khanna and Palepu, 2004).

Regarded as a mechanism, technology or innovation, corporate governance is developed to gain more competitiveness and higher efficiency to survive the fierce market competition (Kester, 1997). This presses the firms to converge to similar optimal governance structure and take similar strategic mechanisms (Kogut, Walker and Anand, 2002). Meanwhile, international efforts further spur the trend of convergence of corporate governance. For instance, OECD (2000, 2004) and World Bank (2001) have established the principle for good corporate governance, which are actively promoted to its member countries and countries receiving their financial assistance. Other international organizations, like International Corporate Governance Network, the International Accounting Standards Committee, and the International Organization of Securities Commissions, also disseminate complementary common standards related to corporate governance, such as accounting rules, principles of internal control and disclosure.

On the flip side, the opponents of convergence of corporate governance argue that corporate governance systems in diverse national institutional settings, in practice, do not race to the presumed converged model (Aguilera and Jackson, 2003). Even if there are changes in the existing models of corporate governance, they are mainly caused by endogenous factors rather than direct international influences towards convergence (Hermes, Postma and Zivkov, 2006). Varied theories are developed to explain the divergence of corporate governance. The path dependence theory argues the present form of corporate governance is greatly influenced by the initial institutional settings (Bebchuk and Roe, 1999; North, 1990, 2005). And, corporate governance in a certain country frequently resonates with its specific institutional environment and will not be converged easily. The complementarities argument contends that the present corporate governance structure in a certain country is a 'system of complementary institutions, legal rules, and practices where improving any one element independently may actually hurt the efficiency' of the whole system (Khanna, 2006, p71). The convergence of corporate governance is henceforth less possible as it will affect the integrity and general efficiency of a nation's whole system. Another hindrance to convergence of corporate governance is said to arise from rent seeking activities by the interest groups. Frequently, key interest groups in the present corporate governance system, such as the banks, labor unions, and controlling shareholders, are inclined to maintain the status quo of the governance structure as any changes or reforms will affect their benefits and reduce their controls (Bebchuk and Roe, 1999; Coffee, 1999; Khanna, 2006). Meanwhile, other factors may also act as efficient impediments to the convergence of corporate governance, such as persistent diversified ownership structure which plays the pivotal role in corporate governance (Milhaupt, 2004), the lack of consensus of an ideal model for the convergence of corporate governance (Bebchuck and Roe, 1999), strong assertions of national differences and identity (Barber, 1995), presence of different social and commercial norms which 'supplement or trump the commands of formal legal rules or explicit commands' (Charny, 2004, p303), and different objectives of business organizations in varied institutional settings(Witt, 2008).

With regard to the convergence of corporate governance, there is a further debate about the optimal corporate governance model. Typically, researchers produce fairly inconsistent and ambiguous findings regarding the impact of corporate governance on firm performance (Thomsen and Pederson 1996). Besides, there is little empirical evidence found for the convergence of corporate governance. For example, based upon the statistics of relevant national corporate governance indicators, Guillen (2000) finds there is no significant trend of convergence of corporate governance in the key aspects, such as the ownership structure and shareholding by institutional investors, debt-equity ratios, mergers and acquisitions. Khanna, Kogan and Palepu (2001) find that though there is evidence of *de jure* convergence, there is litter proof of *de facto* convergence in form or function a the country, industry or firm level.

## 2.5 Key practices in corporate governance --- a brief summary

From the microscopic view, a wide range of issues are elaborated regarding key practices in corporate governance in the extant literature. Credited to some academic reviews on the development of corporate governance (Durisin and Puzone, 2009), principles or codes of corporate governance by international organizations and different countries (OECD, Principle of Corporate Governance, 2004; UK, Combined Code, 2003, 2008; Germany, German Code of Corporate Governance, 2012; France, Corporate Governance Code of Listed Corporations, 2010; US, Principles of Corporate Governance, 2009) and relevant company or corporation laws (US, The Model Business Corporation Act, 2002; UK Company Act, 1980), the present thesis is in a better position to target such issues on corporate governance, especially taking into account the 2007-2009 financial crisis. These embrace the corporate ownership structure, the organization and behavior of the board of directors, code of corporate governance, legal duties. Other important issues, like internal control, executive pay and disclosure, are either skipped due to the purpose of the thesis, or intentionally left to the following chapters.

### 2.5.1 Corporate ownership structure

Regarding the corporate ownership structure, differences are prominent across various models of corporate governance. In the Anglo-Saxon model, with the famous separation of ownership and control (Berle and Means, 1932), the stock market centered system of the dispersed ownership dominates. Such highly dispersed ownership is reinforced by strict legislations and regulations against powers exercised by large financial conglomerates, which aim to restrict the control rights by large block holders (Roe, 1994). In contrast, a concentrated ownership structure (by means of block-holding or cross-shareholding) with less developed stock markets is typical in the Continental model. Bech and Mayer (2001) reports that more than 50% of European countries have single block holders that control majority of shares while, in U.K. and U.S.A, the percentage of such corporations is less than 3%.

The varied ownership structures grant the shareholders different powers over the decision making in the corporation, especially their control over the board of directors and constraints upon the management. In the Continental model, with the existence of the concentrated ownership, the controlling shareholders are fairly powerful and may easily nominate or remove members to the supervisory board and influence the decisions by the board of directors (Becht and RNoell, 1999; Shleifer and Vishny, 1997). On the other hand, in the Anglo-Saxon model, due to the highly dispersed ownership, the shareholders' control over the board of directors is highly diluted. Though there are increasing powers exerted by institutional investors and through proxy fight, many barricades exist like requirement for a sizeable shareholding (to successfully nominate the board members), and limitations upon the binding powers of the shareholders' vote (Gedajlovic and Shapiro, 1998; Fukao, 1995).

Meanwhile, the shareholder's control can be observed regarding constraints upon the executive pay. In the Anglo-Saxon model, executive compensation tends to lie beyond the control of the corporation's shareholders and frequently, and the management can freely decide their own compensation even if this is against the shareholders' will. Though there is increasing power from the shareholders on the compensation package to the managers, typically observed in the recent shareholder's 'say on pay' *ex post* the 2007-2009 financial crisis, the management in this model may frequently manipulate the situation and grant themselves generous 'pay check' (Bebchuk, 2004, 2010). In contrast, excessive executive pay is better constrained in the Continental model due to effective control over the board of directors by the controlling shareholders and existence of high proportional employee representation on the supervisory board (Fukao, 1995).

Another issue is the ownership by the management of the corporation, which is observed in forms of stocks and options. Generally, management ownership is popular in the Anglo-Saxon model and regarded as an efficient mechanism to mitigate the agency problem, which is grounded in the assumption that the managers' interests become congruent with those of the shareholders since they (managers) become the owners of the corporation as well. And, frequently, such ownership takes a large proportion in the compensation package, which is deemed as effective incentive for the management to achieve the best performance of the corporation and thus increase the value of the corporate shares (Shleifer and Vishny, 1997). In contrast, management ownership is less popular in the Continental model, as the concentrated ownership structure well mitigates the agency problem and the shareholders are is in a better position to influence the business decisions by the management. Instead, performance-related pay is more frequently used as incentives for the management in this model (Watson Wyatt, 2009).

However, the ownership structure is not static and unchanged. In the Anglo-Saxon model, most notably UK and US, the structure of ownership has undergone considerable changes in recent decades. With the complexity and maturing of equity markets, US is moving towards a comparative hybrid form of the corporate ownership structure, or called as the market-oriented block-holder model. This new model is featured by the emerging block-holder of corporate public ownership which is expected to better monitor the management and help develop a more efficient and liquid market. These new types of equity owners, mainly the institutional investors, embrace mutual funds, pension funds, and insurance corporations, and contribute to the development of the new ownership pattern (Guercio and Hawkins, 1998; Opler and Sokobin, 1995; Wahal, 1996; Sias and Starks, 1998). At the same time, stock markets have been developing very rapidly in the Continental model countries in past decades, challenging the long-standing block shareholder model of ownership. And the shareholding is now more dispersed, with banks exerting less influence and holding limited powers on the decisions made by the management (Hackethal, Schmidt and Marcel, 2003).

### 2.5.2 The organization and behavior of board of directors

As the 'tone at the top', the board of directors decides 'to be or not to be' questions of the corporation, the enterprise culture and value, and the features of the corporate governance (OECD, 2004). In this context, the organization and behavior of the board of directors take on special significance in the framework of corporate governance, such as the board structure, the board composition, and the board independence (OECD, 2004).

The board structure varies in different models. Traditionally, a one-tier board structure dominates in the Anglo-Saxon model countries, which is said to help improve efficiency in business making process due to its more centralized characteristics. This board model entrusts both management and control powers to the board of directors, which enable it to possess the 'universal powers' within the corporation (Hopt and Leyens, 2004). For the sake of detailed or specific management, the managerial power is further delegated to the committees or individuals under the board level in larger companies. Meanwhile, for control powers, a distinction has to be made between the executive/inside directors who are employed as management and the non-executive/outside directors not involved in day-to-day business. The non-executive directors perform both monitoring and strategic advising functions, which are functionally distinctive from the management responsibilities. In addition, as the non-executive directors are entitled to participate in decision-making process, they enjoy better monitoring powers than the supervisory board in the Continental model that can only make post-decision approvals (Hopt and Leyens, 2004;UK, Combined Code, 2003).

In contrast, a two tier board model is widely used in the continental countries like Germany, Japan, Netherlands and the coordination arrangement is frequently mandatory for public corporations regardless of its size or listing (Hopt, 1998). This board structure stresses on the organizational division of management and control functions in corporate governance settings. The management board is responsible for running the day-to-day business and implement corporate business strategies and policies. The supervisory board is mainly engaged in wide-ranged control functions, which include 'hard' functions of appointing, supervising and removing members of the management board, and 'soft' ones of networking with shareholders, business partners to balance the interests within the corporation. Though in a large degree the supervisory board can control the management and monitor its compliance with law and articles of incorporation as well as the business strategies, it is not eligible in managing the corporations unless stipulated in the articles of incorporation or according to their legitimate discretion (Hopt and Leyens, 2004). Other types of board structures, though different in formality, are more or less connected to the aforesaid two modes, either as a hybrid or a derivative form. For instance, some countries like France, Italy and Japan, allows the corporation to choose form different models of board structures.

As a key feature of the board of directors, the board composition embraces mainly the source of the directors, the proportion of outside directors, the labor participation, and the board diversity. Firstly, the outside directors are playing an increasingly important role in corporate governance and the proportion of outsiders in the board of directors has been rising dramatically, though this is more an Anglo-Saxon model phenomenon (UK, Cadbury Report, 1992; UK, Code of Corporate Governance, 2010; US, Sarbanes-Oxley Act, 2002). The proponents of such movement contend that more outside directors will lead to better board decisions and hence enhanced corporate performance (Rosenstein and Wyatt 1990, 1997), enhancement in corporate governance (Dahya, McConnell and Travlos, 2002), increased value for shareholders (Dahya and McConnell, 2005), reduced levels of earnings management (Benkel, Mather and Ramsay, 2006), and more efficient monitoring on the management (Weir and Laing, 2000). However, other scholars doubt about the merits of the outside directors by challenging the correlation between the corporate performance and the proportion of the outside directors (Agrawal and Knoeber, 1996, 2001), their causal relationship and interaction (Bhagat and Black, 2002), indispensable specialties of varied firms (Duchina, Matsusakab and Ozbas, 2010), and the endogenous nature of the board composition (Lehn, Patro and Zhao, 2004). Meanwhile, there may be a maneuvered increase of outside directors in periods of poor performance (Hermalin and Weisbach, 2003) and biased study focusing on US board which is long dominated by the outside directors. In contrast, the outside board directors are less prevalent in the Continental model unless in the instances of hybrid board of directors where outside directors are recognized and required. Instead, such 'outside' directors in the Continental model are mainly directors of the supervisory board, who may play limited function of independence due to their comparatively lower ratio in the total board of directors (Germany, Code of Corporate Governance, 2012).

The extent of labor participation in the board of directors, on the other hand, may greatly affect the orientation in corporate governance. In general, labor participation on the board in the Anglo-Saxon model is rare and not widely accepted in its corporate governance. Typically, there are few statutory bases for the mandatory consideration of the employees' interests. Though there are limited legislations stating the protection of employees' interests in the framework of corporate governance, they are frequently not clarified, less understood and poorly implemented (UK Company Act, 1980; US, Principles of Corporate Governance, 2009). And, frequently, the protection of the employees' interests is reserved for some specific instances, like merger and acquisitions, and is usually subject to the discretion of the board of directors. In contrast, in the Continental model countries like Germany or Japan, labor participation on the board (the supervisory board mainly) is mandatory. For instance, as an important part of the co-determination practice, the German supervisory board in large companies of over 2000 employees must have 50% members from the labor representatives, though the casting rights is slightly favorable for the shareholders (Germany Code of Corporate Governance, 2012). In deciding the business strategies, meanwhile, the management has to take into account of the interests of the employees as the key stakeholder. Moreover, reforms in Germany always exclude the co-determination as a matter of political principle ((Hopt and Leyens, 2004).

Other issues with regard to the board of directors pertain to the financial and legal expertise of the board directors, the board diversity, and the check and balance mechanism. For instance, many scholars argue that directors with different backgrounds and gender will benefit the corporation, especially in times of economic difficulty (Kirk and Fwin, 2009). Some scholars argue that the financial crisis is largely attributed to the popular male-domination practice in financial firms while more gender-diverse boards can perform better and act as tougher monitors (Kirk and Fwin, 2009; Adam and Ferreira, 2008). Such views are often expressed as the Lehman Brothers will not collapse if it is composed of 'Lehman Sisters', i.e. Lehman Brother's collapse was brought on by male-dominated excessive risk-taking (Lagarde, 2010).

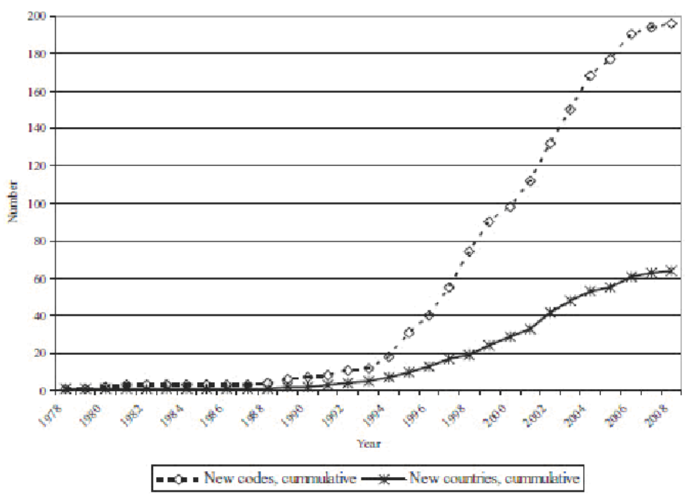
Board independence, as another key element in corporate governance, is drawing more attention from the legislators, regulators and academics, especially in the context of the 2007-2009 financial crises. It mainly focuses upon the proportion of outside directors in the board and the board committees, the standards of their independence, and duality of the CEO and the board chairman. In the Anglo-Saxon model countries, board independence is regarded as the fundamental of a good governance practice. For instance, UK Combined Code (2008) specifically stresses on the independence issues of the board of directors (the outside directors mainly) and prohibits any relationships or circumstances which will affect or likely affect the directors' judgment. This pertains to the relationships between the outside directors and the corporation in terms of employment contracts, business connections, remunerations or family ties. Regarding the proportion of the outside directors, at least half of the board of directors should be independent outside/non-executive directors. Moreover, key board committees, like the nomination, remuneration and audit committees, should be composed of largely or totally of the non-executive directors. Meanwhile, there is a requirement of a separation of positions of board chairman from CEO (UK Combined Code, 2008; US Sarbanes-Oxley Act, 2002).

In contrast, the standard for board independence is comparatively less strict in the Continental model countries. For instance, Germany has laxer requirements for the board independence regarding the independence criteria, the proportion of the non-executive directors in the board and its committees (German Code of Corporate Governance, 2012). Sometimes, the distinction between the membership of the supervisory board and the management board in this model is not easy to define, which may affect the independence of the supervisory board. For instance, the retired former managers may be invited back to the seats of supervisory board for the sake of their specific knowledge and expertise, the chairman of management board may turn into the chairman of supervisory board, and the supervisory memberships are offered to business partners or representatives of cross-holding corporations. This may undermine the independence and objectivity of the supervisory board and cause serious conflict of interests problems (Prigge, 1998).

### 2.5.3 Code of corporate governance

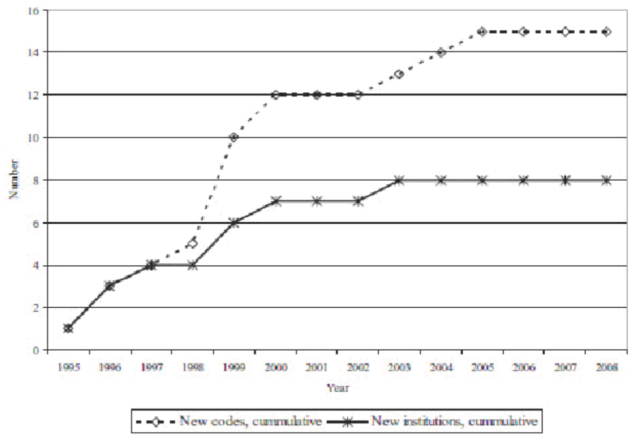
Code of corporate governance, with its increasing significance in a nation's corporate governance framework, is frequently defined as 'the best behavior and structure' in corporate operation. In contrast with 'hard' laws like corporation laws or relevant statutes, code of corporate governance is regarded as 'soft' law or regulation. As observed in the figure 2.1, by mid of 2008, 64 countries have issued 196 distinct codes of good governance and issuers embrace stock exchange, professional associations, or even governments (Zattoni and Cuomo, 2008).

**Figure 2.1 Codes of Corporate Governance by Countries, 1978-2008**




Source: Zattoni and Cuomo, 2008

**Figure 2.2 Code of Corporate Governance by International Organizations, 1995-2008**




Source: et. al Zattoni and Cuomo, 2008

Meanwhile, international entities like OECD, the World Bank and IMF also help promote the spread of the codes which specifically target developing countries and transitional economies, as in Figure 2.2. They promote the practices of good governance at both the country and firm level. Besides, the International Corporate Governance Network and ROSC (report of the observance of standards and codes) by IMF and World Bank are active in facilitating the database and assessment of the code (Zattoni and Cuomo, 2008).

Regarding the content of code of corporate governance, similarity and variance goes hand in hand in different model countries. On one side, there are common concerns in corporate governance code, such as efficient arrangement in the organization and activities of the board of directors, the maintenance of a sound system of internal control, and better information disclosure (O’Shea, 2005). On the flip side, variances can be sorted out. In the Anglo-Saxon model countries like UK, for instance, code of corporate governance spills much ink on the organizations and practices of the board of directors, which illustrates a strong self-regulation orientation on governance structure. It also employs a flexible ‘comply or explain’ approach in testing and assessing the legitimacy and feasibility of corporate governance (UK Combined Code, 2008). In contrast, the Continental model countries use the code as complementary to its hard law, the corporation law, though the code emphasizes the self-regulatory practice by corporations and applies the UK style ‘comply or explain’ principles. For example, the German Corporate Governance Code (2012) presents a comparatively stronger statutory regulations for the management and supervision of the listed companies, a clarification of the management and supervisory board to 'promote the trust of international and national investors, customers, employees and the general public in the management and supervision of listed German stock corporations' (German Code of Corporate Governance, 2012, p5). Meanwhile, it uses three layered rules regarding its compliance by the corporations, the mandatory rules, the 'deviate and disclose' rules and the 'the deviate without disclosing' rules. The mandatory rules are provisions that require the corporations to observe under applicable laws. The 'deviate and disclose' rules are recommendations which the corporations can deviate from but are obliged to disclose annually. The 'deviate without disclosing' rules are suggestions which can be deviated without the need to disclose.

In addition, the Anglo-Saxon model and Continental model countries show great differences regarding the immensity and abundance of the codes. In general, the Anglo-Saxon model countries issued the codes much earlier than their counterpart Continental model countries. US issued its first official code on corporate governance in 1978 and UK in 1992. In contrast, Germany issued its first code in 2002 and France in 2004. Regarding the number of the codes, the Anglo-Saxon model countries generally created more codes than the continental model countries. For instance, US and UK together have created 25 codes while Germany and France only issued 13 codes in all up to 2008. Indeed, issuances of codes in Continental countries are prompted more by legislation reasons than the determination to improve the generic corporate governance practices (Zattoni and Cuomo, 2008).

The code compliance is also a tricky issue and varies across countries. On one hand, compliance by a high portion of listed corporations can be observed in both the Anglo-Saxon model (Weir and Laing 2000; MacNeil and Li, 2006; O'Shea, 2005) and the Continental model countries (Bebenroth, 2005; Werder, Talaulicar and Kolat, 2005). On the other hand, however, there is strong evidence of non-compliance across different model countries, though with various reasons. MacNeil and LI (2006) find that non-compliance by the UK listed corporations are excused by investors in case of superior financial performance. And, in contrast, Beberoth (2005) finds that some recommendations by the German code are intentionally neglected by listed corporations, such as the personal liability, management compensation or supervisory board. Moreover, there are competing views regarding the relationship between the implementation of code of corporate governance and firm performance. Some scholars argue that code implementation is found to lead to improved corporate performance or positive market responses (Augilera, Filatotchev, Gospela and Jackson, 2008), better earnings management (Benkel, Mather and Ramsary, 2006), and increased investment returns and market values of the corporation (Del

Brio, Maia-Ramires and Perote, 2006). Other scholars find, however, inconsistent or negative relationship between code compliance and firm performance (Dalton, Daily, Ellstrand and Johnson, 1998).

### 2.5.4 Legal duties

Another key issue in corporate governance is legal duties, especially the fiduciary duty, by major corporate participants like the board directors, managers and controlling shareholders. Originating from the trust law in the Anglo-Saxon legal system for describing the nature of the duties imposed upon a trustee, fiduciary duty is now frequently used in corporate law and corporate governance. It requires that officers, directors and controlling shareholders own enforceable duties to the corporation and through the corporation to the shareholders (Bauman, Palmite and Partnoy, 2007, p639). Generally, the fiduciary duty is composed of the duty of care and duty of loyalty, though sometimes the duty of disclosure is also included. The fiduciary duty is widely accepted and enforced in different model countries, but differences can be observed, such as the standard of the duty, and the possibility of incurring a civil liability.

The duty of care refers to the duty by the directors and managers to act in the best interests of the corporation, exercise reasonable care in making business decisions, and perform efficient monitoring upon the operation of the corporation (OECD, 2004). In the Anglo-Saxon model, the duty of care largely employs an objective standard which is defined the care 'as an ordinarily prudent person in a like position would use under similar circumstances.' (US, Model Business Corporate Act, 2002). It also embraces efficient oversight by board directors, their adequate competence and qualifications (such as professional knowledge, skills, experience), and due diligence (Francis v.United Jersey Bank, 1981). Furthermore, the duty of care pertains to reasonable monitoring and inquiry on the corporate operation, though there is a dispute regarding the standard, whether applying the triggering event/red flag event (Graham v. Allis-Chalmers Manufacturing Co. 1963) or the establishment of a permanent monitoring system (Irem Caremark, 1994). Similar settings on the duty of care can be observed in the Continental model. For example, German corporate code requires that the board of directors and management must act with diligence of a prudent business man and the breach of which will lead to personal liabilities (Germany Code of Corporate Governance, 2012). But, the standards and rules regarding the duty of care are less rich and detailed than those developed by its Anglo-Saxon counterpart, considering the limited and passive role by the court in the Continental legal system and precedents only used as reference without legal enforceability.

The duty of loyalty requires the directors, managers and controlling shareholders to prioritize the interests of the corporation over their own private interests, and restrain from the conflict of interests activities like self-dealings or related transactions with the corporation (OECD, 2004). In the Anglo-Saxon model, the key concern on the duty of loyalty is the self-dealing by the management, defined as 'transaction between a corporation and one or more of its directors or officers...or an organization in which one or more of its directors or officers are directors or officers, or have a financial interest.' (US, Del. Code, 2005). More than often, such deals must be approved by a majority of disinterested directors or shareholder after full disclosure or proved to be of fair value to the corporation as the arm's length transaction in the market. In practice, however, the application of such principle is complicated due to the confusing coverage, the different meaning of 'disinterested director' at *ad hoc* basis, and the difficulty in defining the fairness of the transaction. Other concerns of the duty of loyalty can be observed in expropriation activities by the managers such as embezzling the corporate assets (Bauman, Palmite and Partnoy, 2007).

In the Continental model country, the duty of loyalty pertains to the board of directors, management and controlling shareholders. In Germany for example, different requirements of duty of loyalty are prescribed for the management board and supervisory board, with the former subject to much stricter and wider restrictions. Specifically, the management board directors are prohibited from competing with the corporation in any means or taking advantages for personal interest. With regard to related transactions involving the member of the management board, they will not be valid unless approved by the supervisory board while the management board has no say. For the duty of loyalty by the supervisory board, a demanding requirement of independence is set, which explicitly separate its members from the management board. However, though restrictions are imposed upon the transaction between the corporation and the member of the management board or supervisory board, they do not pertain to related transactions between the corporation and relatives of the directors or the firms in which directors have a substantial holding (Baums and Scott, 2005).

Moreover, differentiated from the Anglo-Saxon model, the Continental model lays extra emphasis upon the problem of competing interests between the majority shareholders and the minority shareholders. For instance, German corporate law specifically addresses related transactions between its majority shareholders and the corporation, and requires the duty of loyalty be owned by the majority shareholder towards the minority ones. It demands full disclosure of relevant transactions in the annual report prepared by the external independent auditors, though such information is only available to the supervisory board instead of the shareholders (Baums and Scott, 2005).

As the third pillar of the fiduciary duty, the duty of disclose requires the board directors and managers to disclose all the relevant information regarding the corporation business and operation, which may affect the decision making by the investors. And the key component of duty of disclosure is the materiality of information. Applying the objective standard, the materiality of information involves the significance or certainty of the omitted or misrepresented fact in influencing the decision making by a reasonable investor (OECD, 2004). In the Anglo-Saxon model, standards for the duty of disclosure are generally stricter than those in the Continental model. In US for example, the Securities and Exchange Commission (SEC) requires that the corporation should provide all the material information to the shareholders for making an informed voting decision. The test of materiality is that 'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of the information made available' (Bauman, Palmite and Partnoy, 2007, p256). Furthermore, regarding the contingent or speculative information or event, the standard of materiality expands to consider 'a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity' (Bauman, Palmite and Partnoy, 2007, p258). The materiality of misstatement of omissions can be categorized as quantitative or qualitative. The former, widely used by US courts and SEC, stresses upon economic benchmarks as the investor is most concerned with the financial returns on their investment. The latter, which is drawing more attention presently, takes into account 'the subjective intentions and motivations of those involved in making disclosure decisions without reference to the economic significance of the information in question' (Bauman, Palmite and Partnoy, 2007, p259). However, the test of materiality is not limited to the investor protection and can extend to some other goal, typically the public interests (SEC, Section 14 a; Russell, 1976). In contrast, the duty of disclosure is less restrictive in the Continental model. In Germany, for instance, the liability for breach of duty of disclosure is incurred mainly in cases of release or omission of false, misleading material information to the shareholders in securities prospectus, interim reports, and financial statements. The board of directors and managers will not be imposed liability unless proven to maliciously deceive in the process of information disclosure (Baums and Scott, 2005).

Generally, the breach of fiduciary duty by the board directors, managers, and controlling shareholders may lead to personal liabilities or even criminal charges. However, there are barricades for effective enforcement of the fiduciary duties. On one side, it is not an easy job to find the directors and management liable for violating the fiduciary duties due to varied standards. In cases of the duty of care, for instance, there are obstacles like inconsistency on the standard of care, and the business judgment rule which restrains the court from second guessing the merit of the business decision (Aronson v. Lewis, 1984; Smith v. Van Gorkom, 1985; US Principles of Corporate Governance, 2009). Meanwhile, the 'Director and Officer' insurance, widely used in corporations nowadays, covers a wide range of liabilities by the board directors and managers in case of breach of duty of care. Similar obstacles can be found in cases of duty of loyalty and duty of disclosure, though with variances (Bauman, Palmite and Partnoy, 2007).

Another barrier is the difficulty in initiating legal actions by the shareholders against the liable directors and managers. Due to the 'fictitious' legal personality of the corporation, to whom the directors and managers may be held liable, the shareholders can only bring about indirect suits, the derivative suits, through the corporation to seek legal recourses against the directors and managers for breaching their fiduciary duties (Bauman, Palmite and Partnoy, 2007). This is made even harder by the fact that it is the board of directors (in the Anglo-Saxon model) or the supervisory board (in the Continental model) who is entitled to decide whether to proceed the legal actions or not. In most cases, the board of directors is reluctant to initiate the charges as such legal actions may challenge their duty of monitoring. Even if a case is filed, obstacles of various kinds exist which may dilute its merit and efficacy, such as defensive maneuvers, appeals, and delay (Ulmer, 1999). Generally, the derivative suit is more popular in the Anglo-Saxon model than its continental counterpart considering the more active roles by the court. Meanwhile, due to the allowance on contingent fees in fiduciary duty cases in the Anglo-Saxon model, the lawyers are more motivated to solicit such cases from the grievance shareholders.

## 2.6 Chapter conclusion

Setting the ground for the following chapters on corporate governance in banking organizations and its application in Chinese context, this chapter provides an extensive review of the existing theories and academic debate on generic corporate governance. Distinguished from the extant conceptions of corporate governance, the chapter elaborates on a new 'three scope' perception which extends from macro institutional arrangement, meso models to micro practices in the governance structure of the corporation. By analyzing the diversified institutional settings of corporate governance in different model countries, the chapter illustrates the legitimacy for the shaping and formation of the corporate governance structure. This leads to the analysis of varied models of corporate governance, which reflect the orientations for different interests groups in the context of specific institutional environment. And detailed exploration on key practices in corporate governance, as the empirical evidence, demonstrates the influences of the macro institutional settings and meso models upon the micro operations in the corporate governance structure. In sum, Chapter Two draws a detailed blueprint for the following institutional analysis on corporate governance in banking organizations.

# Chapter Three A Discursive Institutional Approach to Corporate Governance

## 3.1 Introduction

In contrast with the extant literature on corporate governance, this chapter sets out an alternative approach. It reinvigorates the implicit institutionalism of the VoC literature by drawing, in particular, on the recent development of discursive institutional theory. It is an approach that is taken in order to further interrogate the processes through which nationally diverse corporate governance arrangements are actually constituted over time and across space. This is quite different to the extant literature which posits and explores changes within different 'models' of corporate governance, but tells us very little about how these models are produced and reproduced in practices. Specifically, the chapter develops the implicit institutionalism of the VoC literatures by differentiating and elaborating on three levels of discourses: legitimacy, paradigm and frame. Implicit or explicit within the VoC literature, legitimacy in corporate governance is shown to involve the pubic sentiments and popular cognitions present in diverse forms of capitalisms, from the 'free market capitalism' to the 'coordinated capitalism'. Such sentiments and cognitions constitute the legitimate roles that corporations are expected to perform across varieties of capitalism. At the level of the paradigm, meanwhile, are sediment institutional arrangements that are typically referred to as the different models of corporate governance. Such models are not simply passive descriptions of diverse and path dependent institutional realities, but are constitutive and competing conceptions of how corporate governance can and should be organized, including the so-called 'the shareholder model', 'the stakeholder model', and 'the state affected model'. But, corporate governance arrangements are also constituted through the norms, ideas, codes, standards or 'frames' embedded in routine and mundane practices that include, for example, the ownership structure, the organization and activities of the corporate board of directors, code of corporate governance, and legal duties.

## 3.2 Varieties of Capitalisms Analysis

As 'a new framework for understanding the institutional similarities and differences among the developed economies' (Hall and Soskice 2001b, p2), their continuity and changes, VoC is developed in explaining economic activities in comparative institutions (Hall and Soskice, 2001a, 2001b; Streeck and Yamamura, 2001; Yamamura and Streeck, 2003; Schmidt, 2003; Amable, 2004; Morgan, 2005).

With its emphasis on 'system coordination' and the idea of 'institutional complementarities', VoC argues that 'correctly calibrated' sub-systems, such as financial system, labor market, inter-firm relations, can reinforce the 'comparative institutional advantage' of the firm (Hall and Soskice, 2001a; Kang, 2006). And, it is in this context that VoC is employed in the present thesis for studying the variances of corporate governance of banking organizations in diverse national configurations.

Several models of capitalisms are developed by VoC, mainly categorized as the liberal market economy (or LME), the coordinated market economy (or CME), the state-affected market economy (SME). LME, typically represented by US and UK, is said to be founded upon the institutional settings of the prevailing ownership of the private property, pro-competitive disengagement by the government, and highly developed legal protections for various property and contractual rights (Hall and Soskice, 2001a). In LME, 'firms coordinate their activities primarily via hierarchies and competitive market arrangements' and 'Market relationships are characterized by the arm's-length exchange of goods or services in a context of competition and formal contracting'(Hall and Sockie, 2001b, p9). In this context, market institutions frequently play dominant roles in coordinating activities by the economic actors. And, the government is expected to confine its role in setting the rules, providing regulatory and legal infrastructures for efficient functions of the capital market, and supplying a basic safety net for the unemployed and the old as well as settling the conflicts (Hall and Soskice, 2001a). These are typically observed in UK, for instance, when the Thatcher's governments adopted a fairly hands-off relationship with both business and labor (King and Wood, 1999; Wood, 2001; Schmidt, 2002 a), and promoted,

'liberation of the financial markets with the "big bang" in 1986, privatized business with the massive sell-off of monopolistic public enterprise as well as state-owned firms in the competitive sector, deregulated business by replacing voluntary self-governing arrangements and formal government–industry relationships with independent regulatory agencies and radically decentralized the labor markets through deregulatory labor policies that reduced unions' organizing and strike powers while increasing employers' ability to hire and fire at will. As a result, the "liberal" British state became even more liberal, and acted primarily as an agent of market preservation by providing framework legislation to locate decision-making power in companies, and limit the power of organized labor' (Schmidt, 2003, p532).

Meanwhile, as a key player in LME, the court exerts unusual influences on business activities and is purported to provide strong legal protection which 'supports formal contracting and encourages relatively complete contracts' (Hall and Sockie, 2001b, p10). Characterized with the legal system of judge-made-law, the court in LME takes a prominent place. Frequently, the rules and principles established by the court, in forms of precedents which are legally binding, are carefully considered by the corporation and integrated into its article of incorporation or practices to avoid further legal suits under the similar cause of action. Meanwhile, the regulators are active in launching legal actions against the violating practices by the corporations, though these cases largely end in settlements and their merits are questioned (Bauma, Palmiter and Partnoy, 2007).

The CME variety of capitalism, on the other hand, relies more on the non-market relationships, coordination and collaboration, and credible commitments among various market participants, and is exemplified by Germany and Japan. In contrast with the overwhelming market institutions in LME, in CME, 'firms depend more heavily on non-market relationships to coordinate their endeavors with other actors and to construct their core competencies', which pertain to 'more extensive relational or incomplete contracting, network monitoring based on the exchange of private information inside networks, and more reliance on collaborative instead of the competitive relationships to build the competencies of the firm' (Hall and Sockie, 2001b, p9). As the firms in this model mainly achieve their goals through strategic interactions, relevant institutions apart from the market competition are needed which are expected to 'reduce the uncertainty actors have about the behavior of others and allow them to make credible commitments to each other' (Hall and Sockie, 2001b, p10), such as better exchange of information, efficient monitoring of behavior, and penalty for defection from cooperative endeavor (Ostrom 1990; Hall and Sockie, 2001b). And, in practice, these institutions embrace 'powerful business or employer associations, strong trade unions, extensive networks of cross-shareholding, and legal or regulatory systems designed to facilitate information-sharing and collaboration' (Hall and Sockie, 2001b, p11).

In CME, the state is legitimized in taking its position as 'enabling' to enhance economic competitiveness, while without 'jeopardizing the non-market coordinating institutions, --- in which regulatory authority was vested in private bodies, including employers' associations and unions' (Schmidt, 2003, p533). The state prefers to help coordinate the relationships between various participants in economic activities and foster coherence between the business and labor. In this context, the rules are jointly decided by the key participants, conflicts are harmonized between the management and labor, and the collaboration is achieved through a combination of external institutions with abundance of low-cost capitals and labors (Hall and Soskice, 2001b). And, even in the instance of economic reform, the government may take a slow step and coordinate with various economic actors such as business, labor, and regional governments. Meanwhile, the legal system in CME model, which belongs to the Continental legal system, is said to provide weak protection for property rights and the court is less active in intervening the economic activities (Shleifer, 1997). Nevertheless, the court in this model takes on some specialty due to the dominant coordinative institutions. In Germany, for instance, 'the character of legal regulation is said to facilitate many kinds of non-market coordination' and the court is expected to 'effectively employ regulatory contract law doctrines based on social market economy norms that are routinely dismissed by US legal experts as untenable' (Hall and Soskice, 2001b, p388-389). This attributes to the strategic capacity of German firms to create inter-firm relations, non-market forms of coordination, which 'consist of sophisticated but standardized contractual structures that facilitate the construction of new forms of industrial organization within the economy. Once firms collectively develop these frameworks, courts in Germany use them to impose strong legal regulation' (Hall and Soskice, 2001b, p390). Meanwhile, applying the regulatory approach, German courts 'have much higher information requirements' and 'must take into account broader societal norms regarding fair contracting when adjudicating disputes and, moreover, assess information pertaining to the relationship as a whole' (Hall and Soskice, 2001b, p392).

The State-affected capitalism (SME), or the state-led/ state-enhanced capitalism, are epitomized by France, Italy, and Korea (sometimes Japan is included considering its close business–government relationship), which are based on the continuing influential role of the state, though drastic changes are taking place (Schmidt, 2002, 2003; Coates 2000; Boyer 1997; Weiss 1999). Although this third model of capitalism is argued to be either 'on the road' to LME (Morin, 2000) or CME (Hancké and Soskice 1996; Rhodes and Van Apeldoorn, 1997) due to financial globalization and deregulation, there is 'continuing importance of the state or state-related institutions in the economic management systems of countries', in which the state, having played a highly directive role in the past, continues to exercise significant albeit less direct influence (Schmidt, 2003, p527).

In contrast with the overwhelming market institutions in LME, or influential non-market coordination in CME, economic activities in SME are frequently state oriented. The state directs the economic process and business activities according to its own needs and wishes, acts either in place of, or takes the place of, the market, and guides the economy by various means, like nationalizing industries, planning and promulgating industrial policies (Schmidt, 2002 a). For instance, in France in 1990s, 'The state mediated inter-firm relations, set medium-term corporate strategies through planning and industrial policy and underwrote the investment of traditionally undercapitalized business, sometimes demanding no financial return at all if the state's medium-term goals were being fulfilled, such as maintaining employment or increasing production in strategic areas' (Schmidt, 2003, p529-530). Even in the process of drastic economic reforms when the state retreats from the leadership of business, such as financial market liberalization, business deregulation and privatization, and labor market decentralization, the government may continue to play a dominant role due to its 'capacity to impose reforms without crippling protests, --- and a discourse that spoke to the necessity of reform in the face of economic crisis and its appropriateness in terms of national sacrifice' (Schmidt, 2003, p533). Though the reforms in SME have actually transformed the state from 'a leadership role to an "enhancing" role', the state continues to 'intervene strategically to protect business and/or labor from the worst effects of the markets' even if the market institutions are becoming increasingly significant (Schmidt, 2003, p533). Meanwhile, the state may intervene in hard times to protect its large enterprises from bankruptcy by means of bail-out and obstruct foreign takeovers by outlawing take-over measures (Schmidt, 2002). These strong government posture and powerful political influence lead to a weaker role of judiciaries in business activities in SME in contrast with that in LME or CME model. And sometimes, the court may even subdue to the political interests and lose its independence in significant economic cases (The World Bank, Doing Business Report, 2004).

Though VoC is well developed in analyzing the comparative institutional advantages, significant limitations are said to be present (Peck and Theodore's, 2007; Kang, 2006; Jackson and Deeg, 2006). Like its advantages in explaining the varieties of capitalisms, the VoC analysis is equally defective in lack of varieties of capitalisms. For instance, major differences can be observed in key institutional aspects among countries roughly categorized as the same capitalism. Though Japan is categorized with Germany in the same CME capitalism, its government plays a more intervening role in economic activities, which makes it more fitful to be categorized as the SME capitalism like France. Meanwhile, there are problems in applying VoC analysis to the transitional economies, which may not fit neatly into the pigeonholes designed by the VoC scholars as they present some hybrid or derivative features of the existing capitalisms (Howell 2003).

Meanwhile, VoC is also less competent in accommodating the changes in institutions. Largely built upon comparatively static institutions, VoC classifies and describes various capitalisms based upon the presumed institutional stability (Howell, 2003; Allen, 2004) and implicitly excludes the influences of the changes in the institutional settings to retain its theoretical intactness. For instance, it can not adequately handle the changes in the existing categories of capitalisms. Since 1990s, some capitalisms (like France) underwent massive institutional changes and did not properly fit into the original category. Instead, they are 'stuck' in a transitional gap between different capitalisms, a state of the different subgroup. In more drastic cases, they may 'jump' to totally different categories of capitalisms. VoC often can not provide a sound explanation for such institutional changes and update its categorization on capitalisms (Jackson and Deeg, 2006).

Moreover, VoC lays special emphasis on the analysis of formal institutions like the capital market and labor relationships, while gives limited consideration to informal institutions like norms, usages and practices by the firms. This may cause problems as sometimes the informal institutions play a far more important role in shaping the activities of the firm. For instance, though there is apparent formal institutional stability in a certain national configuration, the firms may, based upon their own discourses and preferences, pursue a specific strategy which is in substance inconsistent with the existing formal institutions. In this context, the formal institutions may be used differently by the firms and give away to those informal institutions (Morgan, 2005; Hall and Thelen, 2005).

To overcome the limits of the VoC analysis, the thesis brings in the discursive institutionalism as the analytical framework. In contrast with the VoC analysis, the discursive institutional approach is more efficient in explaining institutional changes by analyzing the role of ideas in shaping and changing the activities of the actors. With extensive elaboration on legitimacies, paradigms and frames, the discursive approach provides a much wider exploration on institutions, from micro to macro. Specifically, focusing on the role of ideas, this institutional approach takes into account of both formal and informal institutions. Meanwhile, acknowledging the diversities in institutional settings, the discursive institutional approach uses a more flexible categorization method and addresses effectively the dynamics and changes between different model countries.

### 3.3 Theories of institutionalism

Traditionally, institutionalism is widely used in political and social science as an analytical approach, and institutional explanations have become popular in policy and governance studies. Applied to the present research, it presents a useful analytical framework for better understanding of how the institutional settings constitute corporate governance. Specifically, it illustrates how different corporate governance arrangements are legitimized in diverse national institutional settings by considering the variety of capitalisms, how such legitimacy influences the key orientation in the form of paradigm, and how these legitimacy and paradigm affect the various norms and practices, or frame in general, in the operations of business organizations.

Theoretically, institutional approach can be divided into the old institutionalism school and the new institutionalism school. The former focuses on formal institutions like law and statutes, and their roles in governing. It argues for the dominance of structure and its bounds upon individuals and stresses upon the historical foundations for institutional analysis (Bates, 1998). The latter, on the other hand, develops a further understanding and argues that the institution is a structural feature of the society or polity, which can be formal as in the form of legislature or informal like norms, values or usages. As a 'stable existence', the institution can be used to predict behaviors apart from its binding effects upon the individuals. Also, the institution can lead to some senses of shared values and meanings of members of within its range (Peters, 2004; March and Olson, 1989; Steino, Thelen and Longstreth, 1992).

Within the new institutional tradition, moreover, there are further and more precise categorizations which typically distinguish between the historical institutionalism, rational choice institutionalism, sociological institutionalism, and discursive institutionalism. While broadly united by their emphasis on institutions of all kinds, these different institutionalisms vary greatly in terms of key analytical questions. For instance, historical, sociological and rational choice institutionalisms are somewhat static and typically emphasize on continuity over change. In contrast, discursive institutionalism is more dynamic and capable of analyzing changes (Schmidt, 2010).

The historical institutionalism argues that the initial institution will have a continuing and lasting determinative influence over institutions far into the future (Pierson and Skocpol, 2002; Thelen, 1999), and is mainly characterized with its argument for path dependence and the asymmetrical allocation of powers by different interest groups (Krasner, 1984; G. John 1994; Pierson, 2000). The rational choice institutionalism argues that utility maximization is always the primary motivation of individuals and their goals can be achieved most effectively through institutional action (Peters, 2004). This embraces both internal and external elements, such as the actor's fixed set of preferences, strategic extensive calculations (Kenneth, 1989), and the specific set of structures, procedures or mechanisms provided by the external institutions (Harding, 1968). The sociological institutionalism is said to be the widest institutionalism in explaining the origin and function of the institutions, which defines that institutions embrace not only the usual formal rules, procedures or norms, but symbol systems, cognitive scripts and moral templates. Beside, culture here is also regarded as an institution instead of external factor to traditional 'institutions' (Campbell, 1995). Hence, the relationship between institutions and actors is approached with a 'cultural approach', which develops a highly interactive and mutually constitutive relationship between the institutions and actors. In this context, the actors, consciously and sub-consciously, engage themselves in socially meaningful activities as social players and in turn reinforce the institutional norms they stick to. They work and rework with available institutional templates to devise a course of action (Peter and Thomas, 1996).

### 3.3.1 Defining discursive institutionalism

The discursive institutionalism, in contrast with other three new institutionalism, is 'an umbrella concept for the vast range of works' which takes account of 'the substantive content of ideas and the interactive processes by which ideas are conveyed and exchanged through discourse' (Schmidt, 2010, p3). At the substantive level, the discourse pertains to ideas 'about "what is and what ought to be" at different levels of generality' (Schmidt, 2010), which extends from the specific policy ideas (Hall 1989), to paradigms (Hall, 1993; Berman, 1998), and to deeper philosophic ideas or public sentiments (Campbell, 2004). Moreover, the discourse can also be categorized into cognitive ideas (Hall, 1993; Schmidt, 2002) and normative ideas (Schmidt, 2000), with the former focusing on interests and necessity and the latter centered on values and appropriateness (Schmidt, 2010). At the interactive dimension, the discourse is distinguished between a coordinative process and communicative process, where ideas are constructed and communicated differently. In coordinative discourse, the ideas are jointly constructed by various participants. In contrast, the communicative discourse involves a wide range of actors who 'bring ideas developed in the context of the coordinative discourse to the public deliberation and legitimization' (Schmidt, 2010, p3). Distinguished from other institutionalisms focusing on ideas like ideational institutionalism (Hay, 2001), constructivist institutionalism (Hay, 2006), or strategic constructivism (Jabko, 2006), the discursive institutionalism stresses that 'Discourse is not just ideas or "text" (what is said) but also context (where, when, how, and why it was said). The term refers not only to structure (what is said, or where and how) but also to agency (who said what to whom).'(Schmidt, 2008, p305).

Elaborating upon a multi-facet analysis of the institutions by connecting the macro to the micro level, the discursive institutionalism lays special emphasis upon the role of the ideas and discourses on the social activities. And, it is powerful in generating, deliberating and/or legitimizing ideas about social activities in the institutional context and provides effective explanations for the dynamics of institutional changes, which illustrates when and how ideas in discursive interactions may efficiently enable actors to overcome constraints that are regarded as institutional impediments (Krook, 2007). Meanwhile, an intricate relationship can be observed between the discourse and the institutions. On one side, the discourse is carefully distinguished from the institutions, as the latter is said to play a decisive role in shaping the discourse (Schmidt, 2002; Fischer, 2003). On the flip side, discourses and institutions are intertwined and may 'unfold as ideas are articulated and, over time, are turned into rules-based systems of concepts and conceptions' and 'Institutions, in turn, are authorized and sanctioned discourse. The set of rules governing a discourse are referred to as institutions when these rules, through processes of institutionalization, have attained some degree of authority and been linked to sanctions' (Kennet, 2007, p294). Typically, the power of the discourse may go beyond explaining the reality as it may be the major force in constituting most part of the reality (Fischer, 2003).

As a 'young' institutionalism, however, the discursive institutionalism has its limitations. For instance, from the epistemological perspective, the discourse is comparatively abstract and hard to be tracked down. And it is sometimes not easy to find solid evidence of its causal impacts on social activities and outcomes. This becomes more difficult when there are a great variety of ideas drifting around in a specific social context or when ideas are only a part of a broad social ideology or public philosophy. Meanwhile, ideas may have different levels of abstractions, and there may be certain unconscious ideas at work in people's mind (Parson, 2003). Thirdly, there may be some confusion about ideas as either *explanans* (the explanation) or *explanandum* (what needs to be explained). On one side, ideas may become major causal factors in explaining the social activities on their own. On the other side, however, powerful institutional factors may constrain the production and dissemination of ideas (Schmidt, 2002; Walsh, 2000).

The discursive institutionalism has a complicated relationship with other new institutionalisms. For instance, conflicts are unavoidable in considering the inter-relationship between discursive the institutionalism and rational choice institutionalism, especially when ideas, the core of the former, are being forayed into the latter and act as 'switches' which funnel interests down specific directions (Bates, 1998), or even substitute the interests in explaining the constructions of institutions as 'shared mental modes' (North, 1990). On the other hand, complementary relation can be observed between the historical institutionalism and discursive institutionalism, especially considering the strength of ideas in explaining changes and as a heritage down the history (Blyth, 2003). This is further evidenced by acceptance of ideas by historical institutionalism scholars who gradually combine ideas into their historical institutional analysis (Peters, 2005). The discursive institutionalism has an intimate relationship with the sociological institutionalism, constructivist institutionalism (Hay, 2006) and economic constructivism (Abdelal, Blyth and Parsons, 2005) due to its focus on ideational analysis. On one side, there is a strong 'family resemblance' in these institutionalisms as ideas, acting as the basis of the institutionalism, is argued to constitute the norms, paradigms and frames which help construct the actor's understandings of interests and redirect their actions within the institutions. On the flip side, however, the discursive institutionalism is distinguished by its further emphasis of the interactive process of generating and communicating ideas to the public and the dynamics between the discourse and the institution.

### 3.4 Three levels of discursive institutionalism

As the core of the discursive institutionalism, ideas are regarded as foundations for the formation and changes of the institutional arrangements. Defined as causal beliefs which are products of cognition and connected to this material world via interpretation of the surrounding environments, ideas are said to provide guides for actions and specific ways to address problems and challenges (Jolly and Weiss, 2005). Not infrequently, ideas can take many forms, such as high profile public frames, discourses and ideologies at the foreground of the cognition (Schon and Rein, 1994; Campbell, 2004), or a lower profile assumptions and paradigms that remains at the backgrounds of the arena (Hall, 1993). Generally, ideas in the discursive institutionalism 'tend to occur at three main levels of generality', policy solutions, general programs underpinning the policy ideas, and public sentiments which 'undergird the policies and programs with organizing ideas, values, and principles of knowledge and society' (Schmidt 2008, p306). In this framework, the present thesis reorganizes the discourses into three levels, namely, legitimacy, paradigm and frame.

#### 3.4.1 Legitimacy

First, as the foundation of the institution, ideas take the form of legitimacy comprising public sentiments and public philosophy (Campbell, 1998, 2004). Like observation through the kaleidoscope, the legitimacy is rich in 'colors and shapes' by taking into account various social entities, actors, factors and extends to the political, economic, legal institutions. In its dazzling display, key features of the legitimacy for a period of time in a certain place may be sorted out due to the dominance of certain elements, which are then distilled by the actors and become taken-for-granted public assumptions. For instance, legitimacy may take into account the relationship between citizens and the state, the rights and obligations in political, social and economic institutions, and public sentiments based upon the common language, culture and historical identity (Hay, 2001).

However, there is an intricate relationship between the legitimacy and the actor. On one side, the actor is bound by legitimacy if he intends his activities are institutional acceptable and public desirable. This restricts his choices and options *ex ante* as he has to take same or similar attitudes and stands with the public. In times of uncertainty or instability, the legitimacy can become overwhelming and even dictate the activities of the actor (Campbell, 1998). On the flip side, however, due to the broadness and lack of clarity, legitimacy in general can not provide a specific option or solution but supplement to the decision-making of the actor. Meanwhile, it may be played or even maneuvered by the powerful actor, like the political leader, influential businessman or public figure, to turn his own ideas into legitimacy and promote to the public. For instance, neo-liberal ideas create neo-liberal policies and in turn become legitimate for the public in US and UK. The globalization may become something of a self-filling prophecy and behaving as if it was a reality - the policy-makers may actually be making it happen (Hay, 2006).

In the context of corporate governance, legitimacy varies in different national institutional settings. In the Anglo-Saxon countries, which largely fall under the LME variety of capitalism, the legitimacy of corporate governance lies on the prevailing ownership of private property and strong protection for the private interests. The state always recesses to the corner in the process of economic and business activities, and pledges a pro-competitive disengagement attitude, though in times of economic crisis it prefers to be more active and engaging, and take up the Keynesianism. The court is highly valued by the private parties in settling economic disputes and is expected to render sufficient legal protections for property and contractual rights.

In contrast, in the Continental countries which approximates to the CME variety of capitalism, legitimacy is characterized by the coordination between the government and the industries, banks and enterprises, and business and labor. The state, as a 'coordinator', is more actively involved in industrial adjustment process by coordinating the policies across the industrial sectors, and between the banks and the enterprises. Private ownership is more or less tinged with certain social nature and legal protection for private rights is, to some extent, hindered and restricted.

In the State-affected countries, which are largely consistent with the SME variety of capitalism, legitimacy is characterized by the state's controlling ownership and active intervention in industries and economic process, and promotion of the national economic development. Such intervention is intentionally biased against the private ownership while prioritizing the 'public ownership' by the sovereign for the sake of national economy. The legal system also has a strong flavor of pubic interests and may sometimes give away to regulatory influences.

### 3.4.2 Paradigm

At the next level, ideas take the form of paradigms, such as the 'underlying assumptions or organizing principles orienting policy' (Schmidt 2008, p306). Different paradigms and their relationship can be compared to observing the planets and stars through the telescope, separate but connected. Implicated by different legitimacy discourses, paradigms appear to be isolated from each other and maintain their independence and boundary as separate entities. Nevertheless, due to invisible interactions, especially the similar goal to be achieved, the paradigms are closely connected and affect each other, resembling interactions between the planets because of gravity despite the fact that they revolve 'lonely' in their own orbits.

In social activities, paradigms produce opportunities for actors in the process of forming their own ideas, and in pursuing the solutions of problems. These may be a totally unconscious process, as paradigms are generally rooted in actors' cognitive backgrounds and underlying theoretical and ontological assumptions about how the world runs. For instance, they may be formed through textbooks and case studies in schools and universities, seminars and influential publications by master scholars in the field, which shape the 'discursive path and terrain' of the actor. Or they are shaped by one's experience from his family and working place. Meanwhile, the increasingly powerful social media, especially the internet social networks like blogs, twitters, may greatly influence the actor's mindset by their frequent, overwhelming and persuasive existence (Campbell, 1998).

For paradigms, there are dominant and subordinate, which co-exist but with different weights and influences. However, the dominance of the paradigm in policy, academic popularity and public acceptance may not be decided by its proximity to truth, but how efficiently it is promoted. This is well evidenced by the history of science, from Bruno to Galileo, where the acceptance of the law of nature lagged far behind its discovery as the actively promoted or arbitrary paradigm of pseudo law never easily gave away its throne. In social science, the game is even fanatically played when the 'truth' is 'relative' while the orientations and interests of the players, academia, policy makers and practitioners alike, are 'absolute'. Frequently, the popularity and dominance of certain paradigms is closely connected to the continuous endeavors by scholars, think tanks and policy makers. Like salesman, they design, package and market the distilled, simplified and easy-to-read set of ideas in their aggressive approaches, in forms of commercial ads, brief policy position papers, popular books, journal articles, radio and television appearances and newspapers, which create an air of 'salesmanship' instead of 'scholarship'. Sometimes, instead of generating new ideas, they just cram the government and the public with their favored academic conceptions and theories (Campbell, 1998).

In the context of corporate governance, different paradigms are distinguished by varied models and theories in various national institutional settings, resonating with the legitimacy discourses discussed as above. In the Anglo-Saxon countries, paradigm in corporate governance is categorized as the Anglo-Saxon model and is said to be dominated by the shareholder primacy theory. The ideas of maximizing the interests of the investors, mitigating agency costs, and enhancing the performance of the corporation are actively 'advertised' to the public by academia, policy makers and practitioners. It well echoes the legitimacy of the prevailing private ownership, disengagement by the government for competition, and strong legal protection of private interests. The sub-current theories, like the stakeholder theory which argues for the protection of stakeholders and corporate social responsibilities, are less accepted and believed in despite their merits. Even if they are recognized to a certain degree, they are largely theories on the paper and implemented poorly.

In the Continental countries, the paradigm in corporate governance is labeled as the Continental model and characterized with the stakeholder theory. In contrast with the shareholder primacy theory in the Anglo-Saxon model, it contends for equally protecting the interests of the stakeholders of the corporation, such as the employees, creditors, suppliers, etc., while limiting the maximization of the interests of shareholders. This largely resonates with the legitimacy of coordinating the interests of different players by the state, limitation on the priority of private ownership， and weak legal protection. Although there are scholars arguing for the convergence towards the Anglo-Saxon model and stressing on the maximized investment returns to the shareholders and best performance of the corporation, such subordinate paradigm exerts limited influences upon the existing policy or legislation.

For other types of countries, relevant paradigms are developed, either as a hybrid or derivative of the afore-discussed models. For instance, the paradigm for the Sate-affected countries is classified as the State-affected model, which is said to be the hybrid of the shareholder primacy model and stakeholder model. On one side, it is oriented towards the enhancement of the shareholders' interests, as in the Anglo-Saxon model. On the flip side, it is also targeted to the protection of the interests of various stakeholders similar to the Continental model. However, such paradigm discourse lays specific emphasis upon the national economic development. Always, with the state being the controlling shareholder, the paradigm aims to harmonize the interests by the shareholders, the stakeholders, and national economic growth. This is consistent with its legitimacy of preference for the state intervention and active involvement in corporate operations and governance structure, with the pursuit of national economic objectives.

### 3.4.3 Frame

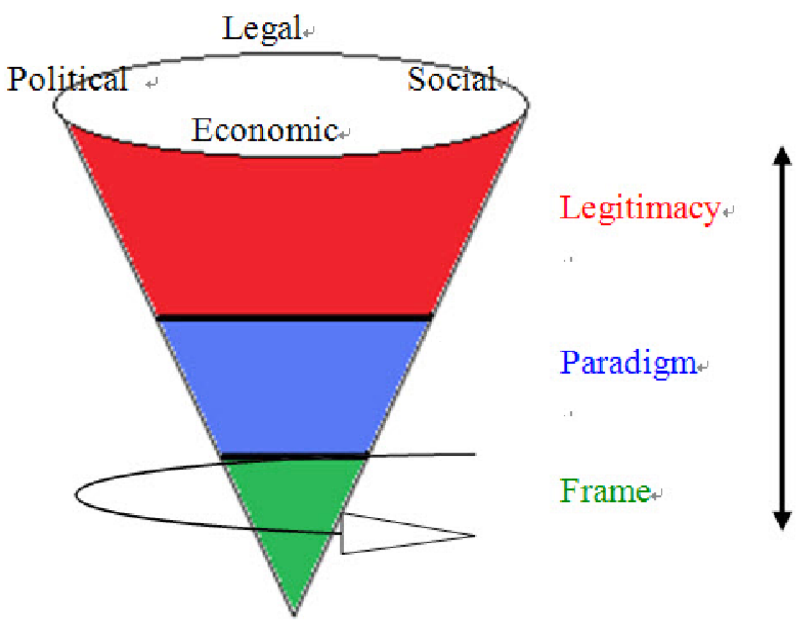
Thirdly, at the empirical level, ideas take the form of frame, which embodies norms, codes, and usages in routine practices. As the manifestation of the legitimacy and paradigm discourses, frame may 'involve specific policies, measures, guidance developed to tackle the practical problems' encountered in social life, which is purported to sort out most efficient solutions and achieve designated objectives (Schmidt, 2010, p5). Not infrequently, the frame is expected to be clear, concise, and behave as efficient 'short-cut' among a great variety of options and ideas (Campbell, 1998).

With regard to corporate governance, frame mainly focuses upon some key practices on the governance arrangement, such as the ownership structure, the organization and behavior of the board of directors, code of corporate governance, and legal duties. Effectively, the frame resonates with the afore-discussed legitimacy and paradigm discourses, and illustrates the impacts of these 'taken for granted' and abstract ideas. For instance, the board of directors varies in different models regarding its organization, practice and duties despite its general function as 'the brain and heart' of the corporation. In the Anglo-Saxon model, the board of directors is organized in one-tier structure for higher efficiency. It is strongly oriented towards best performance of the corporation, effective monitoring upon the management, and higher standards of fiduciary duties. These well represent the paradigm in the

Anglo-Saxon model of the shareholder primacy and legitimacy in prevailing of private ownership.

In contrast, the board of directors in the Continental model is characterized with the two-tier board structure, which stresses upon the relational role with the shareholders, strong connections with the stakeholders, and less burden of legal obligations. These well reflects the paradigm of protecting the stakeholders' interests in the Continental model and legitimacy of coordinating interests among various parties in the framework of corporate governance. The board of directors in the State-affected, similar to that in the Continental model, is distinguished by the state's influence on the board of directors, its strong political connections, and orientations for promoting the national economic development. These are consistent with the paradigm of the State-affected model (the hybrid of shareholder primacy theory and stakeholder theory) and legitimacy of strong state intervention and concerns for national economic growth. Similar dynamics can be observed in other practices of corporate governance, such as the ownership structure, code of corporate governance and legal duties.

**Figure 3.1 Dynamics of Three Level Ideas**




### 3.4.4 Dynamics between legitimacy, paradigm, and frame

In Figure 3.1, a general path, spiraling from legitimacy, paradigm and then down to frame, is illustrated for better understanding of different levels of ideas in the cognitive background and foreground. However, interactions and dynamics between and among different level of ideas are more complicated than it appears. On one side, there is a logic order of ideas funneling down from legitimacy, to paradigm and then to frame, from the cognitive background to the cognitive foreground. For instance, the paradigm is mainly built upon the legitimacy widely accepted by the public as socially desirable. The frame, oriented by the paradigm, may directly integrate the paradigm in the form of norms like specific designed document, guidance or code and gains its justification by relating to the legitimacy. On the flip side, however, such logic may deviate or even be reversed. For instance, the paradigm may diverge from the legitimacy due to the aggressive promotion of by the policy makers, the think tanks and the academia, especially when ideas in legitimacy are less clear and broader. Frame can go further and vary from the paradigm and legitimacy to a larger scale. First, there is some cognitive 'distance' between the frame and the paradigm and even farther for the legitimacy, which enables the frame to be fairly independent and stretch far away from the bounds of the paradigm and legitimacy. This typically happens when the frame is maneuvered by certain interest group for the sake of its own benefits. Secondly, it may happen when the frame is more about specific practices and technical issues, like developments of mathematic modules, patterns or equations targeted at certain business. In a more drastic form, there will be a 'rebel' of the frame when, under the powerful influences of certain interest group, it can defy against the present paradigm and legitimacy and even reshape them. Nevertheless, when this happens, there may already have been some changes going on in paradigm and legitimacy which are consistent with the changing frame.

## 3.5 Chapter Conclusions

Based on the framework of corporate governance theories summarized in Chapter Two, the present chapter proceeds to develop the discursive institutionalism as an analytical tool for better understanding of corporate governance in banking organizations. By bringing in the VoC analysis for diversified institutional settings, the chapter prepares the models for institutional analysis of corporate governance. This is reinforced by the development of the discursive institutionalism, which explores the functions of institutions from macro to micro level and the significant role of ideas in shaping and changing corporate governance. Divided into three levels, ideas may take the form of legitimacy, paradigm and frame. The legitimacy lays a 'take-for-granted' and socially desirable ground for the institutional settings of corporate governance. The paradigms, originating and distilled from the legitimacy, provides a clear orientation and certain preferences in corporate governance. And the frame, targeted at solving specific problems, pertains to the guide, norms and practice in the corporate governance structure. Represented in different forms, ideas play a dominant role in the development and changes of corporate governance in different institutional settings.

# Part II Corporate Governance in Banking Organizations

## Chapter Four Corporate Governance in Banking Organizations (I): Legitimacy and Paradigm

### 4.1 Introduction

Based on the general corporate governance theories and discursive institutionalism analytical framework elaborated in Chapter Two and Three, Chapter Four and Five in Part II, as the second cut of the theoretical analysis, proceed to explore corporate governance in banking organizations. These embrace the discursive analysis on the legitimacy, paradigm and frame of the bank's governance structure in different model countries, as illustrated in Table 4.1. Chapter Four explores the legitimacy and paradigm on corporate governance in banking organizations.

At the legitimacy level, the VoC analysis discussed in Chapter Three is used here to approach different institutional settings for the bank's governance in varied models. It pertains to how corporate governance of the bank is legitimized by the discourse on the relationship between the bank and the economy, especially as this is manifested in financial regulations and the role of legal interventions. In relation to other levels of our analysis, the different paradigms and models of corporate governance in banking organizations, summarized as the shareholder primacy model, the stakeholder model, and the state-affected model, can thus be seen to appear as socially and economically appropriate. Moreover, the discursive institutions of legitimacy also contribute to the shaping of the specific governance frames in the bank, such as differences in the organizational structure of the board of directors, the extent of regulation on executive pay, risk management arrangements, and legal duties.

At the paradigm level, and referring to different models of corporate governance in Chapter Two, this chapter explores different models in the context of the banking industry. The shareholder primacy model takes on some industrial specialties for banking organizations, such as the acuteness of agency problems and intensive conflict of interests between the residual claimants and fixed claimants. For the stakeholder model, referring to the concept of social responsibilities of the bank, protection for various stakeholders comes into the analytical picture. And, for the state-affected model, as a hybrid of the shareholder primacy model and stakeholder model, the paradigm for corporate governance in banking is marked by the state's positioning of the bank as playing an active role in support of national economic development.

### 4.2 Conceptions of corporate governance in banking organizations

The word 'bank' can be traced back to the Italian word *banca* in Middle Ages, meaning bench or counter. And, during the Renaissance, the benches were used as desks or exchange counters by Florentine bankers, who used to make their transactions atop desks covered by green tablecloths (Martim, 1855). In modern times, the bank works as a financial institution with multiple functions. On one side, as a for-profit business association with independent legal status, a bank is similar to a general corporation, characterized with centralized management, limited liability, perpetual existence in law, and free transfer of shares (Bauman, Palmite and Partnoy, 2007). It is subject to the general corporate law, code of corporate governance, and regulations by financial regulators. On the flip side, however, a bank conducts business that is quite different from those of generic corporations, and functions as a financial intermediary. As a licensed financial institution, a bank is mainly engaged in accepting deposits, making loans, and providing other authorized financial services (UK Banking Act, 2009). With constant waves of de-regulations and financial innovations around the world over the last three decades, however, the so-called 'financial disintermediation' has become the keynote of the bank's business, and the bank has drifted away from the homogenous activities of collecting deposits and granting credit and become 'facilitators of risk transfer and deal with the increasingly complex maze of financial instruments and markets' (Allen and Santomero, 1997, p1462). Meanwhile, the bank also turns to investment banking and gets fanatically engaged in 'proprietary trading – that is, betting their own capital at the casino' (Strange, 1997, p9).

Based on the three-tier analysis of generic corporate governance in Chapter Two, the conception of corporate governance in banking organizations is theorized from a three-level perspective of the microscope/micro, telescope/meso, and kaleidoscope/macro. The micro view stresses upon the narrow boundary of the bank's governance structure, such as the best performance of the bank, the maximization of shareholders' interests, and various mechanisms for good governance (Bebchuk and Ferrell, 2009; OECD, 2010; Caprio, 2007; De Andres and Vallenlado, 2008; Laeven and Levine, 2009; Macey and O'hara, 2003; Cooper, 2009). This mainly 'involves the manner in which the business and affairs of banks are governed by their boards of directors and senior management, which affects how they set corporate objectives;

operate the bank's business on a day-to-day basis; meet the obligation of accountability to their shareholders' (Basel, 2010, p7). In the terms we set out in Chapter Three, this is what we have called the specific 'frame' of the governance structure of the bank, like the organization of the board of the directors, the arrangement of management remuneration and its relationship to risk taking and bank's performance, risk management, and legal duties by different participants in the bank.

The meso view, meanwhile, stresses that corporate governance in banking organizations should demarcate an emphasis on the arrangement of various stakeholders' interests, such as protecting the interests of the depositors, creditors and the state. This boundary of corporate governance goes beyond the profitability of the bank and the maximized investment returns to its shareholders, and takes into account of the bank's influences upon its constituencies. In our terms, the meso view leads to the construction of 'paradigms', which focus on how the bank's governance structure should be oriented towards the protection of its various stakeholders, typically the depositors, creditors, and the economy (Basel, 2010).

The macro view, moreover, emphasizes that corporate governance in banking organizations should 'align corporate activities and behavior with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations ' (Basel, 2010, p7). And, in doing so, it concentrates more on the functions of the banking sector for the sake of economic growth and stability, and addresses the macroeconomic implications of the bank's governance structure, such as contagion risk, impacts on payment systems, liquidity problems and bank runs (Basel, 2010). For us, this macro view is a question of producing the 'legitimacy' of the corporate governance arrangements at work in banking organizations.

Corporate governance in banking organizations is not, however, merely constituted through the same discursive institutions of legitimacy, paradigm and frames that operate in corporate governance more broadly. It is certainly the case that distinctive country-level governance arrangements cover both financial and non-financial sectors, especially considering increased competitions and higher threats from the market for corporate control in financial industry, all of which force the bank to take more effective governance structures for the sake of maximizing shareholders' interests and improving the bank' performance, and push the bank's governance structure to evolve towards the general governance system used by generic unregulated firms (Belkhir, 2005, 2008). Yet, although 'Sectoral orientation will generally reflect national orientation', it may have some distinctive features and specifically 'reflect the bias of the dominant agency or agencies in the sector and this may reflect the agencies' particular history, mission, or jurisdictional responsibilities' (Vogel, 1996, P22). Hence, while the discursive institutions of corporate governance in banking organizations are largely consistent with those of generic corporate governance at the country level, specialties abound in banking sector due to its specific characteristics and business activities. These specifics may be more significant in the constitution of some aspects of governance issues in banking organizations, such as highly leveraged capital structure, more opaqueness and lack of transparency, and being more stringently regulated and supervised (Adam and Mehran, 2003, 2005, 2009).

## 4.3 Legitimacy

### 4.3.1 The Anglo-Saxon model

From a kaleidoscope view, institutional settings play a significant role in shaping corporate governance of banking organizations. These mainly pertain to the relationship between the bank and the economy, the influence of the financial regulation, and the legal intervention, as listed in Table 4.1. In what is labeled as the Anglo-Saxon model countries or LME capitalisms, typically represented by US and UK, legitimacy of corporate governance in banking organizations is characterized with the bank's loose ties with industry, separation from the real economy, a pre-competition de-regulative posture by the state (though accompanied with cyclical re-regulation movements), and active legal interventions by the court, regulators and lawyers.

*Bank and economy*

Historically, banks in the Anglo-Saxon model used to perform important functions for the state and were closely integrated into the economy in the early development of the capitalism. Typical examples can be observed in expansion of the British Empire in colonial periods, its industrial revolution when banks contributed numerous funds for commerce, foreign trade and the war (Vogel, 1996; Allen and Gale, 2002). Similarly, in the modernization progress of US in 19$^{th}$ century, banks played pivotal role in providing funds to help build railway, dock and tunnels which could not be accomplished by capital held private households or even the government, especially in the absence of the modern capital market (Bauma, Palmiter and Partnoy, 2007). However, banks gradually loosened their ties with the industry, became isolated from the general economy, and drifted to another trajectory. This attributes to several reasons. First and foremost is the booming of the modern capital market where the industry can obtain a large, better and substitutive source of funding in forms of shares instead of debts and henceforth become less tied to banks,

**Table 4.1 The Discourse of Corporate Governance in Banking Organizations in Three Models**

| **Models of corporate governance in banking organizations** | **Typology of ideas as discursive institutionalism** | | |
|---|---|---|---|
| | Legitimacy | Paradigms | Frames |
| **The Anglo-Saxon model** | Loosened ties with industry, separation from the real economy, and aggressive financial disintermediation;<br>Pro-competitive deregulation by the government, self-regulations, and strong powers from banking industry;<br>Active legal interventions by various parties. | Strongly oriented towards profit maximization and best performance;<br>Shareholder primacy theory;<br>Acute agency problems due to high-leverage capital structure;<br>Aggravated conflict of interests between the shareholders and fixed claimants;<br>Ineffective monitoring from significant stakeholders; | High board independence, strong orientation for maximized profitability, and efficient board size;<br>Higher ratio of shareholding in the executive's pay, and preference for more market oriented regulatory measures like shareholder's say on pay, higher disclosure requirement, and reinforced compensation committee;<br>High-risk preference, and specific risk management in credit risk, compliance risk;<br>More specified and detailed legal duties, typically the fiduciary duty of the board directors and management. |

**Table 4.1 The Discourse of Corporate Governance in Banking Organizations in Three Models --- Continued One**

| | | | |
|---|---|---|---|
| **The Continental model** | Integration into the real economy and close ties with industries;<br>Coordinated financial regulation and moderate powers from banking industry;<br>Less legal interventions. | Stakeholder theory;<br>Long-term interests oriented instead of short-term profits maximization or best performance;<br>Wider-ranged scope of stakeholders; | Limited board independence, strong orientation for long term profitability, and big board size;<br>Limited ratio of shareholding in the executive's pay, increased proportion of base salary and performance related bonuses, and preference for stricter regulatory measures like cap on bonuses;<br>Moderate-risk preference, though sometimes amplified in worsening real economy, and specific risk management in credit risk, compliance risk;<br>Less specified and detailed legal duties, typically the fiduciary duty of the board of directors and the management. |

**Table 4.1 The Discourse of Corporate Governance in Banking Organizations in Three Models --- Continued Two**

| | | | |
|---|---|---|---|
| **The State-affected model** | Close integrated or even affiliated relationship to industries and real economy;<br>Most restrictive and manipulative control by regulators, even in cases of financial reform, and limited powers from the banking industry;<br>Few legal interventions and subject to political influence | Hybrid of a modified shareholder supremacy theory and stakeholder theory;<br>Focusing upon policy objectives and pubic interests;<br>Long-term performance belief shared by both shareholders, management and stakeholders; | Moderate board independence, strong orientation for sustainable development and support for real economy, and moderate big board size;<br>Increasing high ratio of shareholding in the executive's pay, equally higher base salary, and preference for stricter regulatory measures like cap on bonuses;<br>Moderate-risk preference, more frequently amplified in worsening real economy, and specific risk management in real economy;<br>Limited legal duties, typically the fiduciary duty of the board of directors and the management. |

except in times of near insolvency or economic crisis. Such direct, less restrictive and fast financing from the capital market out-competes the traditional intermediate and demanding banking loans and turns the Anglo-Saxon model into the 'capital market-based model/system' of financial capitalism, as in Table 4.2 (Hellwig, 1991; Rajan, 1992; Zysman 1983; Allen and Gale, 2002; Ergungor 2003, 2004; Levine 2002). In this capital market-based model, there is observed a high percentage of financial sector assets, and low concentration of financial sectors, as illustrated in Figure 4.1. In US for instance, the stock market capitalization takes 26% in the whole financial system, while the bank loans (the non-securitized) only take 10%. And, the general capital market takes 73%, while the bank loans, including those securitized through the capital market, take only 27%. Meanwhile, a great variety of issuers and participants are involved in the capital market, the trading volume is high, and the trading activities are fairly active (Antzoulatos, 2008). In this context, the non-financial enterprises can henceforth raise their funding more easily and directly from such robust capital market through direct financing by means of issuing equity and bonds. The household holds a high proportion of investment in the capital market while limited holding of the bank deposit. Moreover, this model of financial capitalism is characterized with the arm's length relationship between the banks and non-financial enterprises, where the enterprises are, except in cases of financial crisis and economic recessions, less dependent on banks. This brings in a stricter requirement on transparency and information disclosure, in which the market mechanisms function more efficiently. Moreover, the capital market-based model is said to be in a better position to satisfy large financing needs and offers liquidity through the assumed efficient capital market, except in times of financial crisis. And the key risk is supposed to arise out the enterprise insolvency (Allen and Gale 2002). These changes, especially the loosened ties between the industry and the bank, force the bank to renovate its business model to efficiently use its assets, and hence develop innovative financial products which are steps away from the real economy (Allen and Gale, 2002).

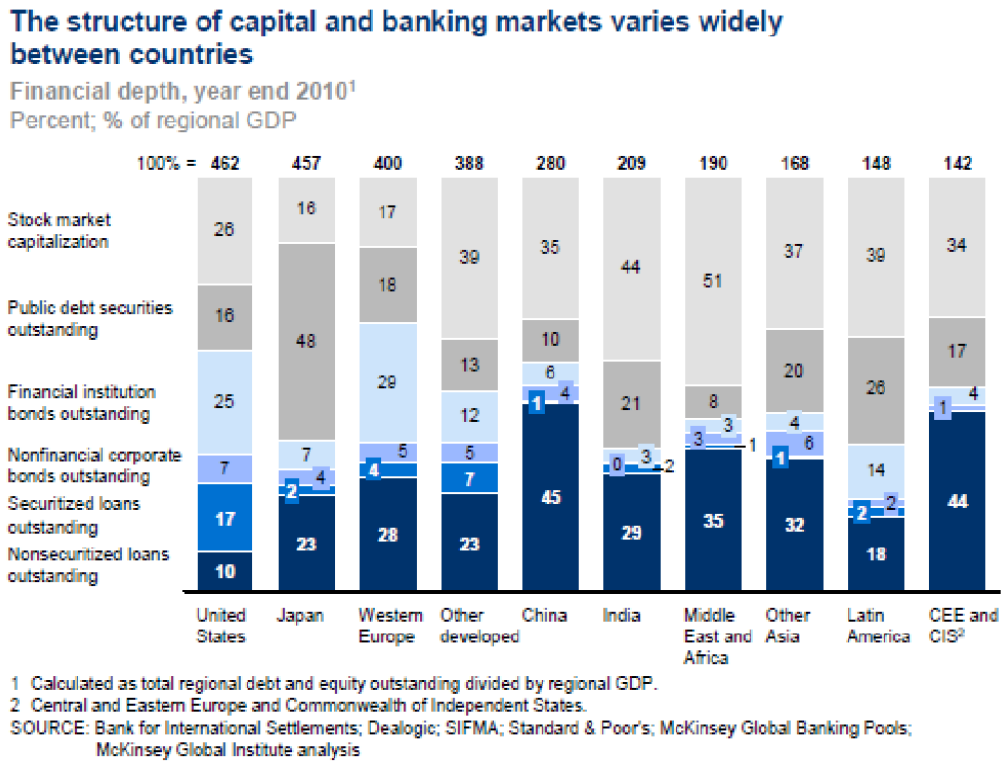
Secondly, the government becomes less competent in coordinating industrial policies and loses its control in guiding efficient allocation of credit to the industry. This expedites the separation of the bank from the industry as its financial interests are less likely to coincide with the industrial ones in such 'standby' political climate. For instance, in the post war era, UK government started an industrial policy for financial sector, but without any financial policy for the industrial sector, which implied the government's strong support for London's role as an financial centre while not intending to use financial system as a tool of industrial policy (though the government might occasionally intervene in industrial finance or help the industries in cases of economic hard times or crisis) (Reid, 1988). The latest example is the inability of the UK government to effectively orient bank loans for funding to the business and industries after the 2007-2009 financial crises (The Guardian, March 5th 2013).

**Table 4.2 Capital Market-based Model and Bank-based Model of Financial Capitalisms**

| | Capital Market-based Model | Bank-based model |
|---|---|---|
| Capital markets | High percentage of financial sector assets; More issuers and participants; and high trading volume. | Relatively small percentage of financial sector assets; Relatively few issuers participants and lower trading volume. |
| Non-financial firm financing | Mainly equity and bond issues | Mainly long term bank loans |
| Household role | Household finances enterprise | Household finance bank, which finances enterprise |
| Concentration of financial sector | Relatively low | Relatively high |
| Qualitative nature of financial and non-financial firm interaction | Arms-length interaction | Relational exchange |
| Information | Higher transparency, and markets gather information | Protects opacity, information is concentrated |
| Liquidity | Able to satisfy large financing needs and offers liquidity through robust capital markets | Relative illiquidity |
| focus of risk | Enterprise insolvency | Bank insolvency |

Source: Hardie and Maxfield, 2010

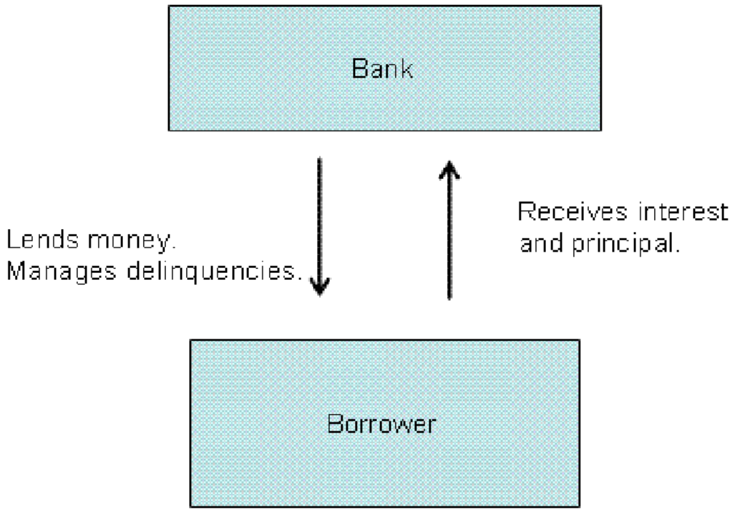
**Figure 4.1 The Capital and Banking Markets around the World 2010**




Source: Mc Kinsey&Company, McKinsey Global Institute, 2011

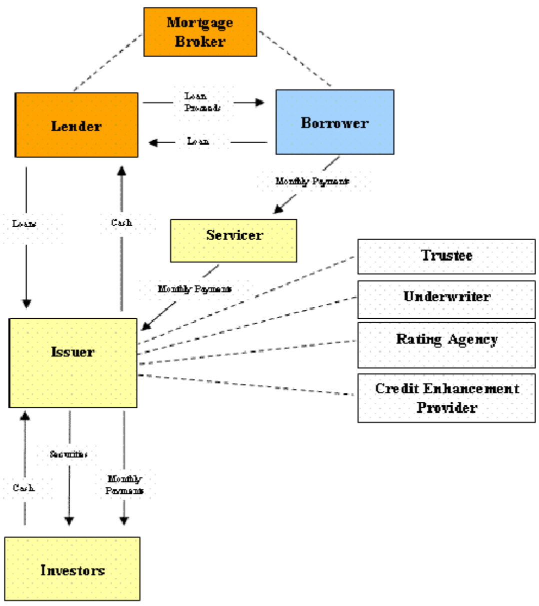
Thirdly, the increasing financial disintermediation leads to further spin-off of the bank from the real economy. Deviating from the traditional capital-raising and risk-bearing intermediation roles, the bank in the Anglo-Saxon model is increasingly engaged in 'managing risks' and initiates the business pattern of 'originate to distribute', such as transferring loan related risk to third parties through the capital market and transactions in various financial derivatives. A typical example is the securization process of the bank's loan. In traditional banking business as illustrated in Figure 4.2, the bank issues loans to the borrower, monitors the credit situations of the borrower, and manages relevant delinquencies. The borrower repays the bank the principals and the interests agreed upon. In contrast, in the securization process in Figure 4.3, the traditional role of the bank as lender is broken into several different independent components and the bank mainly 'underwrites and funds loans that are eventually sold to the SPE for inclusion in the securitization' and gets 'compensated by cash for the purchase of the loan and by fees'(Bair, 2007). Instead of holding the loans on its balance sheet, the bank sells the loan to the issuer, the special purpose entity (SPE), which is formed to facilitate the securitization of the loan and in turn issues such securitized loans as securities to the investors.

**Figure 4.2 The Traditional Model of Banking Process**




Source: Bair, 2007

**Figure 4.3 The Securization Process of Banking in US**



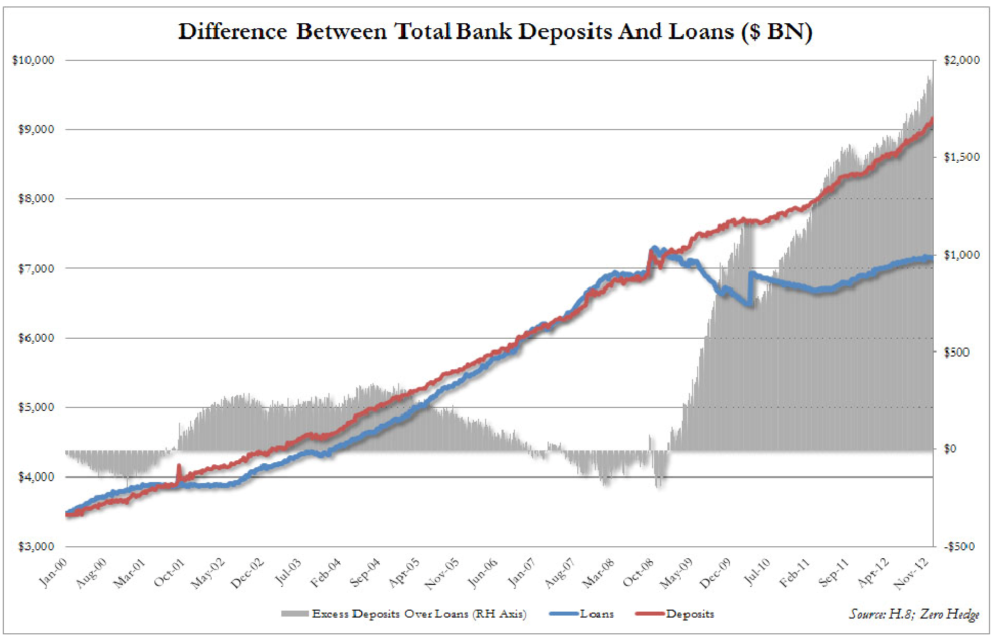

Source: el at. Bair, 2007

In the context, the bank will not bear any responsibilities for monitoring the economic situations of the borrower and managing the delinquency in case of default (Bair, 2007).

These result in the banks' retreat from the real economy. For instance, there has been less or even non-availability of finance provided to smaller businesses by UK banks (UK, Macmillan Report, 1931) and financial support for major infrastructure projects by banks is fairly limited (The Guardian, August 13th 2012). In some instances, the banks' role in economy is criticized as 'socially useless' and or even 'economically damaging and socially destructive' (Mathiason, Newman and McClenaghan, July 9 th, 2012). Another prominent evidence of the bank's 'indifference' to the real economy in the Anglo-Saxon model can be observed in its reluctance to issue loans in times of economic difficulty after the 2007-2009 financial crisis. Though the government injects mountainous funds into the banking industry in times of financial crisis, the invested banks are holding the money back from the real economy and reduce their financing for industries, business and infrastructure projects (Zero Hedge, 2012).

As illustrated in Figure 4.4, from around the end of 2008 to November 2012, though the bank deposit in US kept increasing to over 9.2 trillion, the bank loan issued in the same period declined from \$7.27 trillion to \$7.15 trillion, a zero or negative loan issuance. Around 2 trillion have been held back by the banks which should have been issued to individuals, households, and small, medium and large businesses to fund expansion and growth. In a worse case, the banks use "deposit to loan gap" to take on excessive risky activities, best exemplified by the London Whale Transaction where JPMC bet on derivatives and incurred over \$60 billion losses (Zero Hedge, 2012).

**Figure 4.4 2000 – 2012 Difference between Total Bank Deposits and Loans in US banks (Unit: billion US dollars)**




Source: Zero Hedge, 2012

*Financial regulation*

Regarding the financial regulation in the Anglo-Saxon model, a de-regulative environment is formed in the background of strong orientations for self regulation, pro-competition, belief in the market as the efficient mechanism, and resistance to political intervention by the banking industry. First, there has been a traditional discourse, held by either the regulators or the bank practitioners, for self-regulation which are brewed in the context of 'long-term cultural homogeneity of the practitioners, geographical proximity of their offices and frequent informal meetings and contacts between bank industry and financial regulators' (Vogel, 1996, p135). On one side, the regulator are proud and confident in this market-oriented regulatory approach as they can know the banks better and have an insider knowledge of the markets. On the other side, the bank practitioners prefer this market-oriented approach, which can effectively exclude the political intrusion into the financial industry (Vogel, 1996).

Secondly, the constant financial innovations challenge the regulator's competence to regulate. In US, for instance, the financial institutions have been innovating fairly sophisticated financial products to take advantages or circumvent the regulatory barriers, exemplified by the complicated securization of loan obligations of various sorts and the dazzling financial derivatives, which frequently hinder the regulator to adequately and efficiently regulate due to their complexity, mix of a great variety of different risks, the volatility of the credit quality, and the involvement of too many participants. Meanwhile, as these financial products are traded through the capital markets, the banks and other intermediaries could transfer a core function of traditional intermediation from an industry subject to close, prudential supervision to one largely beyond regulatory oversight (Vogel, 1996). In this context, the government is often incompetent to consolidate various issues into one single coherent debate and initiate an efficient financial regulation. Frequently, financial changes always start with some challenges on the status quo by the banks, followed by a series of responses from regulatory agencies and the courts (Litt, 1990). The latest example is represented in the difficulty of implementing the Dodd-Frank Act in US, where the presence of a great variety of complicated financial derivatives and newer financial innovations perplex the regulators in issuing a clear and finalized interpretation and implementation (US, Dodd-Frank Act, 2010).

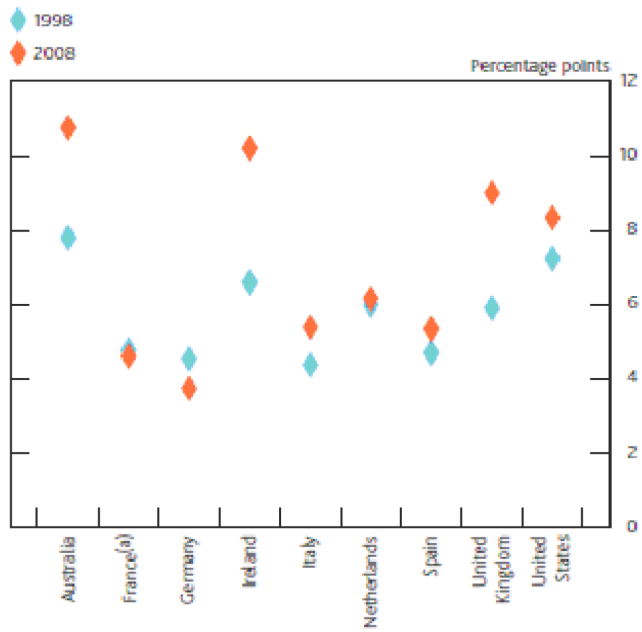
Thirdly, there is an over-stress on the significance of the banking industry in national economy by the regulators in the Anglo-Saxon model, such as its contribution to the economy, and the proportion of its assets in GDP. As illustrated in

Figure 4.5, on measuring finance's contribution to GDP, financial services in the Anglo-Saxon model seem to play a more important role to GDP than in its counterpart of Continental model and State-affected model, with 9.5% in UK, 8.2% in US, a little above 4% in Germany and France. Meanwhile, the total assets of the banks in GDP have been increasing drastically in the Anglo-Saxon model. In UK for instance, the banks' assets as a percentage of GDP remained steady around 50% from 1880s to 1970s, as in Figure 4.6. However, from then on, it started to rise in size and rocketed over 500% of GDP by 2006. And it reaches around 556% of GDP in 2012, much higher than that in German of 160% of GDP and France of 336% (Economist, November 10th 2012).

In this context, banks in the Anglo-Saxon model can get more government financial assistance in times of financial crisis than their counter parts in the Continental model or State-affected model, as listed in Table 4.3. For instance, in 2009, UK and US pledged much higher support to the financial industries than the Continental model or State-affected model countries as a percentage of the national GDP, with UK pledging around 101%, US 42%, Germany 27%, Japan around 21%, France 21%, and Italy 8%. All these lead to the abnormal and unique status of the banking organizations in the Anglo-Saxon model as 'Too big to fail' (Bernanke, 2010), 'Too many to fail' (Acharya and Yorulmazer, 2007; Mitchell, 2001), and 'Too big to jail' (Mother Jones, January, 2010), which are hardly possible in any other sectors. And, against this backdrop, the regulator in the Anglo-Saxon model is fairly resistant to strict financial regulation and fears such restrictions may force the banks to move to other countries, which will damage the country's comparative financial advantages and harm the economy as a whole. For instance, UK financial regulators have been resisting restrictive financial reforms in EU, such as the financial transaction tax (The Tobin/Robin hood Tax) and the cap on the banker's bonus, and contended such reforms may damage its banking industry, henceforth its national economic interests. For US, the regulators simply ignore such moves (The Guardian, February 27 th, 2013).

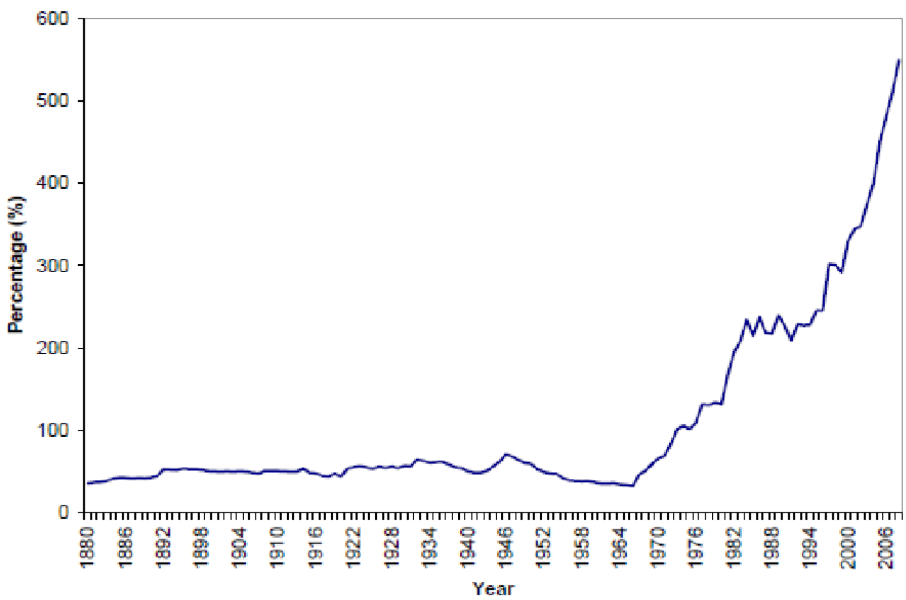
Fourthly, the regulator and government may frequently yield to the powerful banking industry by its aggressive lobbying and political influence. For instance, banks in this model have gained massive powers from the cities they are located in, London in UK and New York in US, both of which hold very distinguished place in the national economy, politics and especially the financial industry. Typically in the case of the City of London, which is a metropolitan corporation of itself and has long steered the UK banking industry, its own orientation is pivotal to UK financial industries as a whole and influential upon the UK government regarding financial policies and regulations. Frequently, the City can persuade the government to provide a more *lassie faire* regulative environment to attract large foreign financial institutions (Vogel, 1996).

**Figure 4.5 Contribution of Financial Sector to GDP across Countries, 1998, 2008**




Source: OECD, ONS and Bank calculation, 2011

**Figure 4.6 UK Banking Sector Assets as % of GDP from 1880-2006**




Note: The definition of UK banking sector assets used in the series is broader after 1966, but using a narrower definition throughout gives the same growth profile

Source: Haldane, 2009

**Table 4.3 Amounts Announced or Pledged for Financial Sector Support by Country**

(In percent of 2009 GDP unless otherwise noted)

| Model | Country | Capital Injection | Purchase of Assets and Lending by Treasury | Direct Support | Guarantees | Asset Swap and Purchase of Financial Assets, including Treasuries, by Central Bank | Upfront government Financing | Total |
|---|---|---|---|---|---|---|---|---|
| | | (A) | (B) | (A+B) | (C) | (D) | (E) | |
| Anglo-Saxon Model | United Kingdom | 8.2 | 3.7 | 11.9 | 40 | 28.2 | 8.7 | 100.7 |
| | United States | 5.1 | 2.3 | 7.4 | 7.5 | 12.1 | 7.4 | 41.8 |
| Continental Model | Germany | 3.4 | 0 | 3.4 | 17.2 | 0 | 3.4 | 27.4 |
| | Japan | 2.5 | 4.1 | 6.6 | 7.2 | 0 | 0.4 | 20.8 |
| State-affected Model | France | 1.3 | 0.2 | 1.5 | 16.9 | 0 | 1.1 | 21 |
| | Italy | 1.3 | 0 | 1.3 | 0 | 2.7 | 2.7 | 8 |

Note: Columns A, B, C, D, and E indicate announced or pledged amounts, and not actual uptake.

Source: IMF, 2010

Meanwhile, aggressive lobbying by banks effectively impacts on the financial legislation and policy making, and exerts great influence on politicians, regulators, and the government. For instance, UK financial service industry spent more than 92 million Pounds in 2011 for lobbying politicians and regulators in 'an economic war of attrition' which achieved 'a string of policy victories', such as slashing of corporation tax upon the bank's overseas branches, suffocating the government's plan for new corporate super-watch dog to further discipline the quoted corporation (Mathiason, Newman and McClenaghan, July 9th, 2012). Further political impact by the banking organizations can be observed in continuous and increasing political donation by the banks. In UK, for instance, the political donation doubled in 2010 in contrast with 2005, which took over 50% of all the cash donations, as listed in Table 4.4.

**Table 4.4 Donations to the Conservative Party from 2005-2010 UK**

| Year | Total Financial Services industry cash contributions to CPCO | Yearly total cash donations to CPCO (all donors) | Financial Service industry contribution as a % of total cash donations |
|---|---|---|---|
| 2005 | £2,748,527 | £11,142,090 | 24.67% |
| 2006 | £6,196,999 | £16,395,889 | 37.8% |
| 2007 | £6,175,695 | £16,728,005 | 36.91% |
| 2008 | £5,364,319 | £13,691,446 | 39.17% |
| 2009 | £10,849,884 | £20,813,184 | 52.12% |
| 2010 | £11,420,974 | £22,482,411 | 50.79% |
| TOTAL | £42,756,398 | £101,253,025 | |

Source: Mathiason and Bessaoud, 2011

These lead to a series of deregulation movements, which reached the peaks in late 1980s and 1990s last century, when 'Big Bang' took place in UK in 1986 and Gramm-Leach-Bliley Act was passed in 1999 in US. These financial deregulations are characterized with bold financial liberalizations, decentralizations of authority and over self-constraints by the regulators, demolishing 'the wall' between the banking and brokerage business, and affording the bank industry more freedom in their business scope and products (Vogel, 1996; Allen and Gale, 2002). Evidence also abounds in the period preceding the 2007-2009 financial crises. Even if there were signs of malpractices or excessive risky activities by the banks, such as the LIBOR manipulation, the highly risky sub-mortgage securization, and mis-selling of various financial products, financial regulators in US and UK took a fairly lax regulatory stance (USA Today, July 18th, 2012; The Guardian, June 29th, 2012).

*Financial re-regulation*

However, accompanying the de-regulative movements in the Anglo-Saxon model are the financial re-regulation campaigns, which are featured with imposing more restrictions, creating more new legal acts, and setting up new regulatory bodies to accommodate the changes brought about by the financial liberalization. In UK, for instance, the 'Big Bang' came hand in hand with a series of new re-regulations such as passing of the FSA, creation of new self-regulatory organizations and dozens of compliance departments, which aimed to establish a new and more extensive industrial system of financial regulations (Vogel, 1996). Moreover, the financial re-regulation frequently takes place pro-cyclically with the financial crisis. For instance, after 1930s US financial crisis, 1933 Glass-Steagall Act was passed which separated banking business from the investment business. And after the 2007-2009 financial crises, a new round of wide-ranged re-regulation moves has been taken by financial regulators in US and UK. First, there are financial reforms and new legislations targeted at stricter regulation on the banking industry and protection of the customers, such as the Dodd-Frank Act in US, the proposal for 'electrifying ring-fence' of the banks in UK, and a great variety of legal actions and penalty against the banks(UK Banking Reform, 2013; US Dodd-Frank Act, 2010). Secondly, new regulatory agencies are established, such as the Consumer Financial Protection Bureau, the Financial Stability Oversight Council (FSOC) by US financial regulators (US Dodd-Frank Act, 2010). Thirdly, there are direct interventions in the bank's business activities, exemplified by prohibitions on the proprietary trading, the separation of the retail banking from investment banking, and the mandatory requirement of 'living will' for future solvency (US Dodd-Frank Act, 2010). However, if perceived otherwise, the afore-said re-regulatory moves in Anglo-Saxon model can be understood as the government's efforts in assuring a proper and smooth operation of the financial deregulation, a periodical self-rectification in the existing financial regulation, and a baseline for the new round of deregulation.

*Legal intervention*

As discussed in Chapter Two, legal intervention plays an important role in generic corporate governance in the Anglo-Saxon model countries. A similar status can be observed for the legal intervention in corporate governance in banking organizations in this model, despite bank's its industrial specialty and demanding requirement for professional knowledge. First, the court exerts great influence on corporate governance in banking organizations, typically with regard to the fiduciary duties by the board of directors and management, such as the duty of care, duty of loyalty and duty of disclosure. Cyclically, the court may raise the standards of fiduciary duty for the bank directors and impose stricter liabilities during or immediately after a wave of bank failures.

Secondly, the financial regulators can be pretty aggressive in legal intervention by initiating various actions against the banks, challenging their duty of compliance, and imposing major penalties. For instance, US Securities and Exchange Commission (SEC) has been proactively engaged in launching charges against the financial industry as well as collecting fines and compensation. This is particularly evident ex post the 2007-2009 financial crises. As listed in Table 4.5, up to January 2013, there were altogether 153 entities and individuals in financial industry charged by SEC, including 65 CEOs, CFOs and other senior corporate officers and 36 individuals received officer and director bars, industry bars or commission suspensions. The total penalties, disgorgement and other monetary relief reached unprecedented high \$2.68 billion. Meanwhile, the legal firms, by soliciting the aggrieved parties by the malpractice or breach of fiduciary duties by the bank, have been launching aggressive and voluminous civil actions.

**Table 4.5 Summary of Charges by SEC against the Financial Industry and the Collection of Fines and Compensation**

| | |
|---|---|
| Number of Entities and Individuals Charged | 153 |
| Number of CEOs, CFOs, and Other Senior Corporate Officers Charged | 65 |
| Number of Individuals Who Have Received Officer and Director Bars, Industry Bars, or Commission Suspensions | 36 |
| Penalties Ordered or Agreed To | > \$1.53 billion |
| Disgorgement and Prejudgment Interest Ordered or Agreed To | > \$756 million |
| Additional Monetary Relief Obtained for Harmed Investors | \$400 million* |
| Total Penalties, Disgorgement, and Other Monetary Relief | \$2.68 billion |

* In settlements with Evergreen, J.P. Morgan, State Street, TD Ameritrade, and Claymore Advisors

Source: US SEC, January 9th 2013

Sometimes, the legal intervention in the Anglo-Saxon model may become so influential that it can not only impact how the banks practice, but actually impact what the bank does. And, the banks even have to hire ex-regulators to cope with the deluge of litigations in the context of chaotic law and multiple litigants. For instance, as listed in Figure 4.7, after the 2007-2009 financial crises, the US banking industry is buried in the increasing hills of judicial subpoenas, orders and claims and mountains of legal document and paperwork, which resulted in excessively high legal costs (Economist, Oct 13th 2012).

**Figure 4.7 US Bank's Legal Costs 2012**


Source: The Economist, Oct 13th, 2012

*Implication of legitimacy on paradigm and frame*

Discussed in Chapter Three, as the discourse at the background of cognition, the legitimacy may greatly influence the formation of the paradigm and frame. In the context of corporate governance in banking organizations in LME like US and UK, this is manifested in the formation of the shareholder primacy model (the paradigm) and the specific governance structure of the bank (the frame). With less concerns for and constraints from the real economy, the bank in LME is 'more individualized and freer' to pursue its own best interests, i.e. maximizing its profitability and bringing best returns to the investors, while frequently ignoring the interest of other stakeholders or the stability of the financial system. Such paradigm of the shareholder primacy is reinforced by the financial deregulation movements. With the conventional belief in self-discipline by the banks and reluctance to intervene in their operations, the regulator actually gives the banks wide discretions in pursuing their own interests, while imposing less pressure on them to either protect the interests of the various stakeholders or serve the real economy. Moreover, the increasingly competitive market the financial deregulation intends to promote intensifies competitions within and beyond the banking industry. To survive the cutting-throat competitions, banks are forced to achieve the best performance (usually in short-term, annually or even quarterly) and attract investors by providing maximized investment returns. Meanwhile, the active legal intervention further contributes to shaping the paradigm of shareholder primacy. By prescribing profound and detailed standards of the fiduciary duty on the board of directors and managers, such as the duty of care, duty of loyalty, and duty of disclosure, the court actually provides an enhanced legal protection for the interests of the shareholders ex post. Though the latest round of financial reforms in UK and US, in the form of financial re-regulation, apparently rebooted the bank's concerns for the key stakeholders, the clients mainly, they can not fundamentally change the bank's paradigm as discussed. For example, there is a varied 'colorful' reoccurrence of bank scandals targeted at taking advantages of the banks' client.

The legitimacy discourse of banks in LME may also influence the constitution of the specific arrangement of governance structure. For instance, the discourses of the bank's disintegration from the real economy and the financial deregulation may largely shape the orientation of the bank board, which is prioritized on the maximized profitability and bringing best returns to the investors, rather than the sustainable long-term development. The discourse of financial deregulation, on the pre-requisite of a more independent and self-disciplined board of directors, can affect the composition of the bank board, exemplified by the requirement for a higher proportion of the outside directors, stricter criterions of independence, and more independent board committees. Meanwhile, the discourses of financial disintermediation of the bank and laxer regulation may influence the arrangement of risk management in the bank. With the banks' active engagement in 'gambling' on various financial derivatives like CDO and aggressive practice in securization, they are subject to a higher risk appetite, difficulty in managing long-chained risks, and exposure to more complicated risks. The 'free-style' financial regulation before the 2007-2009 financial crises, either caused by the regulator's reluctance or inadequate capability to intervene in banks' business operations, provided further discretions for the banks to take their chances and pull in excessive risks or even pursue illegal but highly profitable practice. Next, the discourse of active legal intervention may greatly impact on the formation of legal duties of the board of directors and management. For instance, by setting specific criterions on the duty of care in the context of banking industry, the court illustrates to the bank directors and managers what constitutes an adequate performance of their legal obligations. Meanwhile, legal actions and charges by financial regulators may further clarify the boundary of the duty of compliance by the bank.

### 4.3.2 The Continental model and Stat-affected model

*Continental model*

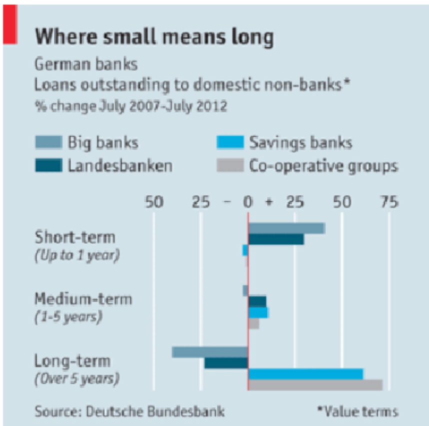
In what is labeled as the Continental model, or the CME capitalisms, corporate governance of the banking organizations is legitimized in the bank's integration in the economy, close relationship with industry and enterprises. Meanwhile, the government regulates by coordinating the interests of the bank with those of the industrial sectors and legal intervention is less important compared with its counterpart in the Anglo-Saxon model.

a. Bank and economy

In the Continental model, the bank is said to be closely integrated into the real economy, oriented towards the long-term financing for the industry, and play a significant role in corporate governance of non-financial firms. First, the bank dominates in the financial sector in the Continental model, and the model is also termed as the 'bank-based' model (Gerschenkron, 1962; Allen and Gale, 2002; Stulz, 2002; Hardie and Howarth 2009; Hardie and Maxfield, 2010), as in Table 4.2. In this model of financial capitalism, the concentration of the financial sector is fairly high. As illustrated in Figure 4.1, the bank loans (the non-securitized) in Japan and West Europe (including Germany and France) takes 23% and 28% respectively in the whole financial sector, much higher compared with that of US. Frequently, the bank provides the lion's share in the long term external funding to enterprises while takes in a large proportion of financial savings from the household in the form of deposits. And, there is observed a close relationship between the banks and non-financial enterprises, which leads to a relational bank/relational relationship in contrast with the arm's length one in the capital market-based system. The capital market in this model is often limited in size and role for enterprise financing, which comprises a relatively small percentage of financial sector assets, involves fewer issuers and participants, and the trading volume is comparatively low. As observed Figure 4.1, in Japan and Western Europe (including Germany and France), the stock market capitalization takes only 16% and 17% in the whole financial sector, much lower compared with that of US. These are caused by several factors. On one side, the banks in the Continental model are said to use their influence to prevent the growth of the stock market, as it may compete with the banks as a funding provider to the large enterprises and collectors of the household deposits. On the flip side, the financial regulators, typically the central bank and financial ministry, intentionally hold back the development of the stock market as they fear that a liberalized stock market may endanger its policy of monetary stability (Fischer and Pfei, 2004). Though many drastic reforms have taken place and the capital market has been developing fast in the Continental model countries in the past decade, the bank still maintains its dominance in the financial sector. In this context, there is less strict requirement on transparency and information disclosure in the Continental model, and opacity is more prevalent and information is highly concentrated. Also, there is relative illiquidity of financing and the first-order risk is the bank insolvency (Allen and Gale, 2002).

Secondly, there is shared discourse among the bank's management, regulators and the general public that the bank, private or public, bears a special responsibility to the national economy, the development of the enterprises, and the welfare of the society at large (Hackethal, Schmidt and Tyrell 2006). For instance, the savings banks and cooperative banks in Germany, with a dominant status in the German banking industry, claim to be designed for 'working for the public or mutual good rather than for shareholders' and argue to be 'well suited to the mixture of households and small companies (known as the Mittelstand) that they serve'(Economist, November 10 th, 2012). Under the austere economic situations in periods of 2007-2009 financial crises, these two pillar banks increased the medium and long-term loans extensively and provided about two-thirds of all lending to Mittelstand companies and 43% of lending to all companies and households. Though the private big banks cut off their medium and long-term lending, they greatly increased the short-term loans to the enterprises and the households. These contribute greatly to the recovery and good performance of the German economy in times of economic recession (Economist, Nov 10th 2012).

**Figure 4.8 Changes of Bank Loans by German Banks from 2007-2012**




Source: The Economist, November 10$^{th}$, 2012

Thirdly, in contrast with the prevalent financial disintermediation of the bank in the Anglo-Saxon model, the bank in the Continental model mostly functions as a financial intermediary, which is mainly involved in providing financial liquidity and monitoring services. As a depository institution, the bank is engaged in providing depositors with liquidity insurance as liquidity providers (Diamond and Dybvig, 1983). Specifically, the bank acts as the delegated monitor for investors and provides monitoring services, avoiding thereof the duplications monitoring costs which is caused by the informational asymmetry between the debtor firm and the creditor depositor. As a financial intermediary accepting deposits and extending loans, the bank in this model ensures the depositor (the investor) better access to their funds and borrowers against the risks of that funding will be withdrawn prematurely (Diamond and Dybvig, 1983).

Fourthly, the Hausebank/ main bank system in the Continental model leads to an intimate relationship between the bank and the enterprises, typically represented in Germany and Japan. The Hausebank, or the main bank, takes a special place in the financing relation with the firm, exemplified by its premier status, a closer relationship, and privileged access to information with the firm. This distinguishes the Hausebank from other banks which also provide funding. However, the Hausebank also takes on extra responsibility. For instance, in times of economic difficulty and worsening financial situations by the firm, the Hausebank has to maintain or even increase its lending to the firm, though other banks may reduce their combined lending exposure (Elsas and Krahnen, 1994, 1998). In this context, the bank actually provides the implicit liquidity insurance to its established long-term enterprise clients, which reinforces the bank's loans as the dominant external financing used by the firm (Hackethal and Schmidt, 2004).

Meanwhile, the inter-relationship between the bank and enterprise in the Continental model is strengthened by the bank's significant role in the corporate governance of the enterprises (Deeg 1998; Vitols, 2005). On one side, this results from the bank's historical role as the large shareholder in the firms. On the flip side, as the significant creditor or the main bank/Hausebank of the firm, the bank obtains strong powers in corporate governance of the firms and their business operations, observed in its presence on the supervisory board of the firms and access to privileged and valuable information (Schmidt, 2003). Due to the large stake vested in the firms, either by shareholding or bank loans, the bank has a strong incentive to monitor the management (Shleifer and Vishny, 1997), and may intervene directly when its client firms runs to a financial distress (Lehmann and Neuberger, 2001; Edwards and Fischer, 1994).

b. Financial regulation and coordination

Though not like the *laissez faire* style of regulation in the Anglo-Saxon model, financial regulators in the Continental model take a comparatively liberal approach and rely considerably on self-regulation. Generally, the banks have more 'say' in their business operations and policies, and are less intervened by the regulators. In

Germany, for example, banks are 'universal' and can provide all kinds of financial services to their clients. The financial regulators mainly view their functions as supervising and monitoring a self-regulatory financial system. Meanwhile, the major financial reforms are orchestrated and coordinated between the government and banking industries. For instance, the major reforms in the stock exchange and centralizing the stock activities in Frankfurt were agreed upon by major banks and financial ministry in Germany (Vogel, 1996; Allen and Gale, 2002).

However, financial regulation in this model can also be restrictive, which is grounded in the protection of the depositors, maintaining the viability of the banks, and the functioning of financial sector as a whole. Financial regulators, like the central bank, the financial ministry, and the bank supervisor, may be actively involved in promulgating guidelines and principles, supervising various business operations of the bank, or even intervening in the bank's financial activities. In Germany, for instance, the Federal Banking Supervisory Office (FBSO, Bundesaufsichtsamt für das Kreditwesen) has been actively engaged in a great variety of supervising activities and 'has far reaching rights to obtain information, intervene into management decisions, recall bank managers, impose moratoria and close a bank' (Fischer and Pfeil, 2003, p11). The central bank, the Bundesbank, also takes an active stand in bank supervision by issuing guiding principles and rules, and developing the process of ongoing supervision, prudential regulation and auditing. Its intervening role was typically observed in obstructing the introduction of securitized money market instruments (such as money market funds, CDs) for monetary policy reasons and deterrence of entry by foreign banks in DM-denominated bond underwriting activity in the era of DM (Fischer and Pfeil, 2003).

Specifically, regulatory restrictions and interventions in the Continental model intend for the stability and sustainability of the whole financial system. In Germany, for instance, there have been restrictions on entry into the banking business, restricting the competition in banking industry, protecting Germany's universal banks from 'invasion' of foreign banks, and setting various restrictions on competing financial services and products provided by non-bank suppliers of financial services (Fischer and Pfeil, 2003). The latest examples are the passing of the financial transaction tax and the capped bonuses of the bank's executives. The former imposes a tax on the financial transactions on derivatives and intends to curb speculative financial trading which may adversely affect the stability of the financial market (Oliver, 2008; EU, European Financial Stability and Integration Report, 2013). The later, as a more intrusive policy, directly intervenes in the arrangement of the compensation package for the bank's management and constrain excessive risk taking activities of the bank (EU, CRD IV, 2013).

c. Implication for paradigm and specific governance structure

The legitimacy of the bank in CME, represented by the bank's integration into the real economy, active financial support for industrial sectors and enterprises, and stricter financial regulation, highlights the formation of the paradigm of stakeholder model in corporate governance in banking organizations. With strong orientations towards economic growth, development of the industries, and growth of the enterprises, banks in CME frequently pursue a long-term, sustainable profitability rather than short-run best performance. Specifically, serious concerns are given to the protection of the interests of various stakeholders of the bank, such as the clients, the employees, the depositors and the society at large. The paradigm of the stakeholder model is reinforced by the discourse of stricter financial regulation. For instance, by coordinating the bank with the general economy and industry development, the regulator orients the banks towards sustainable economic development, financial stability, and protection of the interests of different stakeholders. By mandatory requirement, the financial regulator, in particular, demands the bank to consider the interests of the clients and the employees.

The legitimacy of the bank also presents important implications for the development of specific governance structures of banks in CME. Considering the close connection between the bank and the real economy, the orientation of the bank board in CME, in contrast with its counterpart in LME, is targeted at the promoting the interests of various stakeholders and economic development, rather than prioritizing solely the maximized profitability and best investment returns to the shareholders. By mandatory requirement on the presence of employee representatives on the bank's board (supervisory board), the regulator actually influence the composition of the bank board and its degree of independence. The latest regulatory cap on the banker's bonus, on the other hand, directly shapes the remuneration package and its composition for the bank's executives in CME. For risk management, the banks in CME seem to have moderate risk appetites and comparatively more manageable sets of risks due to its intertwining with the real economy, typically its 'real' and direct lending relationship with the corporate and individual clients. Specifically, the banks are in a better position to monitor and synchronize 'soft' information from its corporate clients due to its active role in corporate governance of the generic firms and status as main banks or key creditors, which are missing in the context of LME. This is further reinforced by the stricter financial regulation on risk taking. Meanwhile, the limitation on competitions within the banking industry, and between the banks and the non-banking organizations in CME, sets less pressure on the banks to take more risks (for the sake of higher returns) and snatch the short-term maximized profitability. However, the bank's close integration into the real economy and the regulator' coordination for financing the industries and enterprises may pose extra risks, typically the credit risks, to the banks, considering the possibility of voluminous non-performing loans by the enterprises as a result of financing them in times of their financial difficulties. Frequently, such default and bad loans by the enterprises may result in great threats to the health of the banks in CME and in turn the whole financial system.

*State-affected model countries*

For the State-affected model, or the SME capitalism, typically represented by France, the legitimacy of corporate governance in banking organizations lies in the bank's active involvement in policy objectives, strong support for national economy, explicit or implicit dominance and active intervention by the state, and weak legal protection. Interestingly, though Japan is categorized as the CME capitalism, it exhibits strong characteristics of the State-affected model. With globalization and progression of market economy, however, the pure SME is retreating and is said to change towards an alternative hybrid of CME and LME.

As a key player in real economy, banks in SME frequently act as 'credit instruments' and are oriented or directed by the regulators towards effectively and reliably allocating low cost funds to the industry, and promoting long term economic growth by means of transferring funds from the households to the corporate sector (Vogel, 1996; Imai,1994). Specifically, banks are restrained by the designed financial system which is biased toward bank lending and hence the government can easily control the flow of financial aid and direct them to prioritized sectors (Zysman, 1983). For instance, in France, the government have traditionally controlled the financial flows by means of a national operation of a wide range of semi-public financial institutions, exerted great influence on the largest commercial banks, and actively participated on the board of most prominent investment banks. Meanwhile, private banks are indirectly controlled by being compulsorily organized into banking associations which institutionalizes a close tie with the regulators and the industry (Vogel, 1996). In Japan, on the other hand, its Ministry of Finance (MoF) has used various means to maximize its controls over the financial system, facilitated major ministerial functions, and deployed the functional 'policy banks' to achieve designated policy objectives (Anderson, 1990).

In return for its credit service and low rate financial help, banks in SME are frequently awarded a large portion of the enterprises' borrowing business. Such inter-dependent relationship between banks and industries is believed to contribute to healthy development of the real economy. Meanwhile, the bank's dominant role in economy is strengthened by regulator's intentional restraints on the development and the size of the capital market, such as imposing stringent conditions, restrictive regulatory measures, and even active interventions which adversely affect the trading activities and volatility of the market. These regulatory measures largely constrain the financing function of the capital market and hinder its ability to provide adequate capital to the enterprises (Vogel, 1996).

Characterized with a more centralized regulation style, financial regulators in SME countries have a closer control over the banking organizations. For example, they can enjoy more decisive leadership and play an overwhelming role in financial activities, such as removing credit controls, creating new money markets, and liberalizing the interest rates. Not infrequently, the financial regulators are able to orchestrate the financial market and perform more of a restructuring of the regulatory powers. In Japan, for instance, the MoF has been both a powerful bureaucracy and singular political institution which can integrate the political bargains into the financial policies, without being either independent from the financial institutions or captive to them. More importantly, the MoF officials always filter in some of their agenda in structuring these deals, such as their ideology for Japan, the financial system, and for the ministry itself (Vogel, 1996). In the event of significant financial reforms in SME, the financial regulators can easily take the lead, set the reform agenda, and shape the outcomes of the proposed reforms in their wide administrative discretion. Specifically, they may insert their own preferences into the policy outcomes and enhance their powers and jurisdictions. The appeals from financial institutions, however, are less likely to be considered by the regulators as they already decide which groups to favor and which to compensate and henceforth manipulate the deliberation to gain industrial acceptance. Though the regulators may be inspired by ideas from the financial institutions, with heavy regulation and a firm hand, they can always persuade the financial community, overcome their resistance, and resolve their conflicts ((Vogel, 1996).

Similar to CME, restrictive financial regulations for the sake of financial stability is emphasized in SME countries, such as limitations on entrance into the banking industry, restricting bank competitions, and providing administrative measures for minimizing the risk of bank failures. Meanwhile, specific mechanisms are developed for better control over the management and practices in the financial institutions, such as timely intervention by means of close working relationship between the financial regulators and the financial institutions. In Japan, for instance, the representatives of financial institutions frequently interact with the industry and stay informed of the latest development in the MoF (the so-called MoF-watchers). Such practice is welcomed by the MoF as the ministry believes the control over the financial system is a product of their close contact with the financial institution, and such cooperative relationship is deemed to further promote the effective policy implementations (Vogel, 1996; Litt, 1990). In France, on the other hand, the regulator may control the banks by delegating its officials as the directors of the bank board to avoid excessive risky decisions (Vogel, 1996).

The legitimacy of banks in SME presents significant implications for the formation of the paradigm discourse of corporate governance in banks. For instance, under the close control by the state, banks are frequently oriented towards playing a more proactive role in promoting the economic growth, funneling funds to relevant industries and enterprises in accordance with policy objectives, and contributing to the achievement of national economic strategy. This may sometimes undermine the maximized profitability for the shareholders and best performance of the bank. Meanwhile, the legitimacy of the bank presents important implication for developing the bank's specific governance structure in SME. Due to strict financial controls and bank's integration into the economy, the bank board in SME is more subject to the influences of the government policies and oriented towards promoting the economic growth and national development strategy. And, the appointment of chairman or CEO may be subject to political influence and sometimes, delegates form the government will be assigned to the board of the bank and act as the board directors or supervisory board directors. Regarding the executive pay, financial regulators in this model may use more intervening measures and impose strict regulations. As a result of the bank's intimate relationship with the real economy and restrictions on the competition, the bank generally has a moderate risk appetite. However, there may be excessive risk exposures in the process of financing the development of industries and enterprises, typically the credit risk, which may result in voluminous bad loans. Meanwhile, weak legal intervention in SME may lead to the less detailed specifications of the legal obligations and limited judiciary protection for the private interests of the bank investors.

## 4.4 Paradigm

### 4.4.1 The Anglo-Saxon model: shareholder primacy theory refined

As discussed in Chapter Two, corporate governance in the Anglo-Saxon model is characterized with the shareholder primacy theory which focuses upon maximizing investors' interests, pursuing best performance of the corporation, and mitigating the agency cost (Jensen and Meckling, 1976). Similar paradigm of the shareholder primacy can be observed in corporate governance in banking organizations in this model, but with variances. On one side, the general shareholder primacy theory applies as banks in this model frequently take the form of bank holding corporations/groups and are treated no different from general corporations (Adams and Mehran, 2003). In the context of increasing financial disintermediation, deregulation, and fierce competition, there is immense pressure on the bank to procure best profitability and maximized return to shareholders (always assessed in the short term) while ignoring its industrial specialty. On the flip side, due to the uniqueness of the banking industry, the shareholder primacy theory in corporate governance in banking organizations takes on some new characters, exemplified with excessive pursuit of profit maximization, acute agency problems, and intensive conflicts of interests between the shareholders and the stakeholders.

*The primacy of the shareholders' interests*

As the priority of the priorities, bank managers in the Anglo-Saxon model have been committed to pursuing the best performance and maximization of the bank's profitability. And, it has long been the culture of the Wall Street and London financial center to bring in as much and fast profits as possible from every channel. Such orientation toward profitability even becomes the motto and the only criterion to evaluate the success, value, and meaning of existence of the bank and its employees (Smith, 2012). Sometimes, however, the desire for maximized profitability can stretch so far as to derail the bank off the track. These are readily observed in the recent notorious bank scandals, like the LIBOR manipulation, London Whale Gambling, mis-selling of financial products like payment protection insurance in UK, money laundering, to list few, when the banks are willingly and intentionally engaged in excessive risky or illegal financial transactions to harvest a windfall without any care for its legitimacy and legality (USA Today, July, 18th, 2012; The New York Times, June 28th, 2012; The Guardian, 29th June, 2012).

Moreover, to better achieve the shareholder primacy in the context of bank governance, there has been increasing emphasis on the protection of the shareholders' interests in the Anglo-Saxon model. Increasingly, a bank is expected to 'build long term sustainable growth in shareholder value' and 'accountable to shareholders for its performance in achieving this objective', specifically the long-term success of the bank on its stewardship (US, New York Stock Exchange Commission, 2010; UK, Financial Reporting Council, 2012). For this end, active engagement and involvement by the shareholders, especially the institutional investors, are promoted and more shareholder rights are legitimized in corporate governance and business decision making in banking organizations. In UK, for instance, the investors are playing an increasingly important role as the stewardship and hold the board of directors of the bank accountable for various responsibilities. Particularly, the shareholder's role goes beyond voting and embraces 'monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings' (UK, Financial Reporting Council, 2012, p 10). Meanwhile, the shareholders are exerting more influence regarding the arrangement of the executive remuneration by means of advisory vote or even binding vote, the so called 'say on pay', and henceforth better control the extortions by the management in the form of excessive compensation(UK, Enterprise and Regulatory Reform Bill 2013; US, Dodd-Frank Act, 2010). Additional mechanisms are also developed, such as relational directors in banks who are specifically responsible for better communication with the investors and providing better transparency (HSBC, 2012; Barclays, 2012).

For the shareholder primacy theory in bank governance in LME, meanwhile, there is paralleled intentional neglect over the interests of the stakeholders. Though protection for the interests of the bank's constituency is mentioned by the banks, such as funding the small enterprises and protection for the clients, it is frequently weakly implemented and gives away to the pursuit of maximized profitability. In even worse cases, which were prevalent in the 2007-2009 financial crises, the bank managers intentionally took advantages of the stakeholders and prospered at their expenses. These are typically exemplified by the general practice of treating the customers as 'muppets', mis-selling 'toxic' financial products, conducting fraudulent transactions with the bank's clients and 'ripping their clients off', which becomes the rule of thumb for maximizing bank's profits in US and UK banking industry (New York Times, March 14 th, 2012; The Guardian, July 15 th, 2010; Securities and Exchange Commission v. Goldman Sachs & Co. and Fabrice Tourre, 2011).

On the other hand, however, the shareholder primacy theory does not totally exclude concerns for the stakeholders, as banks in the Anglo-Saxon model are increasingly aware of the significance of protecting the interests of relevant constituencies in their performance of citizenship, such as the bank's suppliers, the communities and consumers, the neighborhood and regional welfare, the employees, and the environmental sustainability (Citi Group, 2011). The concerns for the bank's stakeholders, especially the clients and tax payers at large, are further reinforced *ex post* 2007-2009 financial crisis, when the regulatory discourse strengthens and mandates the protection of the stakeholders' interests through a new round of financial re-regulation/reform. In US, for instance, the Dodd-Frank Act explicitly states the discourse to 'promote the financial stability', and 'to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices' (US Dodd-Frank Act 2010). And, such regulatory discourse is echoed in the new orientation of the bank's paradigm which presents serious concerns for the bank's constituencies. For instance, in US, a bank is 'guided at all times by the best interests of the client, taking into account the broader needs of society and the environment' (Citi Group, 2011, p1), and with emphasis on 'responsible finance', the bank is more oriented towards 'responsible lending --- providing capital to support customers of all economic backgrounds and projects that serve the public' (Citi Group, 2011, p1). Goldman Sachs, in its *2013 Business Standard Committee Impact Report*, explicitly states that '(the bank's) Our clients' interests always come first' and the bank's business standards committee will ensure that the bank will 'meet or exceed the expectations of our clients, other stakeholders and regulators' and 'contribute to overall financial stability and economic opportunity' (Goldman Sachs, 2013, p1). Specifically, the bank combines the protection of the clients' interests with the employees' remuneration by stressing upon 'individual accountability for clients in our annual employee performance review process and, for senior client relationship professionals, in compensation determinations' (Goldman Sachs, 2013, p3).

*An acute agency problem*

As discussed in Chapter Two, the key concern for the corporate governance in the Anglo-Saxon model is the principal-agent problem or agency problem, which dominates in banking organizations as well. However, due to the specialties of the banking industry, such as the high-leverage capital structure, opaqueness in financial information, and strict financial regulation, there are some deviations from the generic model. These are characterized with the acuteness of agency problems, aggregated conflicts of interests between shareholders and other stakeholder, and less efficient monitoring.

First and foremost is the acuteness of agency problem in banking organizations, which largely results from the short-term stand taken by the bank management. Frequently, the bank managers take a short-term horizon and such short-termism orientation often motivates the bank executives to cash in their compensation, including both the equity-based stocks and options and bonuses, far before the final consequences of their business decisions are realized, especially those with long term duration like merger and acquisition, stabling new lines of business (Bebchuk and Fried, 2003, 2004, 2005). In this context, the bank management may focus excessively on short-term results while less concerned on the adverse effects of the risk-taking on long-term shareholder value. This is typically represented in the 2007-2009 financial crisis (Blankfein, 2009; Bebchuk and Fried, 2009), when the bank executives' pay was tightly connected to the highly leveraged bets on the value of banks' assets and the bank management ignored any losses that risk-taking could impose on other key stakeholders, such as the creditors, depositors and taxpayers (Bebchuk and Spamann, 2010).

Another contributory factor to the acuteness of the agency problem in banks is the fundamental change in the relationship between the shareholders (residual claimant) and creditors (as fixed claimant), and the laxer monitoring over riskier activities by the bank management. Due to the higher debt-to-equity ratio in banks, with shareholder only contributing around 10% of total equity, the conflict between the fixed claimants (creditors and depositors) and the shareholders are exuberated in contrast with generic corporations. This leads to the reinforcement of 'wealth transferring effects' from the fixed claimants to the residual claimants, frequently in the form of excessive risks taken by banks for the sake of higher returns. Meanwhile, distinguished from generic firms where fixed claimants and other stakeholder control the risks more closely by means of contracts or other devices, monitoring by fixed claimants in banking organizations is laxer due to the serious free rider problems. Moreover, the presence of deposit insurance in either explicit or implicit form largely removes the fixed claimants' incentives to monitor the bank. In the absence of adequate monitoring by the fixed claimants, the shareholders of the bank and the management may 'conspire' and assume higher risks for higher returns, while transferring most of the losses to the depositors in cases of investment failures, especially when the bank is near or in period of insolvency (Bebchuk and Spamann, 2010).

This is evidenced in the reoccurrence of moral hazards in the banking industry, such as frauds, self-dealings and excessive shirking by the bank management. For instance, early in 1980s in US, frauds and self-dealing transactions were found around one thirds of today's bank failures. And between 1990 and 1994, insider lending contributed to over half of 286 bank failures. In addition, as large portions of the bank's assets were held in the form of illiquid forms, such violations were even harder to be detected (Bebchuk and Fried, 2003). More evidence are readily observed in 2007-2009 financial crisis where there is a toxic 'cocktail' of various violating and illegal practices by banking management ringing overall over the world, from malpractices in sub-prime mortgage, to London Whale gambling and notorious LIBOR scandal.

*Implication of paradigm over the formation of governance structure of the bank*

The paradigm of the shareholder primacy in corporate governance of banking organizations in LME presents great influences on constituting specific governance structures in banks. For instance, the shareholder primacy discourse effectively impacts on the orientation of the bank board, which focuses on the maximized profitability and best investment returns to the shareholders. Meanwhile, such paradigm largely decides the composition of the bank board, represented by higher independence of the board of directors, more specific and stringent requirements on the criteria of the independence of the outside directors, and increasing independence of the board committees. These are targeted at providing stronger monitoring on the bank managers to mitigate agency problems and protect the interests of the shareholders. The paradigm of the shareholder primacy also shapes the regulation on the executive's pay, especially the composition of the banker's remuneration package. Frequently, shareholders in LME prefer to use options or vest of shareholdings as key part of the executive's compensation, which is presumed to better align the interests of the bank's management with those of the investors and henceforth provide effective incentives for the management to achieve better performance. Meanwhile, though there are various mechanisms like the shareholders' 'say on pay', the bank investors are not reluctant to grant generous remuneration packages to the bank's executives so long as their pay is adequately correlated to the bank's profitability and investment returns to the shareholders. For risk management, due to the high-leverage capital structure in banks, shareholders in this model may prefer higher risks for higher returns, which further amplifies the bank's risk appetite and encourages bank managers to pursue excessive risks for abnormally higher turns. Furthermore, the paradigm of the shareholder primacy may influence the constitution of the legal obligations of the bank board directors and management, typically their fiduciary duty, which are purported to provide strong protection for the shareholders.

### 4.4.2 The Continental Model and the State-affected model

*Stakeholder theory in banks*

In contrast, the paradigm for corporate governance in banking organizations in the Continental model is characterized with the stakeholder theory, which emphasizes the protection of the interests of various stakeholders. Banks in this model are purported to be 'responsible for independently managing the enterprise in the interest of the enterprise, thus taking into account the interests of the shareholders, its employees and other stakeholders, with the objective of sustainable creation of value.' (Germany Code of Corporate Governance, 2012, p15), and 'firmly believe that the best way for us (the bank) to create sustainable value for our shareholders, is by committing ourselves to all the constituencies around us who have a stake in our success' (Deutsche Bank, 2012, p6). In practice, various measures are taken regarding the protection of different categories of stakeholders, including but not limited to the clients, employees, government, communities, regulators, along with environmental sustainability and economic stability.

For instance, banks in the Continental model stress upon expanding sustainable products and financial services for its private and corporate customers, and promoting sustainable financial investment for the wealth management customers (Commerz Bank, 2012). Specifically, a series of mechanisms are employed to assess and enhance the customer's satisfaction, such as periodical surveys, analysis of the degree of the customers' satisfaction, and evaluation of the customer's experience with the bank. Frequently, the benchmark of the customer's satisfaction is used as a variable in determining the compensation for the bank executives. Meanwhile, customer-oriented programs like 'Market Leadership Course' are promoted for a uniform quality standard on customer satisfaction management (Commerz Bank, 2012).

For employees, banks in this model care about their career advancement and personal welfares. For example, a comprehensive range of professional development and self-advancement opportunities are provided to the employees to enhance their skills and expertise, and accordingly, a wide range of training programs is developed. Considering the pressure of the banking industry, heath care programs are initiated for bank's employees, such as periodical health checks and anti-stress treatment (DZB, 2012). Meanwhile, there are various options for flexible working hours, part-time working models, or other employment arrangement for the balance of the work and life for the employees. Further measures pertain to the diversification and gender equality in the workforce and benefits designed for the employees' family (DZB, 2012).

In contrast with the generic firm, banks own serious accountability to the government as a significant stakeholder in economic sense. This can be observed in the bank's unique access to government financial safety net (by means of explicit or implicit deposit insurance or other forms of government guarantees) in the event of hard times or nearing insolvency, which is rare or impossible for generic firms. The government is indeed a potential owner though disguised in the form of less concerned stakeholder in 'peaceful' times (Usui, 2003). For instance, when there are bank failures, esp. the large ones, the government has to bail out the banks and inject voluminous money from the tax payers. In this scenario, the bank bears a significant responsibility for the overall economy and the public at large, especially considering its designated economic function. 'The presence of an effective corporate governance system, within an individual company or group and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy.'(BIS, 2010, p6). And this accountability is impeding especially in the event of the domino effects caused by 'bank run' and henceforth the financial contagion, which in turn causes the collapse of financial system and then the collapse of the whole social system. Regarding the regulator as a stakeholder, banks actively implement their responsibility of compliance with the legal and supervisory requirements, prevent money laundering and the financing of terrorism. And, this pertains to the mechanisms like better transparency in business relationships and financial transactions, verification and documentation of the client's identity, and clarification of the origin of the assets employed in the business relationship or transaction (Commerzbank, 2012).

Another stakeholder of the bank, though frequently invisible, is the environment. The responsibility by banks for environment mainly focuses upon environmental protection and energy saving. These are observed in the bank's financing and investment in energy and resource efficiency projects, promoting activities on energy and environmental sustainability, and reducing its own impacts on the environment. For these ends, specific mechanisms are developed, such as the environmental steering committee, environmental and social reputation risk framework, and certified sustainability management system (Deutsche Bank, 2012). In practice, these embrace the development and marketing of various sustainable financial products and projects, emission trading, and advisory services for clean technology business (DZB, 2012).

Moreover, in the Continental model, banks extend the concept of the stakeholders to a wider sense. For instance, to improve the welfare of the community and society at large, various philanthropic actions are taken by the banks, such as the charitable donations, financial assistance to talented but poverty-stricken students to continue their study and their way into universities, and promoting employment by financing socially beneficial enterprises. Meanwhile, there has been an increase in the microfinance by the banks to help needed people set up their small business (DZB, 2012; Commerzbank, 2012).

b. Implication for specific governance structure

The paradigm of the stakeholder theory in CME plays a significant role in developing specific corporate governance in the banking organizations. For instance, the paradigm largely decides the key aspects of the organization of the board of directors in the bank, such as the board's orientation and composition. With a high proportion of employee representatives in the supervisory board of the bank, the bank has to afford serious concerns for the interests of the key stakeholders, the employees. The two-tier board structure and inclusion of different kinds of directors (in the supervisory board mainly), meanwhile, also leads to a large-sized bank board in CME. Regarding the regulation on executive pay, as the shareholders and the supervisory board can have a close control and effective monitoring over the bank management, the use of shareholding as incentive is less popular compared with its counterpart in the Anglo-Saxon model (though this is being changed by the latest CRD IV by the European Parliament considering the risk taking by the banks). The paradigm of the stakeholder theory also sheds lights on the formation of the risk management. For instance, the banks generally have a comparatively less risky appetite due to concerns for various stakeholders, such as their long-term clients, the employees, the economic development and the financial stability.

*State affected model – a hybrid of models*

Like generic firms discussed in Chapter Two, the paradigm for corporate governance in banking organizations in the State-affected model takes on a hybrid of the shareholder primacy model and stakeholder model. On one side, better performances of the bank and maximized investment returns for the shareholders are emphasized in SME. And, 'Regardless of its membership or how it is organized, the Board of Directors is and must remain a collegial body representing all shareholders collectively. It is required to act at all times in the interests of the company' (France, corporate governance code of listed corporations, 2010, p5). On the flip side, similar to the Continental model, the interests of various stakeholders are taken into account under the umbrella of corporate social responsibility. In France, for instance, the banks use various indicators to assess the implementation of the bank's social responsibility, such as the business indicator, social indicator and environmental indicator. For business indicator, it embraces the bank's compliance practice, social and environmental evaluation of the counterparties and projects, products and services oriented towards sustainable development, customer satisfaction, and contribution to local development. For social indicator, it covers the welfare and benefits of the employees, skills and career development programs, working hours and health and safety. And regarding the environment indicator, it embraces environmental management system, environmental awareness, etc (Societe General Group, 2012; Credit Agricole S.A., 2012).

Meanwhile, there is a specialty in the paradigm of the State-affected model where the banks are responsible for financing the economy. French banks, for instance, explicitly state their roles in real economy and claim 'we are the leading financial partner of the economy and we intend to carry on fulfilling this role, --- because we know that the lending of today produces the jobs and growth of tomorrow.' (Crédit Agricole, 2012, p35). And 'supporting the growth of the French economy is a priority for the bank. In 2011, it (the bank) played a major role in the French effort to support businesses, associations and individual' (Societe General Group, 2012, p35). Such discourse is represented in the increase of the outstanding loans by French banks in the turmoil of financial crisis and economic recession, when the banks are generally reluctant to issue loans (as observed in the Anglo-Saxon model countries). For instance, in 2011, there was an increase in outstanding loan of 4.6% by Crédit Agricole, 4.4% by Societe General, 5.1% by BNP Paribas (BNP Paribas, 2012; Societe General, 2012; Crédit Agricole, 2012). Meanwhile, the banks are actively engaged in financing the strategic customers and large corporations, with the purpose of financing the real economy. The regional banks, on the other hand, are committed to financial support for the major projects by various sectors and local authorities, and support the local economy by a wide range of tailored banking services (BNP Paribas, 2012).

The paradigm of corporate governance in banking organizations in the Sate-affected model leads to the constitution of specific governance arrangement for banks. For instance, the bank board is frequently oriented towards financing the economic development and granting generous credit to industrial sectors and enterprises, rather than solely maximizing the interests of the shareholders. The composition of executive pay, presenting the hybrid of the shareholder primacy and stakeholder model, uses both high ratio shareholdings as efficient incentives, and adequate fixed salary and performance related bonus as the long-termism remuneration for the bank managers. With regard to risk management, banks in SME have moderate risk appetites and the risks mainly come from financing the real economy. However, the deterioration of a certain industry and enterprises may bring about higher risks to banks in this model. With comparatively less emphasis on the protection of private investors, the legal duties of the bank are limited, such as fewer specifications of the fiduciary duties by the bank's board of directors and managers.

### 4.5 Chapter conclusion

Exploring the kaleidoscope and telescope perspectives of corporate governance in banking organizations, the present chapter reviews the legitimacy and paradigm of the bank's governance structure. The legitimacy analysis elaborates on varied discourses of the role of bank in the economy, the function of financial regulation, and the influence of the judicial system in LME, CME and SME, which legitimize the institutional grounds for the formation of corporate governance in banking organization. Based on the legitimacy as afore discussed, the paradigm analysis summarizes dominant orientations prevalent in various models of corporate governance in banking organizations and the relevant problems, mainly the shareholder primacy theory, stakeholder theory and hybrid theory. These provide a solid ground for the study of specific practice, the frame, in corporate governance in banking organizations in the coming Chapter Five.

# Chapter Five Corporate Governance in Banking Organizations (II): Frame

## 5.1. Introduction

Continuing the discursive institutional analysis of corporate governance in banking organizations, Chapter Five explores the discourse at the level of frames, i.e. the specific governance structure in practice, in banks across different models. The discursive frames pertain to four pivotal sets of subjects, embracing the organization and behavior of the board of directors in the bank, regulation on executive pay, risk management, and legal duty. As the manifestation of the varied discourses of legitimacy and paradigm discussed in Chapter Four, frames are analyzed in the present chapter in terms of how they contribute to the constitution and development of specific corporate governance structures in banks in different national institutional settings and models. The discussion of the board of the bank illustrates how different paradigm and legitimacy discourses are represented in the orientation of the board of directors, the board size, and its independence. The regulation on executive pay, on the other hand, presents the implication of varied paradigms and legitimacies on the composition of the executive remuneration and differentiated regulative measures. The analysis of risk management, as the pivotal issue in the banking industry, manifests how divergent national legitimacy and paradigm co-function to constitute the conceptions of different risks, the overall risk management framework, and the specific risk management mechanism. And, the legal duties of the bank, mainly the compliance duty and fiduciary duty, represents the influence of different paradigm and legitimacy discourses in shaping the boundary of the responsibilities and the liabilities by the bank board directors and management.

## 5.2 The Board of directors

Similar to the board of directors in generic firms as discussed in Chapter Two, the board of directors in banking organizations lies at the center of the governance structure and takes 'overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values,' and is 'responsible for providing oversight of senior management' (BIS, 2010, p7). However, industrial specialty is present. Adams and Mehran (2003) and Hayes, Mehran, and Schaefer (2005) find that differences in board structure across manufacturing and banking firms are statistically significant. Distinguished from non-financial corporations, the board of directors of the bank plays a more central role in corporate governance in banking organizations (Adam and Mehran, 2003, 2008). This is a consequence of the industrial specialties, including the opaqueness of the bank's business activities, the fast changing nature of its balance sheet, and limited information disclosure (Morgan, 2002). Meanwhile, the board of the bank is subject to more regulations and monitoring by financial regulators, such as the mandate on the composition of the board of the bank, the separation of roles between CEO and the board chairman, and the composition of the board committees (US, Dodd-Frank Act, 2010). The specific requirements on the composition of the board of directors of the bank, for instance its proportion of the outside directors, may even determine the availability of the government financial assistance in times of financial crisis (US, TARP, 2008). Moreover, the bank board, distinguished from its counterpart in generic firms, lays special emphasis on 'the bank's long-term financial interests, its exposure to risk, and its ability to manage risk effectively; approve and oversee the implementation of the bank's overall risk strategy, including its risk tolerance/appetite; policies for risk, risk management and compliance' (BIS, 2010, p7)

### 5.2.1 The orientation of the bank board

As the bank board plays a more central role in corporate governance in banking organizations, its orientation may take on extra significance in various governance issues, such as the bank's risk preference and management, executive pay, and legal duties. In practice, by setting the 'tone at the top', the board of the bank develops the enterprise culture and corporate value as the foundation of its governance structure. These embrace a great variety of norms, incentives, professional standards and values that are purposed to promote integrity throughout the bank, while discouraging improper, illegal activity and excessive risk-taking activities (BIS, 2010).

Though there are some similarities regarding the protection of the interests of the shareholders and stakeholders, the orientations of the bank boards vary in different model countries, which are largely attributed to different discourses of legitimacy and paradigm as discussed in Chapter Four. In the Anglo-Saxon model, echoing its paradigm discourse of the shareholder primacy and maximized profitability for the bank, the board of directors is oriented towards the maximization of the shareholders' interests and best performance of the bank. For example, the board of Bank of America explicitly stresses that its mission is to 'produce strong growth and consistent, quality returns for its owners' and 'producing quality returns was, as always, our (the bank's) top priority.'(Bank of America, 2002, p1). Though a series of financial reforms after the 2007-2009 financial crises largely, as it appears, reshape the value of the bank in the Anglo-Saxon model and the bank starts to illustrate concerns for the interests of their clients, the discourse of the shareholder primacy and maximized profitability is persistent. For example, the board of the Citi Group in announcing its serious concerns over the clients that '(the bank) we will serve the true interests of our customers above anyone else', manifests clearly that 'if we do that successfully, we will be generating real, sustainable value for shareholders.' (Citi 2009, p II)

In contrast, the orientation of the bank board in the Continental model, apart from focusing on investment returns for the shareholders, pertains to serious concerns for various stakeholders such as consumers, employees and national economic development. This well represents the paradigm of stakeholder theory which lies at the heart of the Continental model as discussed in Chapter Four. For instance, in setting its vision, the board of Commerzbank intends the bank to be the 'first choice for our customers, employees and investors' and 'customer satisfaction is at the heart of everything we do at Commerzbank' (Commerzbank, 2012, p1). DZ Bank group, on the other hand, lays specific emphasis on its employees and argues 'it is only with highly skilled, satisfied employees that our business can be successful, fit for the future, and deliver the improvements in performance for the clients and customers' (DZ Bank Group, 2012, p9). In practice, banks in the Continental model are specifically oriented towards active performance of corporate social responsibilities (CSR), which are purported to protect the interests of different stakeholders like private customers, employees, environment and society at large (Deutsche Bank, 2012; DZ Bank Group, 2012)

As a hybrid of the Anglo-Saxon model and Continental model, the orientation of the bank board in the State-affected model lies in better investment returns for the shareholders and protection for relevant stakeholders. Meanwhile, concerns for national economic development are observed as a key part of the orientation of the board of directors, echoing the paradigm of the state-affected model discussed in Chapter Four. For instance, the board of French Crédit Agricole Group clearly states that in 'serving the real economy, Crédit Agricole Group supports the projects of its customers in all retail banking business lines and associated specialized businesses.' (Crédit Agricole Group, 2012, p1). As 'the leading financial partner of the economy', the bank knows that the 'lending of today produces the jobs and growth of tomorrow.' (Crédit Agricole Group, 2012, p3). Specifically, the bank gives priority to 'organic growth, retail banking and its associated businesses serving the real economy', such as serving the needs of large corporations and the local economy where the bank operates (Crédit Agricole Group, 2012, p2). The board of BNP Paribas, in identifying four pillars of its CSR policy, stresses that 'the first (pillar) is the economic pillar, which consists in financing the economy in an ethical manner' (BNP Paribas, 2012, p10). Specifically, the bank believes that 'a bank's responsibility–indeed, its primary role–is to be able to provide financial backing for a project. This is how the real economy is financed.' and 'staying attuned to the needs of enterprises and entrepreneurs is in our DNA' (BNP Paribas, 2012, p11).

### 5.2.2 The size of the bank board

Regarding the size of the bank board, there are different research findings on its relationship to the bank's performance. Adams and Mehran (2003, 2008) find that a positive correlation can be observed in the board size and the bank size. A larger board of directors can be beneficial to the bank, due to its increased pool of expertise, richer resources, more balanced and less extreme business decisions, and lower level of risks (Dalton, Daily, Johnson and Ellstrand, 1999; Cheng, 2008). On the flip side, however, a large bank board may bring about inefficiencies and have negative effects upon the performance of the bank (Hermalin and Weisbach, 2003). For instance, it may be less effective in monitoring the management, presents more difficulty in the board coordination, and low efficiency in making business decisions (Jensen, 1993; Cheng, 2008).

The size of bank's boards varies in different model countries. In general, the board of directors in banking organizations in the Continental and State affected model is larger than their counter-part in the Anglo-Saxon model. Ferreira and Metzger (2011) finds that in 2006, the average of board size in banking organizations across countries is 15.6, with the average board size in US is 10.7, 12.4 in UK, while 21.3 in Germany. Similar results can be found in research by other scholars, though the board size varies a little due to different selected samples (Minton, Taillard and Williamson, 2010). As illustrated in Table 5.1, the average board size in sampled US banks is 13.4 and 12.75 in UK, which is much smaller than the continental model country, with Germany of 28.5. Japanese banks seem to have a smaller board size, with average of 12.5, but this figure does not include the auditor committee (which usually has 5-7 members in parallel with the board of directors). And, France, as the state-affected model country, takes middle in the spectrum, with the board size of 16. Meanwhile, in the Anglo-Saxon model, there is tendency of reducing the board size without influencing its adequate functions, while such limitations are rare in the Continental model and State-affected model.

**Table 5.1 The Boards of Directors of Selected Banks from FTSE Top 200 and Top 5 Largest National Banks (Total Assets)**

| Country | Bank | Total member of the board of directors | Independent/non-executive directors |
|---|---|---|---|
| US | Bank of America | 18 | 15 |
| | Goldman Sachs | 13 | 10 |
| | Wells Fargo | 14 | 13 |
| | JP Morgan | 11 | 10 |
| | Citi Group | 11 | 9 |
| | Total | 67 | 57 |
| | Ratio | 100% | 85.08% |
| UK | Barclays | 12 | 9 |
| | RBS | 12 | 9 |
| | HSBC | 17 | 14 |
| | Lloyd TSB | 10 | 8 |
| | Total | 51 | 40 |
| | Ratio | 100% | 78.43% |
| France | BNP Paribas | 16 | 12 |
| | Credit Agricole CIB | 18 | 6 |
| | Natixis | 14 | 4 |
| | Societe general | 16 | 10 |
| | total | 64 | 32 |
| | Ratio | 100% | 50% |
| Japan | Mitsubishi UFJ Financial | 16 | 2 |
| | Mizuho Financial | 9 | 3 |
| | Resona Holdings | 10 | 6 |
| | Sumitomo Mitsui Financial Group | 15 | 3 |
| | total | 50 | 14 |
| | Ratio | 100% | 28% |

**Table 5.1 The Boards of Directors of Selected Banks from FTSE Top 200 and Top 5 Largest National Banks (Total Assets) --- Continued**

| Country | Bank | Total member of the board of directors | Independent/non-executive directors |
|---|---|---|---|
| Germany | Commerzbank | 30 | 11 |
| | Deutche bank | 27 | 11 |
| | total | 57 | 22 |
| | Ratio | 100% | 38.6% |

Note: ND --- no data

Source: Websites of the selected banks, March 2013

For example, in examining the changes of the board size in US banking organizations from 2003 to 2008, Minton, Taillard and Williamson (2010) find that the average board size decreases continuously over the years, from 12.32 in 2003 to 11.63 in 2008, as illustrated in Table 5.2. Though it is only reduced by 0.69, it is a comparatively significant change considering the already limited board size of the bank in the context of continuous bank expansion.

The different bank board sizes in different model countries reveal the constitutive role of varied discourses in paradigm and legitimacy. For instance, in the Anglo-Saxon model, the smart sized bank board can be more efficient in making business decisions in the fast changing business world and achieve better performance and profitability, which reflects the paradigm discourse of the shareholder primacy.

**Table 5.2 2003-2008 Yearly Summary Statistics (mean) on Board Characteristics in US – Board Size**

| Year | Number of obs. | Board size |
|---|---|---|
| 2003 | 252 | 12.32 |
| 2004 | 277 | 12.24 |
| 2005 | 295 | 11.84 |
| 2006 | 314 | 11.75 |
| 2007 | 322 | 11.56 |
| 2008 | 193 | 11.63 |

Source: Minton, Taillard and Williamson, 2010

Meanwhile, arrangements for such efficient, small-sized bank board are a response to the more competitive business environment promoted by the financial regulators in the Anglo-Saxon model. In contrast, the larger sized bank board in the Continental model, though not without concerns for efficiency, illustrates the paradigm discourse of the stakeholder theory and the idea of coordination found in the legitimacy discourse. Considering the presence of representatives of various stakeholders at the supervisory board, especially the mandatory high proportion of employee representatives, the bank board in the Continental model is likely to be considerably larger. Reflecting the hybridization of the Anglo-Saxon and the Continental model countries, the State-affected model countries like France have a bank board size which is somewhere in between the other two models.

### 5.2.3 The board Independence

Another key issue for the board of directors in banks is its independence. Deemed as one of the most of significant elements in corporate governance in banking organizations, the independence of the bank board is said to greatly impact on the bank's performance, its market value, risk management, and survival in financial crisis (De Andres and Vallelado, 2008; Kumar and Sivaramakrishnan, 2008; Minton, Taillard and Williamson, 2010). Specifically, it may enable the bank board to 'to exercise sound judgment after consideration of all relevant information and views without influence from management.' (BIS, 2010, p26).

**Table 5.3 2003-2008 Yearly Summary Statistics (mean) on Board Characteristics in US – Board Independence**

| Year | Number of obs. | %Independent |
|---|---|---|
| 2003 | 252 | 72% |
| 2004 | 277 | 75% |
| 2005 | 295 | 76 % |
| 2006 | 314 | 76 % |
| 2007 | 322 | 76 % |
| 2008 | 193 | 78% |

Source: el at Minton, Taillard and Williamson, 2010

However, varieties can be observed regarding the independence of the bank board in different model countries. Generally, the bank board in the Anglo-Saxon model countries is more independent than its counterpart in the Continental and

State-affected model countries, observed in the much higher proportion of outside directors (Ferreira and Metzger, 2011), stricter requirement for more independent board committees (UK, Corporate Governance Code, 2012; US, New York Stock Exchange, 2003; US, Dodd-Frank Act, 2010), and more extensive and stricter requirements regarding the independence of the outside directors.

For instance, in Table 5.3, over the period from 2003 to 2008, the percent of independent directors in US financial institutions increased from 72% in 2003 to almost 80% in 2008 (Minton, Taillard and Williamson, 2010). And, as illustrated in table 5.1, the averaged proportion of independent board directors in selected banks amount to 85.1% in US, and 78.4% in UK. In contrast, in the Continental model countries, the bank board is found with fewer outside directors/supervisory directors, which account for around 28% in Japan and 38.6% in Germany. In France, the state-affected model country, there is higher board independence in the selected banks and the averaged proportion of the outside board directors reaches approximately 50%.

As a key issue of corporate governance in banking organizations, the independence of bank boards is a manifestation of the discourses of paradigm and legitimacy as discussed in Chapter Four. Resonating with the paradigm discourse of the shareholder primacy, higher board independence of the bank in the Anglo-Saxon model is believed to be one of key solutions to mitigate agency problems through better monitoring by independent ‘outsiders’. Meanwhile, a bank board comprising a high proportion of outside directors with diversified backgrounds, professional expertise, and rich business experience may contribute to better and more efficient business decisions, henceforth enhancing the bank’s performance and bringing better returns to investors. The higher-level of the board independence in the Anglo-Saxon model banks is also shaped by key elements of the legitimacy discourses, such as financial deregulation and legal intervention. For instance, in the 2007-2009 financial crisis, troubled banks with more outside directors were more easily shielded against their liabilities and procured the government financial assistance (US, TARP, 2008; Adam, 2009; Minton, Taillard and Williamson, 2010). In the context of the dominating market institutions, higher board independence is regarded as a better arrangement for the bank corporate governance, which is assumed to bring into the board room the arm’s length relationship and henceforth better external monitoring. Moreover, the higher level of board independence is a reflection of legal interventions in the Anglo-Saxon model. Frequently, a bank board with higher independence can mitigate or even be immune from legal liabilities in cases alleging breach of fiduciary duties (where the independence of the board may be a key criterion for imposing liabilities).

In contrast, though the board independence is increasingly emphasized in the Continental and State affected models, the discourses of paradigm and legitimacy imply less emphasis. In the Continental model, as a response to the paradigm of the stakeholder theory and the legitimacy of the coordination relationship, the board independence of the bank is said to give away to coordination among representatives of different stakeholders included in the board. Specifically, echoing the regulatory mandates of the presence of the employee representatives, the bank board in the Continental model countries, for instance in Germany, has a large proportion of 'inside' employee representatives which may greatly confine the board's independence (Germany, Corporate Code of Governance, 2012). Moreover, the two-tier board structure in Continental model banks, where the management board directors are all inside executives, further reduces the overall board independence. In the State-affected model countries like France, the board independence of the bank takes on a hybrid nature. For instance, due to the changes towards more liberalization and 'convergence' to the Anglo-Saxon model, there is a stricter requirement in France for a significant proportion of outside directors on the bank board. Meanwhile, there is also the presence of employee representatives on the board of the directors, which may limit the board independence (French Corporate governance code of listed corporations, 2010).

### 5.3 Regulation of executive pay

Executive pay, or executive remuneration/compensation, in banking organizations has been a hot subject ever since the beginning of the 2007-2009 financial crisis, especially considering its extravagance and said correlation to excessive risk taking by the bank executives. It has become a key focus for regulators, academia, the public and media, and also became a core target of the 'Occupying Wall Street' movement (The Washington Times, October 12 th, 2011). In this context, flourishing legislations and regulations were promulgated across countries to rein this 'wild horse' and mitigate the executive's incentives to take unnecessary and excessive risks for the sake of their short-term interests (UK, Walker Review, 2009; US, TARP, 2010; Germany, SoFFin program, 2009; EU, CRD IV, 2013). Meanwhile, at the international level, Basel III requires financial regulators to monitor compensation structures with a compatible sound risk management (Basel III, 2009). G20 meetings during the crisis also revealed leaders' determination to implement international compensation standards to eradicate excessive-risk taking practices in banks (G20, 2009).

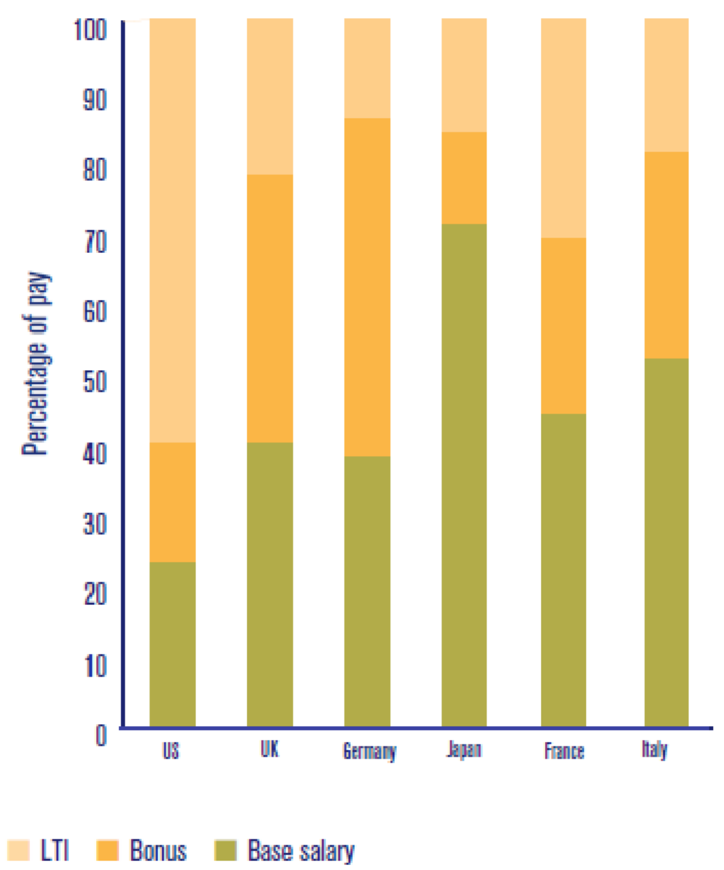
On pay regulation, there are competing views in the extant literature. Opponents argue that there is no place and no need for pay regulation, as the interests of management and owners can be aligned subjectively and objectively (Jensen and Zimmerman, 1985). This is typically observed in the positive correlation between the firm performance and executive compensations (Jensen and Murphy, 1990; Kose and Yiming, 2003), and the efficient alignment of the interests of the management with those of the shareholders by means of granting the management large shareholdings (Core, Guay and Thomas, 2005; Kaplan, 2009). Meanwhile, other scholars argue that the recent harsh regulations of executive compensation in banks are rooted in the political idea of the 'evils' of the excessive remuneration for the bank executives, rather than the careful analysis of the technical defects of the present compensation arrangement (Bhagat and Romano, 2009; Core and Guay, 2010). However, proponents for pay regulation cast skepticism on the merits of high-level executive remuneration in both financial and non-financial firms (Murphy, 1999). They argue that such excessive pay does not necessarily provide proper incentives for the management, but cause increasing income inequality (Frydman and Saks, 2007), especially in the financial industry where executive pay appears excessively high (Kaplan and Rauh, 2009). Specifically, the drive for higher pay is assumed to have contributed to many of the banks' failures which are exposed by the financial crisis, as the bank managers hold a very short-term stand and take unacceptable risks. There is also said to be a prevalent 'pay-for-no-performance' element in the current executive compensation practices, evidenced by the very weak sensitivity of executive pay relating to the firm performance (Bebchuk and Fried, 2010).

### 5.3.1 The composition of executive pay

The executive compensation in banking organizations is mainly composed of salary, bonus, (restricted) stocks, stock options and various forms of benefits, which can be generally categorized into cash compensation, long term incentives (referred to as LTI ) and benefits (BIS, 2010). The cash compensation comprises the base salary, short-term incentives (like performance related annual bonus), long-term bonus, and some non-monetary benefits like pension commitments, luxurious working conveniences. Long-term incentives mainly take the forms of restricted stocks and stock options. Another form of executive pay, though less visible and with limited effects, is various benefits by the executives, such as generous leave or retirement plan, health insurance, and lower interest or interest free credit by the bank (Burghof and Hofmann, 2000).

As illustrated in Figure 5.1, differences can be observed in the composition of executive pay in banks across different model countries. For the Anglo-Saxon model, specifically US, LTI frequently plays an overwhelming role and largely dominates in the composition of executive pay, which takes over 50% of the total compensation package (though in UK, bonus takes a larger proportion compared with the LTI). In the Continental and State-affected model countries, the situation changes, generally with less LTI and a higher proportion of basis salary and bonus. Within the model, variances are present for different countries. In Japan, for instance, executive pay in banks is distinguished by its high proportion of basic salary and very limited bonus and LTI. France, though as a typical State-affected model country, is marked by a higher ratio of LTI in the composition of the executive pay, even higher than that in UK, revealing its hybridization of the Anglo-Saxon and Continental model (Watson Wyatt, 2009).

**Figure 5.1 CEO Remuneration Packages in Companies with Revenue (Including banks) between 1-3 Billion US Dollars (including banking organizations) 2009**




Source: Watson Wyatt, 2009

The different composition of executive pay in banks across varied models reflects the implication of various paradigm and legitimacy discourses. For instance, a higher proportion of shareholdings (as LTI) is readily observed in the Anglo-Saxon model, which echoes the paradigm of the shareholder primacy and the idea that shareholdings by bank managers can turn them into the 'owners' of the bank, henceforth mitigating the agency problem and motivating the management to pursue the best performance of the bank (Jensen and Murphy, 1990; Core, Guay and Verrecchia, 2003; Core, Guay, and Thomas, 2005). In contrast, LTI is comparatively less prevalent in the Continental and State-affected models due to stricter controls by the large shareholders, and less agency problems in the context of the paradigm of the stakeholder theory. Instead, the bonus is more frequently used as the incentive for bank executives based on their performance. Specifically, as a response to the long-termism for and by the management emphasized in the paradigm of the stakeholder theory, the base salary is comparatively high in the Continental model countries, especially in Japan. As a hybrid of the shareholder model and stakeholder model, France as the State-affected model country presents emphasis on using both a high proportion of shareholding and a good base salary for the bank executives.

### 5.3.2 Regulation on executive pay

For regulation on executive pay in banking organizations, various regulatory measures are developed. These pertain to the limitations on base salary (especially since the financial crisis and the bail-out of the banks during the 2007-2009 financial crises), caps on bonuses, more stringent disclosure requirements, increasing 'say on pay' by the shareholders, and the enhanced powers by the compensation committee. Though there is now some commonality on pay regulation across different model countries with regard to the afore-said measures, (US, TARP, 2008; Germany, Soffin, 2009; EU, CRD IV 2013; US, Dodd-Frank Act, 2010;UK, Enterprise and Regulatory Reform Bill 2013), differences are prominent.

In the Continental model and State-affected model, regulation on executive pay in banks is typically observed in the regulator's direct capping on the banker's bonuses. With the latest CRD IV by European Parliament (2013), Germany and France set a cap on the bankers' bonuses, a directive intervention on executive pay in banking organizations. In this context, the banker's bonus will be capped at a ratio of 1:1 fixed to variable remuneration (variable pay), which implies the bonus will not exceed the total of the fixed salary. Though this ratio can be raised to a maximum of 2:1, it requires 'a quorum of shareholders representing 50% of shares participates in the vote and a 66% majority of them supports the measure', or in case such quorum cannot be reached, the ratio can be approved if supported by 75% of shareholders present (EU, CRD IV 2013). Meanwhile, further regulations on the banker's bonus pertain to its composition and terms of payment. For instance, at least 50% of the variable pay should consist of shareholding or equivalent ownership interests of the bank. And, at least 40% of the variable pay should be subject to deferral payment which lasts from three to five years. Regarding the 'particularly high variable pay' by the bank executives, at least 60% of such variable pay will be deferred (EU, CRD IV 2013). In addition, the length of deferral period should take into various factors like the bonus cycle, the nature of the bank's business, and its risks and activities of the member of staff in question. In addition, all the variable pay will be subject to the 'claw-back' arrangement.

In contrast, in the Anglo-Saxon model, instead of using the direct and intrusive regulation like bonus cap, market-based regulative measures are employed and pay regulation on bank executives is largely left to the bank and its investors. These include the shareholder's say on pay, stricter information disclosure, and the enhanced function of the compensation committee. Meanwhile, there is a specified regulation on the vesting of the shareholding to the bank executives. First, the regulator in Anglo-Saxon model countries gives extra weights to the shareholder's vote on executive pay, which covers a great variety of pay issue, and provides more detailed arrangement and frame for its functioning (US, Dodd-Frank Act, 2010). Typically, a new package of 'binding' say on pay is being developed in UK, which is purported to reinforce the shareholders' powers in deciding the compensation for the bank's executive (UK, Enterprise and Regulatory Reform Bill, 2013). For instance, for at least very 3 years, a binding shareholder vote will be held on the bank's compensation policy report, which sets the future plan on the remuneration package for the bank's directors and executives, including the disclosure of key elements of the pay, maximum potential value and performance metrics, and information on contracts or terms of the board directors affecting the compensation package (UK, Enterprise and Regulatory Reform Bill, 2013). Meanwhile, there are further specifications on the advisory shareholder vote held annually regarding the implementation report of the bank's compensation policy, which pertains to how the bank's compensation policy is implemented, the actual payments to bank's executives, and details on the relationship between the bank's performance and executive pay. Other key issues embrace the total amount of remuneration for the bank's directors and specifics of each categories of payment (including but not limited to salary, benefits, pensions, bonuses, and long-term incentives), performance against metrics for long-term incentives, variable pay awarded in the previous fiscal year, and the total shareholding (UK, Enterprise and Regulatory Reform Bill, 2013).

**Table 5.2 Disclosure Requirements for Companies with Revenue between 1-3 Billion US Dollars across Different Model Countries 2009**

| Country | US | UK | Germany | Japan | France | Italy |
|---|---|---|---|---|---|---|
| Disclosure | DRR | DRR | GR/notes of accounts | | DRR for CAC40 | |
| Policy for Executives | √ | √ | √ | If it exists | √ | √ |
| Detail in Policy Disclosure | Detailed | Detailed | Brief | Brief | Brief | Brief |
| Aggregate | | Share awards | | EDs | | Share awards |
| Detail for CEO | | | | | | |
| Detail for board | √ | √ | √ | | | √ |
| Detail for top five highest paid | √ | | | | √ | |
| Base salary | √ | √ | √ | Total amount paid | √ | √ |
| Incentive type and quantum | √ | √ | √ | | √ | √ |
| Pension | √ | √ | √ | | √ | |
| Value of benefits | √ | √ | √ | | √ | √ |
| Termination provision | √ | √ | √ | | √ | √ |
| Appointment of advisors | √ | √ | | | | |

Notes: DRR, Director's Remuneration Report; GR , General Report; CAC40, French top 40 listed companies; EDs, Executive directors.

Source: el at Watson Wyatt, 2009

Secondly, as a key component of pay regulation, disclosure is of great significance in ensuring a fair compensation system in the bank. In the Anglo-Saxon model, disclosure requirements on executive pay in banks are more extensive, specific, and stricter than its counterparts in the Continental and State-affected model. As illustrated in Figure 5.2, almost all the indicators on executive pay disclosure are covered in US, with demanding requirements of the details related to the executive compensation. Particularly, there is inclusion of the disclosure for appointments of advisors for executive pay, which are absent in either the Continental or State-affected model. In contrast, the Continental model and State-affected countries illustrate comparatively less stringent disclosure requirements. Japan, for example, stands out as the least transparent country with details of many aspects missing in the executive pay and only a total amount of payment is presented (Watson Watt, 2009).

Thirdly, in the Anglo-Saxon model, the compensation committee plays a more important role in deciding the executive pay (Walker Review, 2009; UK Remuneration Code, 2010; US Corporate and Financial Institution Compensation Fairness Act, 2009). To guarantee a more objective, independent, and efficient function of the compensation committee, higher independence is required for its composition (US Dodd-Frank Act, 2010; UK Remuneration Code, 2010). The compensation committee members are also required to possess relevant knowledge, skills and experience from their years of working in high level business positions, which may facilitate them in setting adequate goals, negotiate and evaluate pay and performance conditions, and hold the executive accountable for their performance (Walker Review, 2009; UK Remuneration Code, 2010; US, Corporate and Financial Institution Compensation Fairness Act, 2009). Meanwhile, regulation on executive pay also extends to LTD in the Anglo-Saxon model, which can be observed in different aspects. In UK, for instance, there is traditionally an overall limit in banking organizations for all types of share plan amounting to 10% in any rolling 10 years period to constrain the level of dilution of the shareholder's equity (Watson Wyatt, 2009). In US, on the other hand, banking organizations under TARP are prohibited to vest restricted stocks unless all the borrowed funds are paid back. And, such vesting is subject to the claw back clauses (US, TARP, 2008).

The different frames of regulation on executive pay in banking organizations reveal the influence of varied paradigm and legitimacy discourses in different model countries. In the Continental and State affected model, for example, the direct intervention through measures like capped bonuses reflects the legitimacy discourse of relatively strict financial regulation. Specifically, such regulation is purported to rein excessive risk taking by bank executives and promote the overall financial stability. This also reflects the paradigm of stakeholder theory, which seeks to advance long-term sustainability, continuous profitability, and concerns for different stakeholders in the bank. In contrast, pay regulation for banks in the Anglo-Saxon model represents the paradigm discourse of the shareholder primacy and legitimacy of dominant market institutions. For instance, though there are concerns for financial regulators to curb the excessive risk taking by bank executives for higher pay, more attention is given to the correlation between the bank executives' pay and their performance. Specifically, measures like say on pay by shareholders, more extensive and stricter requirement of disclosure on executive pay, and a reinforced remuneration committee reflect the discourse of protecting the shareholders' interests and mitigating the agency problem. Considering the significance of LTD in the overall compensation for bank executives in the Anglo-Saxon model, there is also specific regulation on vesting of shareholding. Moreover, pay regulation on bank executives in this model reflects the legitimacy discourse of financial deregulation where the pay issues are largely left to the bank and its investors, while the financial regulator is self-constrained from taking the kind of direct regulatory measures that are legitimated by the Continental and State-affected models.

## 5.4 Risk management

As a pivotal component in corporate governance in banking organizations, risk management has become particularly visible in the context of the 2007-2009 financial crises, which is said to be caused by failures in risk management by bank managers. The following analysis of risk management mainly focuses on the categories of risks in banks, the general and specific risk management frameworks deployed, and variances of risk management in different model countries.

The word 'risk' can be traced far back to the Latin word *risicum*, understood as risk or that which cuts. In the context of the banking industry, risk includes financial and non-financial uncertainties of various kinds and is generally categorized into business risks and control risks. The former originates from the bank's operation and business activities, such as risks relevant to credit, market, and liquidity. The latter arises, on the other hand, out of the defects in the control mechanisms employed by bank, including but not limited to risks in internal control, business operation, and legal compliance (BIS, 2010). Generally, four key groups of risks stand out in corporate governance in banking organization, namely, the credit risk, market risk, liquidity risk and operational risk. Risks of other kinds, which also impact on the bank and are closely intertwined with the aforesaid risks, include the reputational risk, legal/compliance risk, and settlement risk. Meanwhile, perceived from the financial regulator and central banking side, there is a more significant and overarching risk, the so-called ‘systemic risk’ (BIS, 2010).

### 5.4.1 General risk management structure

For administering the aforesaid different risks, a systematic approach for risk management is promoted in banking organizations around the world, which

‘encompasses the process of identifying key risks to the bank; assessing these risks and measuring the bank’s exposures to them; monitoring the risk exposures and determining the corresponding capital needs (i.e. capital planning) on an ongoing basis; monitoring and assessing decisions to accept particular risks, risk mitigation measures and whether risk decisions are in line with the board-approved risk tolerance/appetite and risk policy; and reporting to senior management, and the board as appropriate’ (BIS, 2010, p17).

Such overall risk management embraces a wide range of processes, models and patterns, which motivate or constrain the bank in formulating and implementing its risk-based policies, banking activities and financial practices. And a wide range of techniques and management tools are used to identify, measure, monitor and control the various risks. Meanwhile, the complicated network of risk management involves various participants in the bank, such as the board of directors, the management at all levels, the chief risk officer (CRO), the risk management department and relevant business lines, all of whom play different but connected functions in the risk management system. Moreover, the efficient function of risk management depends upon other related departments, typically the internal control and auditing. For instance, as one of the key components of risk management system, the internal controls are ‘embedded in a bank’s day-to-day business and are designed to ensure, to the extent possible, that bank activities are efficient and effective, information is reliable, timely and complete and the bank is compliant with applicable laws and regulation.’ (BIS, 2010, p41).

Targeted at key risks in banking organizations, specific risk management mechanisms are developed across different model countries. For instance, credit risk management is purported to ‘maximize a bank’s risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters’ (BIS, 2000, p7). Liquidity risk management, on the other hand, embraces a ‘sound process for identifying, measuring, monitoring and controlling liquidity risk’, and requires a ‘robust framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance sheet items over an appropriate set of time horizons’ (BIS, 2008, p3). Typically, various scenarios of stress tests, either short-term, protracted institutional-specific or market-wide, are employed to decide the liquidity of the bank. The market risk management is more concerned with future uncertainties of the values of both on-and-off balance sheet financial items, which are caused mainly by the sudden changes in equity and commodity prices, foreign exchange rate, interest rate and their volatility and correlations (BIS, 2010). In contrast with other risk management techniques, operational risk management is more extensive and extends to the bank's portfolio of products, activities, processes, and systems. Specifically, a three line defense mechanism is established for this set of risk management, including the business line management, an independent corporate operational risk management function, and an independent review. At the frontier, the business line management at various levels and localities is responsible for identifying and managing operational risks within its authority. In the intermediary, a functionally independent corporate operational risk function (CORF) constitutes the second line of defense, which effectively complements the first line defense. The third line of defense lies with the independent review, composed of verification of the risk management framework and validation of the quantification systems mainly, and is designed to challenge the bank's operational risk management controls, processes and systems (BIS, 2008).

### 5.4.2 Variance in risk management in different model countries

Though risk management in banking organizations shows some commonality across different model countries, especially under the influence of international framework like BIS I, II and III and major joint international efforts like G20 after the 2007-2009 financial crisis, variances are persistent considering the different discourses of legitimacy and paradigm as discussed in Chapter Four. These differences pertain, in particular, to risk appetite, the mechanisms for managing risks, and variations in risk management focuses.

As a key element of risk management, risk appetite refers to 'a high level determination of how much risk a firm is willing to accept taking into account the risk/return attributes; it is often taken as a forward looking view of risk acceptance' (BIS, 2010, p7). It is sometimes used synonymously with risk tolerance, which is defined as 'a more specific determination of the level of variation a bank is willing to accept around business objectives that is often considered to be the amount of risk a bank is prepared to accept.' (BIS, 2010, p7). Frequently, risk appetite is closely connected with the bank's risk culture and strategy, and implemented in various financial activities in different business lines.

Risk appetite is found to vary in different models of corporate governance in banking organizations. Generally, banks in the Anglo-Saxon model have a greater appetite for risks than their counterparts in the Continental and State-affected model. As it is frequently the investment banker who sits at the top of the bank as CEO or Chairman, it is not rare to find that the board of the banks in the Anglo-Saxon model sets a tone for higher risks and preferences for risky financial trading and innovations (Goldman Sachs, 2012; Citi Group, 2012; Bank of America, 2012). In US, for instance, highly risky bank loan products like NINA loans (No Income and No Asset loans), NINJA loans (No Income, No Jobs, No Assets) or Light Doc loans (Documents for loan application are very light, i.e. very limited credit record) were fanatically developed and extensively marketed to the public before the 2007-2009 financial crisis. Especially the NINJA loan, the very low quality subprime loan, has extended the bank's risk appetite so far as it does not need any record of income, job or evidence of assets, but just a simple borrower's credit rating which is no more than showing his willingness and ability to pay. These subprime bank loans frequently lead to extravagant risks and pose great threat to the whole financial system, as evidenced in the past 2007-2009 financial crisis (Langley, 2008)

Secondly, banks in this model are frequently involved in financial transactions or innovations, in which the risks are hard to be measured due to the complex financial trading structure and complication of risks inherited in the no-body-understand financial products. For instance, as a part of the 'gambling culture', the banks are aggressively engaged in trading speculative and highly risky financial derivatives like credit default swap (CDS), which are highly leveraged, too complicated to be measured accurately, and involve great uncertainties. This is revealed, for example, by the 'sinking' of the London Whale, where JPMC took a highly risky derivative bet on CDS and lost around $ 5.8 billion, and the risk officer apparently could not totally understand the risks of the transactions and the potential for ensuing losses. Meanwhile, banks in the Anglo-Saxon model are fanatically engaged in 'originate to distribute' mode of riskier securitized loan business, which creates a long chain of risks, involves too many participants, and bring about many difficulties in precisely measuring the risks.

Thirdly, banking organizations in the Anglo-Saxon model are more proactive in global expansions, typically through transnational mergers and acquisitions, which bring in more risks of various kinds. An illustrative example is the take-over of ABN AMRO by RBS, the said largest take-over in the banking history, which proved to be a 'bad mistake' and contributed to the falling of the RBS. In the process of this merger, various excessive risks are involved, such as risky transaction structure, increasing exposure to risky trading assets, and funding the acquisition by debts instead of equity (FSA, RBS Report, 2011). Another example was the charge against HSBC for financing terrorisms, which was said to involve a bank merged by HSBC in its international expansion. Meanwhile, banks in this model may over-extend the risk appetite to the extent that they 'take in more than they can eat', typically observed in their reckless engagement in illegal transactions like the manipulation of LIBOR, and the mis-selling of financial products as discussed in Chapter Four.

In contrast, banks in the Continental and State-affected model have a comparatively lower risk appetite, which reflects an orientation for the sustainable profitability and close integration into the real economy. For instance, banks in these models are more engaged in traditional retail banking business which involves comparatively more direct and measurable risks, clearer lending and borrowing relationships, and specified counterparties. Moreover, the banks are more closely connected to the regional economic development and finance the enterprises they know well. Nevertheless, certain banks in the Continental and State-affected model may also have a high risk appetite and take risks beyond their reach. For instance, though the banks in both models are generally less active in initiating securitized loans, they may purchase such risky financial products as part of their investment portfolios. Excessive risk taking may also be connected with over-financing the industries and enterprises in the real economy. For instance, in the banking crisis in 1990s in Japan, Japanese banks took excessive risks and over-extended bank loans, which had inflated the 'bubble' in the real estate industry. This kind of excessive risk taking resulted in a high level of non-performing loans and might feed into deep economic recession. Another risky activity of the bank in Japan is the holding of shares/common stocks in the balance sheet, and the bursting of the stock price eroded a tremendous value of the bank's capital (Hoshi and Kashyap, 2004; Fiji and Kawai, 2010).

The divergence of the risk appetite by the banking organizations across different model countries can be understood to be a manifestation of the variances in the legitimacy and paradigm discourses discussed in Chapter Four. In the Anglo-Saxon model countries, the overwhelming paradigm of the shareholder primacy, which stresses on the maximized profitability of the bank and best investment returns to the shareholders, apparently motivates the bank management to pursue excessive risks for higher returns. Specifically, constraints on excessive risk taking in banks are enfeebled due to the congruence of the interests of the management and shareholders, and the inefficient monitoring by the depositors and the deposit insurance agency. Moreover, the significant correlation between executive compensation and risk taking encourages the bank executives to take in more risks without second thought. Such excessive risk taking by the Anglo-Saxon model bank managers is further aggravated by various factors in the legitimacy discourses. For instance, the increasing financial disintermediation and separation from the real economy make the risks faced by the bank more complicated, less direct, and less measurable. The pro-competition and de-regulative posture by the financial regulators further encourages higher risk taking by the banks. For instance, the general hands-off attitude by the regulators empowers the banks to take more freedom in whatever financial activities they prefer. And the favoring of free competition by regulators forces the bank's managers to follow the 'jungle rule' in order to survive the challenges from within and beyond the banking industry, frequently by taking more risks for better profitability by every means. Major legal impediments for charging liabilities on the bank's directors and managers, typically the logic of TBTF (Too big to fail), along with defensive principles like business judgment doctrine, make the bank's management less subject to personal liabilities even in cases of bank failures due to excessive risk taking. This in turn alleviates the bank's management concerns when making excessive risk-taking decisions.

In contrast, in the Continental and State-affected model countries, the paradigm of the stakeholder theory and concerns for economic development constrain the bank's management from pursuing excessive risks. Frequently, bank managers in this model focus on the long-term, sustainable, and steady profitability of the bank, rather than the best performance in the short run by taking in higher risks. Meanwhile, illustrating the implication of the legitimacy discourse, typically the bank's integration into the real economy, close connections with the industry, and intertwining with enterprises, banks in these models may have a more direct and better understanding of the risks they face. Moreover, the strict financial regulation, manifested in limitations on financial competitions and concerns for financial stability, helps rein the excessive risk taking by the bank managers. And, considering the less significant correlation between executive pay and excessive risk taking, and the general long-termism by the bank managers, the bank management in the Continental and State-affected model is less motivated to seek for riskier investment.

Alongside risk appetite, differences are also prominent in varied risk management mechanisms and contrasting focuses across different model countries. Regarding credit risk management, for instance, banks in the Anglo-Saxon model are more concerned with the default or degrading in the credit quality of the over-the-counter (OTC) derivative counterparties and issuers of the securities, considering the bank's proactive involvement in financial derivative products and trading. For example, US banks may identify that credit risk largely arises from the client transactions in OTC derivatives, securities financing transactions like resale or repurchase agreements and securities borrowing and lending activities, and receivables from brokers and dealers (Goldman Sachs, 2011; Citi Group, 2011). In contrast, credit risk management in the Continental and State-affected models lays specific emphasis on credit situations of industrial sectors, public finance, and key financial institutions. For example, in the Continental model country like Germany, banks closely monitor their lending to major sectors such as the mechanical engineering, automotive industry, and specific industry like shipping (Commerz Bank, 2011). By supporting public finance, banks hold a large part of the government's lending exposures and the borrowers are 'sovereigns, federal states, regions, cities and local authorities as well as supranational institutions' (Commerz Bank, 2011, p172). Meanwhile, due to involvement in the Euro Crisis, banks in Germany are also subject to sovereign exposures to other falling EU countries like Greece, Ireland, Italy, Spain and Portugal. There are further credit exposures to selected financial institutions, such as the Federal Reserve Bank, the European Central Bank and certain European issuing banks classified as 'exceptional debtors'. Moreover, further credit risk exposures come from investments in Central and Eastern European economies where there is continued uncertainty as a result of the sovereign debt crisis (Commerz Bank, 2011).

In contrast with their counterparts in the Continental and State-affected model, banking organizations in the Anglo-Saxon model, especially after 2007-2009 financial crises are experiencing financial re-regulations, and subject to more prescriptive specific regulatory rules, principles, and various additional regulatory requirements, which result in further emphasis on the regulatory/ compliance risk management. Meanwhile, considering the active globalization activities by banking organizations in this model, banks are more prone to diversified financial regulations in various host countries. These lead to the uncertainties of various kinds regarding the regulatory risks which make compliance by the bank even more complicated. For instance, in US, the Volcker Rule and the regulation on the derivative markets are still in the developmental stage, and significant ruling and interpretation are not ruled out, which brings about further uncertainness regarding the standard and content of legal compliance. The new agencies created by Dodd-Frank Act, like the Bureau of Consumer Financial Protection, also bring some dubiety considering their early stage and authority to regulate. Moreover, regulatory uncertainties come from on-going international changes, such as the financial transaction tax and capping on the bonuses of the bankers by EU (Citi Group, 2011).

The variance in specific risk management across different model countries echoes the legitimacy discourses as discussed in Chapter Four. Steps away from the real economy, banks in the Anglo-Saxon model have more complicated risk management mechanisms to deal with more diversified and complex risks of various kinds. In credit management, for instance, the banks are more concerned with credit exposures to financial derivatives and securization loan business from the 'fictitious economy'. Meanwhile, due to the proactive international expansion and financial re-regulation movements, banks in the Anglo-Saxon model are increasingly subject to more compliance/regulatory risks. In contrast, banks in the Continental and State-affected model, due to their close connection to the real economy, are more concerned with performance of loans by the enterprises and sovereign. Though there are increasing requirements on regulatory/compliance risk management, they are comparatively less extensive and stringent compared with their counterpart in the Anglo-Saxon model.

## 5.5 Legal duties

In the context of corporate governance in banking organizations, legal duties can mainly be categorized into the compliance duty and fiduciary duty. The former falls under the umbrella of extensive regulatory responsibilities, where financial regulators play key roles and violations will incur disciplinary, administrative or even criminal penalties. The latter, similar to the discussion of legal duties in generic firms in Chapter Two, largely refers to the fiduciary duty by the board directors and management of the bank, and embraces the duty of care, duty of loyalty and duty of disclosure, where the court plays a dominant function and the breach of which will lead to personal liabilities.

The compliance duty in banking organizations mainly focuses on complying with laws, regulations, and relevant standards. In a wider sense, the compliance duty goes beyond legally binding norms and embraces broader standards of integrity and ethical conduct. It involves a great variety of sources like primary legislations, rules and standards issued by regulators, market conventions, codes of practice by the industrial association, and the bank's internal codes of conduct. In practice, the compliance duty pertains to 'observing proper standards of market conduct, managing conflicts of interest, treating customers fairly, and ensuring the suitability of customer advice', as well as some specific areas like prevention of money laundering and terrorist financing, and meeting tax laws related to some banking products and services (BIS, 2005, p12). Frequently, the compliance duty in the banks is intertwined with risk management, such as the legal/compliance/regulatory risk management, as partially discussed in risk management early in this chapter.

The other set of legal duty in banks, similar to those discussed in generic firms, is the fiduciary duty which requires the board of directors and managers 'exercise their "duty of care" and "duty of loyalty" to the bank under applicable national laws and supervisory standards', and includes 'engaging actively in the major matters of the bank and keeping up with material changes in the bank's business and the external environment, as well as acting to protect the interests of the bank' (BIS, 2010, p27). Meanwhile, the duty of disclosure, as the third pillar of the fiduciary duty, may play a significant role in banking organizations, especially considering the 2007-2009 financial crises when the banks were said to hold back material information of various kinds from the investors, creditors and the regulators. In general, the fiduciary duty extends mainly to the bank board directors, the management, and the controlling shareholders. Considering the industrial specialty of the bank, however, the fiduciary duty may be more extensive and subject to higher standards in contrast with the generic firms. For instance, not only does the fiduciary duty cover the interests of the bank's shareholders, it may also extend to the protections of the stakeholders of the bank like creditors, depositors and clients, or even regulators who provide deposit insurance for the bank and bail it out in times of financial crises. Furthermore, the bank is argued to bear a wider fiduciary duty to the public due to its great impacts on the society at large (US, Dodd-Frank Act, 2010).

Similar to legal duties explored in the generic corporate governance in Chapter Two, variances can be observed in different models of corporate governance in banking organizations. In general, the fiduciary duty in banks is more specific, diversified, and stringent in the Anglo-Saxon model countries compared with its counterparts in the Continental and State-affected model. For instance, in the Anglo-Saxon model, the fiduciary duty the in bank is distinguished case by case and a careful distinction is made for different circumstances. Meanwhile, a more extensive criterion is developed, along with higher standards and stricter liabilities. Moreover, the fiduciary duty of the board of directors and management may be further integrated into specific corporate governance of banks. In JMPC, for instance, a mechanism of fiduciary risk management is established as part of the business risk committees, which is specifically designed to deal with particular issues of fiduciary duties and ensure that the investment, risk management products or services (which may give rise to fiduciary duties to clients) of the bank will be performed at the appropriate standard relative to their fiduciary relationship with a client (JMPC, 2011). In contrast, the fiduciary duty for banks in the Continental and State-affected model are comparatively less specified by the regulators and legislators, and frequently referred to the general ones in corporate law and code of corporate governance (Misawa, 2005).

The variances of the fiduciary duty in corporate governance of the banks across different model countries, though present in the duty of loyalty and the duty of disclosure, is typically exemplified in the duty of care. As discussed in Chapter Two, differentiated from the Anglo-Saxon model, there are comparatively less specific principles or rules on the duty of care by the corporate board directors and managers in the Continental model or State-affected model. And in the context of banking organizations, even fewer stipulations are found with regard to the specific standards of the bank board directors and managers regarding their duty of care and relevant civil liabilities (Misawa, 2005). In the Continental model, for instance in Germany, the bank board directors and managers are generally required to perform their duties based on the generic standard of duty of care. And 'If they violate the due care and diligence of a prudent and conscientious Managing Director or Supervisory Board member, they are liable to the company for damages' (Germany Code of Corporate Governance, 2012, p5). Meanwhile, 'The Supervisory Board must take care that he/she has sufficient time to perform his/her mandate. (el. at. Germany Code of Corporate Governance, 2012, p12).

In contrast, more specific and detailed requirements on the duty of care by the bank board directors and managers are observed in the Anglo-Saxon model. For instance, the US court cyclically raises the standard of care by the bank's directors and managers and imposes a more stringent liability. Typically, the court may shift from considering the fairness of the business decision making process to the scrutiny of the more substantive decision, its end result, and consequence in bank cases (Villa, 2013). In contrast with generic firms, bank directors are said to be subject to a higher standard of the duty of care considering the trust invested in them by the creditors and depositors, and 'While legalistically the relation between the bank and its depositors is that of debtor and creditor, practically the directors are charged with the trust responsibility to see that depositors' funds are safely and providently invested' and 'the main responsibility of the director is for the safe and legal application of the bank funds in the form of loans and investments' (Broderick, as Superintendent of Banks of the State of New York v. Marcus, 1934). Positioned as financial specialists, the duty of care by bankers goes beyond the standard of ordinary care and 'a bank director should perform his or her duty as banking professional in such a manner that a violation of duty as a professional constitutes a violation of a bona fide manager's duty of care' (Misawa, 2005, p19). Specifically, subject to a more stringent standard of care as a 'prudent banker' (Litwin v. Allen, 1940), the bank director 'shall bear fiduciary duty of providing reasonable monitoring relative to bank operations' and specifically, shall 'properly monitor lending functions, --- ascertaining the situations of the bank, and monitoring them exercising their monitoring right in reasonable manners' as bankers (Misawa, 2005, p26). Meanwhile, financial regulators may further enhance the standard of care born by the bank director and managers. For instance, in US, the Dodd-Frank Act authorizes the FDIC to claw back up to 2 years of compensation paid to the bank's directors and managers, if they are found substantially responsible for the failure of the bank. Such enhanced standard of care pertains to the board directors and senior mangers who are responsible for the strategic policy making or company-wide operational decisions for the bank, or found liable by the court for breach of his duty of loyalty, or removed form the post by FDIC due to his responsibility to the failure of the bank (Dodd-Frank Act, 2010; Villa, 2013).

The variances of legal duties in different models manifest different paradigm and legitimacy discourses as discussed in Chapter Four. In contrast with the Continental and State-affected model, the Anglo-Saxon model, reflecting the paradigm of shareholder primacy, provides stronger and specific legal protections for investors by means of more extensive fiduciary duty, stringent standards, and stricter liabilities, which aim to mitigate the agency problem by the bank managers and maximize investment returns to the investors. For instance, to bring about a better performance of the bank and mitigate the shirking problem by the bank directors and managers, a higher standard of duty of care is set in place in banks in this model, which requires the bank board directors and mangers to perform their due diligence, adequate prudence in decision making, and sufficient monitoring over the bank's operations as banking professionals. Meanwhile, the varied legal duties are also representation of different legitimacy discourses of legal intervention. For instance, as discussed in Chapter Four, the Anglo-Saxon model presents more legal intervention by the court, the regulator, and the law firm. The dominance of the market institutions and the arm's length relationship between different market players reinforces the status of the judiciary to resolve the disputes by private parties. And, such active legal intervention is typically observed in the higher standards of fiduciary duty by the bank directors and managers.

In contrast, reflecting the paradigms of the stakeholder theory and the hybrid of model, strong legal protections for shareholders is comparatively less prevalent in the Continental and State-affected model. The fiduciary duty on the bank board directors and mangers, for example, is less extensive, less strict, and frequently less possible to lead to the imposition of the legal liabilities. Though there are laws, guidance, and rules regarding the generic fiduciary duty of the corporate directors and mangers, specific legal standards for the bank directors and managers are not abundant as their counterpart in the Anglo-Saxon model (Another possibility is that many of the specific rules regarding the bank directors and managers are in German or French and not available in English version). Moreover, legal duties in the Continental and State-affected model countries manifest it legitimacy discourses. For instance, manifesting the limited legal intervention and comparatively self-constrained posture of the courts, legal duties in the bank are less diversified.

## 5.6 Chapter conclusion

Continuing the discursive institutional analysis, Chapter Five summarizes the key frames of corporate governance in banking organizations across different model countries. The discussion of the board of directors of banks embraces a detailed comparative analysis of the board's orientation, the board size, and its independence. As the key component of corporate governance in banking organizations, the varied orientation, composition, and independence of the bank board in different models manifest the corresponding legitimacy and paradigm discourses. The regulation on bank's executive pay, on the other hand, presents competing views on the merits of the pay regulation, the composition of the executive remuneration, and the varied regulative measures in different model countries. As a key concern for the regulators, academic and public, different focuses are observed in regulation on bank's executive compensation in various models, which demonstrate the implication of the paradigm and legitimacy as discussed in Chapter Four. Risk management, as the pivotal issue of corporate governance in banks, summarizes general categories of risks, the overall risk management, and the specific key risk management mechanisms. Specifically, risk management reveals the implication of the varied paradigm and legitimacy discourses in shaping key practices like the risk appetite and specific risk management mechanism. Legal duties in the banking organizations embrace the compliance duty at public law and fiduciary duty at private law. Reflecting on the paradigm and legitimacy of different models, prominent differences can be observed for the intensity of compliance obligation and the standards and boundaries of the fiduciary duty by the bank board directors and managers.

# Part III Corporate Governance in Banking Organizations in China

## Chapter Six Corporate Governance in Banking Organizations in China (I): Legitimacy

### 6.1 Introduction

Continuing the institutional analytical framework of discursive institutionalism and variety of capitalisms, Chapter Six offers an in-depth analysis of legitimacy discourses of corporate governance of banking organizations in China. In contrast to the existing categories of VoC, institutional settings in China are shown to take a hybrid form that combines different elements of the CME, SME, and LME capitalism. And, in the context of legitimacy for corporate governance in Chinese banks, this hybridity is apparent in the discourses on banks' integration into the national economy, close relationships with industries, and intertwining with enterprises. Regarding the discourses of financial regulation, running in parallel is continued close control and administration by the government and an increasing orientation on opting for deregulation. In terms of legal intervention, meanwhile, Chinese courts are legitimated as playing a paradoxical role of passivism and activism, where strong policy orientation and consideration for social stability are frequently prioritized. Meanwhile, the discourse of international impact is increasingly significant in the legitimization of particular corporate governance arrangement in Chinese banking organizations, especially considering China's active presence in international economic organizations, intensified competition from foreign banks gaining their grounds in China, and the fast overseas expansion of Chinese banks.

As discussed in Chapter Three, three are mainly three typology of capitalisms in VoC, namely LME, CME, and SME, which are the creation of western political economy. When applied in Asian context, there is a different picture due to the 'evident heterogeneity' of technology, products, and forms of organization, and 'plurality of institutional architectures' (Boyer, 2005; Gedajlovic Eric, Yang Xiaohua 2009). On one side, some scholars endeavor to stereotype Asian capitalism into state capitalism or familial capitalism, based on either its prominent characteristics of relational connections among politicians, state officials, and elite entrepreneurs (Krueger, 1974), enduring inter-firm networks (Fruin, 1998; Weidenbaum and Hughes, 1996), or dominant role of the state in the progress of industrialization (henceforth the state-capitalism) (Amsden, 1989; Wade, 1990; Carney Michael; Kim, 1998). On the flip side, other scholars stress on the varieties of Asian capitalisms, considering the different authority structures (Hamilton and Biggart, 1988), the different economic stages (under the same umbrella of familial capitalism) (Kim, 1998; Steier, 2009), the various capitalist configurations (Orru, 1997), or even over-emphasis on national uniqueness and divergence (Whitley, 1999).

Similar issues occur when the western VoC scholars endeavor to categorize China into one of the existing groups of capitalisms. For instance, Richard Carney (2007) argues that growing reliance upon banks in Chinese development will 'turn China towards a CME style of capitalism'. In contrast, Szamosszegi and Kyle (2011), when analyzing the role of SOES, argue that China is pursuing a state-guided capitalism. And, Witt (2010) concludes that China in many respects resembles a liberal market economy (LME). There are still other scholars who argue for the familial capitalism in Chinese context considering the significant status of the family-ruled enterprises (Tsui-Auch, 2004; Kim, 1998). Yeung's (2004, 2006), refusing the stereotyped single capitalism typology for China, tries to portray China as a hybridized capitalism for its 'institutional bricolage or recombination' (Crouch, 2005), constant efforts to innovate 'creative' institutional solutions by selecting and recombining elements from the established models of capitalisms, henceforth resulting in new institutional settings with resemblance to the original models (Campbell, 2004). Meanwhile, the so-called 'Chinese capitalism', or 'ethnic-Chinese capitalism', is said to wield great influence on the constitution of the Asian capitalisms, especially the South East Asia capitalism (Hamilton, 1996), as 'capitalism operates under a distinct logic in Southeast Asia and much of this is results from the specific functioning or social capital of Chinese business'(Crawford, 2000, p73), and 'the flow of people and wealth - rooted in regional dialect and kinship - has provided a regional foundation for the socioeconomic networks that define capitalism in Southeast Asia today' (Crawford, 2000, p78).

Though these literatures cover some of the institutional characteristics of the Chinese case, they can not capture the complicated nature of Chinese political economy overall. And, specifically, the aforesaid typology of capitalism, which is deeply embedded in Euro-American political economy, is not interested, welcomed, and accepted in China. By exhibiting some typical features of CME, SME, and LME capitalism, Chinese economy is better understood as a hybrid of the existing VoC, which needs to be well 'blended' with 'Chinese specialties' for adequate understanding of China's institutional settings.

Table 6.1 **Discursive Analysis of Corporate Governance in Banking Organizations in China**

| **Model** | **Typology of ideas as discursive institutionalism** | | |
|---|---|---|---|
| | Legitimacy | Paradigms | Frames |
| **Chinese Model** | Integration into the national economy and reform process, close connection to industrial sectors, intertwining with enterprises;<br>Close control by the state, in parallel with financial deregulation and retreat of the state intervention;<br>Paradoxical judicial activism and passivism, with concerns for public policy and social stability;<br>and increasing influence from international discourse and financial globalization. | A hybrid paradigm of the Continental model, the State-affected model, and the Anglo-Saxon model;<br>The enhanced shareholder primacy theory, characterized with the state as the controlling shareholder and specific agency problem;<br>and the diversified stakeholder theory with concerns for multiple constituencies. | The organizations and behaviors of board of directors with focus on the orientation of the board of directors, its composition and size, and the independence of the board with various impediments;<br>Regulation on executive pay focusing on the composition of the executive compensation, the regulatory measures, and the coordination process;<br>Risk management on the formation of the risk framework, the risk appetite, and the specific risk management in Chinese context;<br>and legal duties composed of the compliance duty and fiduciary duties, with strong regulatory influence. |

Viewed in this context, the discourses that legitimate corporate governance in banking organizations in China can be seen to refer to the followings, bank's close ties with the macro economy, intimate relationships with industries, intertwining with enterprises, and strong policy orientation and administrative governance (coupled with increasing financial deregulation). Meanwhile, there is paradoxical legal intervention *ex ante,* and increasing international influences. I will now address each of these elements of legitimacy discourses of corporate governance in Chinese banking organizations in turn.

## 6.2 Bank and economy

### 6.2.1 Bank and economic development

Legitimized as efficient financial intermediaries, Chinese banking organizations, particularly the large-sized stated-owned commercial banks and joint-equity commercial banks, are well integrated into the fabric of national economy. This is typically represented by the banks' active engagement in national economic planning, extending generous loans to prioritized sectors and industries on favorable conditions, and financing the development and upgrading of state-owned enterprises and regional development. As a tradition, Chinese banks have long been legitimized as 'Serving the Real Economy' in their business strategies and enterprise cultures. As observed in the sampled banks, Bank B states that its business strategy and function is to 'earnestly carry out the macroeconomic policies of the State, consciously serve general interest of the national economy, highlight the due responsibilities of a large bank to support the sustainable development of the real economy', which, in practice, focuses upon innovations in economic restructuring, support for underdeveloped economic and social sectors, and financing for economic growth (Bank B, 2012b, p25). Bank C, on the other hand, has 'Patriotism and Serving the People' as its 'soul', which is themed upon 'Pursuing the well being for the public, and the wealth and great power for the state' and sets the discourse of 'Serving the public and improving the people's living' as its starting point for its overall banking business (Bank C, 2012b, p9). The bank aims to implement the national economic strategy, serve the real economy, and play active roles in healthy economic development and social restructuring.

In this context, various financial measures and credit policies are developed by Chinese banks for supporting economic development under the framework of national economic planning. For instance, in Bank B, its Shanxi Branch's prioritized support for the development of key enterprises, projects and industries in Shanxi Province in accordance with the national economic theme in the National

Twelfth-Five-Year Plan. And, its Ningbo Branch provided strong financial support to local economic development by carrying out the "six priorities" strategy (covering the advanced manufacturing industry, modern service industry, marine economy, high-quality industrial technique-reconstruction projects, demand of the economically affluent counties and towns to develop the economy, and small and micro enterprises). Meanwhile, the bank's Hebei Branch has been elaborating on stepped-up efforts for key strategic regions and the key county markets under the theme of 'One Circle, One Zone, One Region, and One Batch' (Bank B, 2012b, p34-36).

Moreover, Chinese banks say that they contribute to economic development in different regions by optimizing the allocation of credit resources to achieve equilibrium and balanced regional economic growth. Bank B, for instance, differentiates its financing strategy towards varied regions, and sets relevant priority policies and extra credit support. These include in-depth development and exploration of the Western Region, facilitating the rise of the Central Region, and revitalization of the old industrial bases in the Northeastern region. In 2011, the increase in newly issued loans to the Central Region, the Western Region and the Northeastern region amounted to 128.201 billion RMB, 169.105 billion RMB and 54.305 billion RMB respectively, which represented an increase of 13.94%, 14.81% and 13.29% compared with 2010. Meanwhile, major credit was extended to key strategic regions, with newly extended corporate loans of 282.515 billion RMB and accounting for 54% of the newly issued corporate loans by the Bank (Bank B, 2012b).

And, in times of economic difficulties and social turbulence, typically during the 2007-2009 global financial crises, Chinese banks contributed greatly to the stability of the national economy. Typically, in the '40 Trillion Stimulus Package' in 2009, Chinese banking industry extended voluminous loans to crisis-solving-targeted national projects, which covered the improvement of infrastructure in urban and rural areas, constructions and updating of the present railway system, projects for better environment protections, etc., as illustrated in Table 6.2. This drastic move was not frequently found in SME or CME model countries, even less in LME ones.

In addition to the views of banks and the banking industry, expressions of the discourses which position Chinese banks as crucial to the national economy can also be found elsewhere. First, the regulatory discourse plays a significant role on the bank's integration into of the national economy. For instance, after *2011 National Finance Conference* when Premier Wen Jiabao emphasized upon the role of Chinese banks in serving the economic development and social progress, typically their financial support for the real economy, the green industry, and rural financial reforms, active responses were observed from the banking organizations industrial wide, whether the state-owned or highly privatized (China, Premier Wen Jiabo Speech, January 7th, 2012). For example, the chairman of the board of directors in Bank A stressed that the Bank A would implement the guidance in 2011 *National Finance Conference* and *2011 Economic Working Conference by Chinese Central Government*, and integrate the macro economic coordination policies into the bank's mid-and-long term developing strategy. Specifically, Bank A would be committed to the development of the real economy, the steady and sustainable economic growth, and social welfare projects (Bank A, Internal News, January 11th, 2012). Similarly, the chairman of the board of directors in Bank B emphasized on Bank B's dedication and contribution to the national economy, and its mission to support policy-oriented industries like agriculture, culture, and service sectors (Bank B, Internal News, January 15th, 2012).

**Table 6.2 Statistics on Bank Loans by Chinese Banking Industry and Financial Institutions in Facilitating the Chinese National '40 Trillion Stimulus Package' in 2009 Unit: billion RMB**

| Categories | Total of Bank Loans (2009) |
|---|---|
| Constructions for Core Infrastructure Projects | 29 133.78 |
| Reconstruction in Wei Chun ex post 2008 earthquake | 1766.82 |
| Accommodation Projects for the Low-income Group | 1144.42 |
| Social Engineering Projects | 3772.63 |
| Independent Tech Innovation and Adjustment in Industrial Structure Projects | 2337.10 |
| Energy-saving, Pollution-control and Eco Construction Projects | 3096.47 |
| Projects for Social Advancement | 2078.82 |

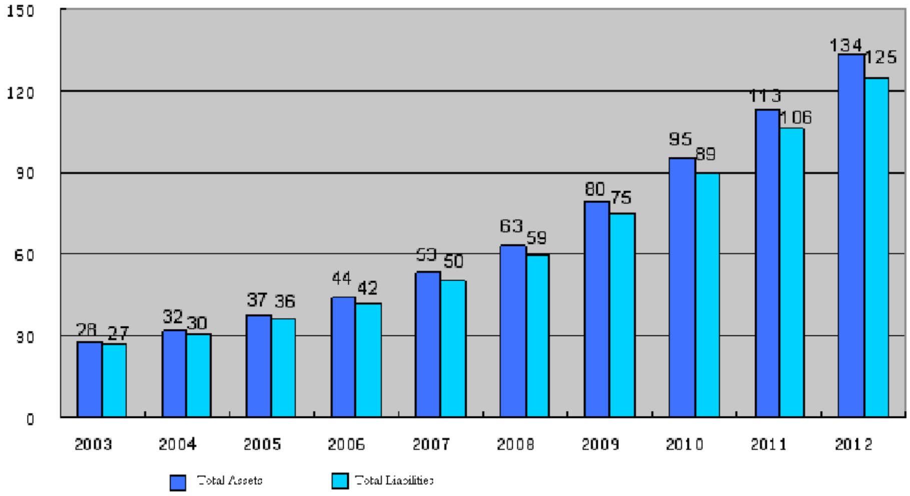
Source: CBA, 2009

Secondly, the historical discourse on the role of the Chinese banks is in persistence and sediment in their institutional configuration. In the 'Single Bank' period before 1978, which was modeled upon the bank system in former Soviet

Union, People's Bank of China (PBC) was the only bank which functioned as the central bank, financial regulator, and commercial bank, with branches extended all over China. And the present sampled banks used to be departments of PBC or relevant ministries and perform designated functions for the government. For instance, Bank A was responsible for funding key infrastructure projects, and Bank C was engaged in international banking business. In this context, Chinese banks were more administrative institutions than commercial financial institutions, and performed mainly the secondary financing for the state in the era of planned economy. From 1979, especially since the *Opening Up and Reform* policy, Chinese banks started to spin off PBC and acquire their independent financial entities. Nevertheless, as industrial-specific banks, they were still closely bound to the economy and served the industrial development. For example, Bank D was responsible for extending credits to the agriculture, developing rural related banking business, and setting up cooperative banks rural areas. Bank C was mainly engaged in international financial activities, such as trading in foreign currency, facilitating international trade and business. Bank B was designated for funding the development of manufacturing industries, expanding commercial and economic activities, and supporting the development of service industries, hence facilitating the progress of the *commodity economy* in China. And Bank A focused on planning and managing voluminous loans to infrastructure projects and key construction programs developed by the state. With a strong tinge of public function, these banks were highly policy-oriented and served the industries in times of economic transition. Similar traces could be observed in less or indirectly state owned banks like the joint-equity commercial banks, or more privatized banks, where the close ties with real economy was the key tone due to strong government orientation and the general financial environment (Wang and Guo, 2008).

Thirdly, the dominance of banks in Chinese financial system is reinforced by the limited development of the capital market. Chinese stock market did not take shape until 1990s and plays limited role in funneling funding to enterprises, considering its total value, economic power and influence, and national strategic importance. As illustrated in Figure 6.1, up to the end of 2012, the total assets by financial institutions in Chinese banking industry amounted to 134 trillion RMB, which increased by 4.8 times compared by that before financial reforms in 2003(CBRC, 2013). In contrast, in 2012, the total value of the Chinese capital market amounted to 23.9 trillion RMB, with Shanghai Stock Exchange of 16.49 trillion RMB and Shenzhen Stock Exchange of 7.41 trillion RMB (NetEase, January 8 th, 2013). And these numbers are dwarfed by the total assets of the Chinese banking industry.

**Figure 6.1 2003 --- 2012 Total Assets and Total Liabilities of Chinese Banking Industry Unit: Trillion RMB**




Source: CBRC, 2013

### 6.2.2 Bank and industries

Under the strong orientation and coordination of the government, Chinese banks have developed a close relationship with industry. This close relationship has been manifested through major bank loans to prioritized industries, such as household appliances, energy, telecommunications, and real estate (Lei, 2009). For instance, banks have been playing an overwhelming role in the development of Chinese real estate industry since 1990s and largely dominated the supply and demand in the real estate market (Li, 2005). By 2005, the real-estate related bank loans had reached around 28 trillion RMB (Tang, 2005).

Meanwhile, with the changing policy orientation for different industries, Chinese banks have been prioritizing loans in new national projects and economic programs, such as energy, communication, environmental protection, upgrading of industrial structure, and renovation of the new manufacturing and emerging industries with national strategic significance (Bank A, Internal News, January 11th, 2012). The latest example is the booming financial support for agricultural industry by Chinese banks, which is less popular in the past and rare in the Anglo-Saxon Model countries. In the context of continuous policy guidance by the central government in reinforcing the development of the rural areas, such as *The Guidance* *on Promoting Innovation in Financial Products and Business Patterns for Rural Areas on Full Aspects* jointly issued by PBC, CBRC and other financial regulators (CBRC, 2010c), Chinese banking industry is expanding agriculture related loans, and granting massive lending to rural related projects, programs and infrastructures. For instance, Bank D in 2011 initiated 6 key programs in financing the development in rural areas, which focused on the agricultural industrialization, rural urbanization, country level goods circulation and public service, major grain producing areas and counties, two kinds of impoverished counties, and county level SMEs (Bank D, 2012b). Likewise, Bank B reinforces its lending policies to rural areas, covering the rural infrastructures, the farming equipment manufacturing, and reforms of the bank's county level sub-branches. Also, the bank enhances the credit development of the rural outlets, and strong financial assistance for different stages of the production, processing and circulation of agricultural products (Bank B, 2012b).

In practice, various mechanisms are developed for financing the rural areas. First, rural related loans by Chinese banks have been expanded fast in supporting the 'Three Rural Issues' policy, which covers the development of agriculture, progress in rural areas, and better welfare for the peasant household. For instance, from 2009 to 2011, the balance of rural related loans in Bank A rose from 5, 895.21 billion RMB to 10,499.12 billion RMB, increased by around 78 % (Bank A 2012, b). And for the same period in Bank D, such loans increased from 12, 055 billion RMB to 16,753 billion RMB, increased by around 39 % (Bank D, 2012 b). Secondly, an extensive financial network is being developed in rural areas, including the standard and simplified sub-branch of the bank, POS machines and ATM, and mobile financing services for remote areas. By the end of 2010, financial services by Chinese banks had well extended to rural areas across almost all provinces in China, though the coverage in east and middle regions was better than in west region. For instance, by financial technological innovation, Bank D greatly extends its network and by the end of 2011, and the bank had operated 'a total of 25,000 self-service banking devices such as ATMs and CRSs, 1.368 million payment transfer telephones and 201,000 POSs, and 76,000 withdrawal terminals for farmers in rural areas at or below county-level, covering 38% of village administrative units nationwide'. And these bring better access by farmers who can 'use their cards to withdraw and transfer money without leaving their village' (Bank D, 2012b, p35).

Thirdly, various programs and projects in rural areas are financed by Chinese banks to promote agricultural economy. For instance, Bank D prioritizes financing the agricultural industrialization and aims to boost 'the development of leading industrialized enterprises, increasing farmers' income share in the industry chain, and promoting the national strategy of industrialization, urbanization, and modernization of agriculture' (Bank D, 2012b, p36). By the end of 2011, the bank had increased its coverage for national and provincial agriculture enterprises to 73% and 52% respectively, up by 1% and 4% compared with early 2011. And, varied financing strategies were tailored to the specialty of different regions. For example, Bank D's Xinjiang Branch capitalized on the region's distinctive forestry and fruit resources, and provided strong financial support for the county-level fruit storage and processing enterprises, and the large-scale fruit growers. By the end of 2011, a total balance of 2.086 billion RMB loans had been granted to the forestry and fruit industries (1.891 RMB billion in corporate loans and RMB195 million in loans to individual fruit growers) (Bank D, 2012b). Bank B also takes many innovative measures for financing the development of rural economy and agriculture industry. For instance, considering the specialties of the local agricultural enterprises in different phrases of procurement, production and sales, its Qingdao Branch specifically designed individualized financial products like 'Agro Financing Express', which integrated different production stages of the agricultural enterprises and achieved the 'commodity financing based on specialty agricultural products, supply chain financing products, and other business varieties' (Bank B, 2012b, p44). Meanwhile, Bank B set up the strategic partnership with Hei Longjiang Agricultural Reclamation Bureau and Beidahuang Group at the head office level and its Hei Longjiang Branch piloted the program of personal loans for modern farming machinery, which facilitated the process of agricultural mechanization and accelerated the development of the new rural areas.

Moreover, financial innovations by Chinese banks are encouraged in serving the rural development. For example, guided by *Notice on Experimental Rural Financial Reform in Lishui, Zhejiang Province* (PBC, 2012), Chinese banks took great initiatives in pilot financial reforms in Zhejiang Province and provided active financial assistance to the forestry in Lishui. These embodied the establishment of new medium and small sized community banks, innovative credit patterns, and expansion of the scope of collaterals. Such moves by Chinese banks contributed to the development of three-tier rural credit system, which is composed of the small amount and credit-based loans, collateral-based loans, and loans guaranteed by qualified entities. Particularly, with the breakthrough in the traditional state ownership and marketability of the forest resources, the ownership to forestry could be used as collaterals for bank loans. By 2012, bank loans based on titles to forests had amounted to 51.61 billion RMB, with the outstanding balance of 26.35 billion RMB, which well met the needs of the peasants engaged in forestry, the storage corporations, and warehouses of the forestry resources (Stock Times, May 18th, 2012).

### 6.2.3 Bank and enterprises, SOEs vs. SMEs

Traditionally, there has been an intimate relationship between Chinese banks and the enterprises, especially the state owned enterprises (SOEs). This close bank-enterprise connection arises out of the discourses of strong policy-orientation, overlapping of the same largest shareholder (the state), cultural homogeneity, and strong political connections by the SOEs. Generally, in transitional economies, the SOEs frequently have very strong political connections which can bring them extra values and advantages (Fisman, 2001； Johnson and Mitton， 2003; Faccio, 2006;), such as favorable treatments by the government, lax taxation policies, and loose regulations(Faccio, 2006). Specifically, SOEs may have easier accesses to loans by the state-owned banks on more favorable conditions (Charumilind, 2006), especially the long-term loans which banks are reluctant to extend due to much higher cost of monitoring, stringent requirement upon collaterals, and information asymmetry (Diamond, 1991, 1993). In Chinese context, the SOEs enjoy similar political connections (Brandt and Li, 2003; Cull and Xu, 2005; Jiang and Li, 2006), and easier accesses to the long-term loans by the state-owned banks (Ma, 2001). Meanwhile, the bank loans to SOEs are better guaranteed due to the implicit government rescue in case of financial difficulties (by the SOEs), which mitigates the risk of default for such long-term bank lending (Jiang and Li, 2006). And, the intimate bank-enterprise relationship is customized to the extent that gigantic credits to SOEs are widely accepted while those to non-SOEs are less favored (Ma, 2001). For instance, over 50% of the outstanding bank loan is frequently allocated to the SOEs. Meanwhile, there is an inter-dependent relationship observed between Chinese banks and the SOEs. On one side, the bank needs the borrowings business from the SOEs to maintain a comparatively stable and safe interest income, maximize the profitability of its deposit, and achieve designated business objectives. On the flip side, the bank needs to attract voluminous deposits from the SOEs to retain an adequate capital pool. Such reliance on SOEs further strengthens the close connections between Chinese banks and the SOEs.

The bank-enterprise relationship can also be observed for small and micro-sized enterprises (SMEs), though in a different scenario. Under the strong policy orientation for maintaining economic growth, creating more jobs, and promoting the development of SMEs, such as *Notice on Support for Further Improvement on*

*Financial Services by Commercial Banks to SMEs* (CBRC, 2010d), Chinese banks are proactively financing this type of enterprises less favored in the past. For instance, Bank B has been continuously supporting and financing the development and growth of the SMEs and set such practice as its key business strategy (Bank B, 2012b). Bank D, in 2011, laid down 12 business measures to 'help SMEs overcome financial difficulties and boost their real economic development, including reducing financing costs, eliminating unreasonable bank charges and helping to maintain their liquidity' (Bank D, 2012b, p67).

First, there has been increasing bank loans to SMEs by Chinese banking industry. By the end of 2010, the total loans from Chinese banks to the SMEs had amounted to 75,000 billion RMB, which was 9.4% higher than the increase of the averaged bank loans and 29.3% higher than that of same period in 2009 (CBA, 2011). Such voluminous financing significantly eased out the difficulties of SMEs and efficiently supported their development. And by the end of 2011, Bank B's balance of the SMEs loans had amounted to RMB959.3 billion, increased by RMB302.8 billion or 46.1% over the beginning of the year (Bank B, 2012b). Bank D extended a total of 575.219 billion RMB in loans to 45,265 SMEs and further 110 billion RMB in personal business loans to hundreds of thousands of SME owners and individually-owned businesses (Bank D, 2012b). Secondly, special internal rules and departments are developed by Chinese banks for managing bank credits to SMEs. For instance, Bank C formulated its own *Guidance for SMEs' Business* and *Management of Wholesaling for SME Clients* (Bank C, 2012b). Bank B has established relevant departments responsible for loans to SMEs throughout the whole group, including the head office, 38 tier-one branches, and over 300 specialized sub-branches under the tier-two branches. And, a total of 1,400 such specialized institutions covered almost all of the cities and regions where SMEs were concentrated (Bank B, 2012b).

Thirdly, new financing services and innovative financial products tailored for the SMEs are carefully developed by Chinese banks. For instance, Bank D initiates more efficient SMEs loan business, which greatly simplifies the traditional complicated procedures for loan approval and offers the SMEs better access to financing services. These include new financial products like 'Easy Loan', 'Self-service Revolving Factory Credit Facilities', and 'Factory Loan', and individualized trade financing products targeted at providing financial assistance to the industrial chains, supply chains, and logistics by the SMEs. Considering the regional specialty, Bank D designs various products with regional-specific features like 'Overdraft Loans', 'United Insurance and Credit' and 'Loans for Government

Procurement Bids', as well as other diversified financing sources like financial leasing, equity funds, and other new financing vehicles (Bank D, 2012b). Considering the specialty of bank lending to the SMEs, namely 'short, frequent and urgent', Bank B designs specialized financial products, such as 'mid-term turnover loans, circular loans, trade financing, operational property loans, standard plant building mortgages'. Also, the innovative 'E-loan Express' business makes it possible for the SMEs to apply for, receive, and pay back loans on the internet (Bank B, 2012b, p55). Bank A, based upon the agreement among the bank, the local government and the SMEs, develops *Helping and Guaranteed Financing Business* (Bank A, 2012b). Meanwhile, various financial innovations for facilitating the development and growth of the SMEs can be observed across Chinese banking industry, such as Xing Ye Bank's *Xing Ye Sesame Blossoming Loan Business* targeted at SMEs which prepare for going pubic, Beijing Commercial Bank's financial products in supporting SMEs in new industries like technology innovations, culture and environmental protection (CBA, 2010).

Moreover, significant financial reforms are initiated regarding bank loans to SMEs. By issuing *Notice on Support for Further Improvement on Financial Services by Commercial Banks to SMEs* (CBRC, 2010d), CBRC allowed for higher tolerance for non-performing bank loans by SMEs, considering different credit risks, the cost of financing, and the relevant financial settlements. In this context, its Shenzhen Bureau, issued *The Working Guidance on Financial Services for SMEs by Financial Institutions of the Banking Industry in Shenzhen* in 2012, which aimed to loosen supervision on bank lending to the SMEs, increase the tolerance for non-performing bank loans by the SMEs from 1% to 5%, and in turn expedite the sustainable development of financing services for the SMEs. Nevertheless, such financial deregulation was not intended for unrestrained financing to the SMEs, but for removing concerns by the banks and the relevant credit approval departments in granting the SMEs loans (Xinhua Net, April, 12th, 2012)

## 6.3 Bank and administrative control, governance and financial regulation

### 6.3.1 Financial control and administrative governance

Traditionally, there has been a strict government control and restrictive regulation on Chinese banking organizations. On one side, this is the legacy of the highly concentrated financial system, when the identities of banks and government were overlapped and the government could directly intervene in banks' business operation, and use banks as 'credit instruments' to channel financial resources to needs of the planned economy. On the flip side, the government is motivated to continue intervening in banks' business, though in less and limited scale, in the era of economic transition, desire for fast growth of GDP, and pressure to deal with various financial difficulties resulting from the economic reform.

First, at the macro level, the central government has been planning and monitoring on the total volume of the bank loans by Chinese banking industry on the annual basis, allocating 'the quota of credit' to different banks, while leaving to the banks how to use their loans. At the local level, the local government has been actively intervening or even directing the allocation of financial resources from the banks, which is always effective considering its local dominance. For instance, to support the development of the local SOEs and the regional economy, the local government may frequently motivate or press the banks to provide generous long-term bank lending, even in cases of insufficient mortgages/collaterals and possibilities of default (Yv and Pan, 2008).

Secondly, the selection of the senior management is greatly influenced by the government. For instance, the chairman of the board of directors and the CEO of the large sized state-owned banks are frequently appointed by the Organization Department of the Central Committee of the Chinese Communist Party (CCP), and the chairman of the supervisory board of the bank is appointed by the Central People's Government of the People's Republic of China (CPGPRC). With administrative ranking as senior government officials, such senior management of the bank is strongly politically oriented and may pursue the political commissions in the bank's business operation. Other senior managers, though not directly appointed by the government, are required to be registered with the government and subject to close regulatory supervision. In this context, the government appointed or influenced senior management may be more responsible to those who select them than to the bank.

Thirdly, at the operation level, Chinese financial regulators may set close regulations on various banking practices, the operation procedures, financial innovations, and development of new banking products or services. Meanwhile, the bank loans are heavily oriented by the government for prioritized sectors, industries and national projects with strategic significance, as discussed in the relationship between bank and economy. And, by frequent informal meetings, policy guidance ('window-guiding'), and annual on-site inspections, the regulator can reinforce its influence on the bank's business operations and its governance structure. In closely monitoring the business lines by the bank, for instance, the regulator can efficiently restrict and call off financial products and banking activities which are deemed as excessively risky. A typical example was the issuance of the *New Rules for Bank*

*Loan* (The New Rules) by CRBC in 2010, or termed as *The Three Regulation Ordinances and One Guidance,* which imposed constraints upon many of the major banking business in Chinese banking industry. They embrace *The Temporary Regulation for Liquidity Cash Loans* (CBRC, No.1, 2010), *The Temporary Regulation for Individual Loans* (CBRC, No.2, 2010), *The Temporary Regulation for Loans for Fixed Assets and Guidance for Project Financing Business* (CBRC, No.2, 2009), and *Guidance for Project Financing Business* (CBRC, No.71, 2009). The New Rules intended for better mechanisms in managing the bank's loans, facilitating the sustainable development of the national economy, guiding the banks in efficiently using and allocating financial resources for the real economy, and preventing against the credit risks .

### 6.3.2 Deregulation

In parallel with close financial regulation, however, there has been increasing opt for deregulation in Chinese banking industry. The *Opening-up and Reform Policy* from 1980s in China has gradually removed the government's intervention in Chinese banks and market-oriented regulation started to take place, especially after the financial reform in 2003. For instance, direct government control is losing colors and gives away to more liberal economic and legal mechanisms like financial supervision. First, the regulation style by Chinese financial regulators has changed from the past bureaucratic and tight control to the present more market-oriented coordination. Typically, the regulators 'walk out of their kingdom' and go to the 'factory floor' of Chinese banks for better understandings of the specific banking business, the needs of the banking organizations, and the problems to be resolved timely. For instance, a periodical research project has been set up by CBRC for its officials to conduct on-site research programs in Chinese banks, such as the arrangement of risk management, the internal control, and the credit policy. Instead of directing the business activities of the bank, such research projects are only intended for better discernment and update of information on various aspects in Chinese banking industry and provide empirical reference for relevant policy making.

Secondly, in issuing new policy guidance, principles or regulations, Chinese financial regulators increasingly stress upon consulting opinions from a wide range of resources, such as the banking industry, academia and public. In 'importing' international principles of BIS I, II and III into Chinese regulatory jurisdiction, for instance, the financial regulators invited and coordinated with Chinese banks on the terms and implementation of these international discourses. For example, regarding the liquidity risk management based on BIS II, CBRC has arranged a wide range of discussions, negotiations and seminars with representatives from key Chinese banking organizations, and integrated their needs and wishes into the final policy documents, such as the quantitative risk management models, risk measurement, and relevant risk indicators. And, upon revising corporate governance of commercial banks in China, CBRC actively consulted the opinions from the Chinese banking industry, organized seminars and discussions on the specific issues, and informed the banks of relevant revisions.

Thirdly, a standardized corporate governance structure has been established in Chinese banks, where the board of directors and senior management, rather than the government's officials, run the bank and make significant business decisions. Typically, the selection and appointment of the bank directors and senior executives are increasingly based upon their professional expertise, experience, and skills instead of the merely conventional political qualification and loyalty. And, Chinese banks have also more say in decision making with regard to significant investments and are less subject to the government command and intervention (CBA, 2010). Meanwhile, financial de-regulation, as an extensive move by different Chinese financial regulators, extends to various fields and aspects of financial activities, such as acquiescing for non-financial institutions to be engaged in certain banking business, granting more freedom to Chinese banks regarding their financial activities in insurance and mutual funds business, and loosening control over the interest rates.

However, the financial de-regulation is not an easy job in China and it takes decades to achieve the present laxer financial environment. The first round of financial de-regulation for Chinese banking organizations started in 1980s. In 1985, the PBC and other relevant ministries and departments of the central government jointly drafted the planning of the financial reform, which particularly clarified the large-sized state-owned banks as independent market players. That is, the banks would be free from controls by the government, independent in their business operation, and fully responsible for their profits or losses. In practice, the reform also pertained to the management of the bank capital, the allocation and changes in the bank's profits, and accountability of the head of the bank (CPGPRC, 1993).

The second round of deregulation took place in 1990s. In 1993, with the issuance of *The Decision on the Reform of the Financial System* by CPGPRC, the large sized state-owned banks were restructured further from the traditional industrial specific banks into independent commercial banks. Specifically, the government loosened the banks' bondages to their respective industries, transferred their policy financing functions to the newly established specific policy banks, expanded the scope of the bank's business, and promoted free competition. These de-regulative moves were further codified through the promulgation of *The Chinese Commercial Bank Law* in 1995, which recognized the independent legal status of the state-owned commercial banks and expedited their transformation from industrial specific banks to solely state-owned commercial banks. In general, the second round of financial regulation can be summarized as:

(i) The establishment of the independent legal entity of the commercial bank, centralized management in using and allocating the bank's loans, and formulation of relevant rules in managing the bank's capital;

(ii) The establishment of internal control system, the management of the balance between bank's assets and liabilities, and the quality management of bank's risks;

(iii) Improvement in the bank's corporate governance in accordance with *Chinese Corporate Law* and *Chinese Commercial Bank Law*, division among the board of directors, the management and the supervisory board, and designation of their separate functions,

and optimizing the bank's organizational structure, restructuring the networks of branches and subsidiaries in different localities.

The latest round financial deregulation started in 2003, which has greatly reshaped the landscape of corporate governance in banking organizations in China. In contrast with the past financial reforms, this round financial move was more drastic and purported to establish a market-oriented financial system in China. First, most of the solely state-owned large-sized banks went public and became listed shareholding commercial banks, with Bank C and Bank A as first group in 2004. By the end of 2006, 13 big publicly held commercial banks had become listed corporations. And up to 2010, all the sampled banks had turned into listed financial institutions. Secondly, there has been a drastic reform on the ownership structure of Chinese banks. On one side, with its establishment in 2002, Central Huijin Investment Ltd. (CHI), on behalf the state, became the majority shareholder of the key large-sized Chinese banks. By appointing directors to the banks' board of directors and supervisor board, CHI can efficiently monitor the performance of the bank, and fundamentally changed the situation of the absence of the owner in the state-owned banks. On the flip side, as required by CBRC, many of the large sized commercial banks have introduced the 'strategic' foreign investors and hired foreigners as the board members, which internationalized the shareholding of Chinese banks. Thirdly, a standard corporate governance structure, by referring to international practice, has been widely accepted by Chinese banking organizations.

These embody the collective decision making structure by the shareholder's general meeting, the board of directors, the senior management and the supervisory board, the enhanced internal control system, and improved risk management mechanisms. Further financial deregulation can be observed in the relaxation on market entrance into Chinese banking industry, increasing privatizations of the medium-and-small sized banks, less restrictions and interventions in business activities of the bank, and promotion for free competition (Wang and Guo, 2008)

## 6.4 Bank and legal influences

Categorized as the Continental law system, Chinese legal system shares a family resemblance with the Continental law countries like Germany, France and Japan, such as the codification of laws, the inquisitive role by the judges, and limited influence of the precedents (the decisions of the prior cases). Regarding corporate governance in banking organizations, these are represented by less legal intervention, passivism by the court, and strict application of the laws. On the other hand, however, there is judicial activism observed in China due to the strong political impacts, regulatory orientations, and pursuit for balance between legal justice and overall social stability. For instance, the Supreme People's Court of the People's Republic of China (SPCPRC) in its latest *Reform Blueprint of the People's Court for the Third Five-year Plan from 2009-2013 in China* (SPCPRC, 2009 a), explicitly manifested such orientation by emphasizing the balance among 'legal effects, political effects and social effects' in Chinese judiciary system. Meanwhile, a complementary guidance further stresses upon the court's role in achieving the CCP's mission, the people's overall interests, and the authority of Chinese Constitutions and statutes (SPCPRC, 2009 a).

### 6.4.1 Judicial passivism

Similar to its counterpart in the Continental law countries, Chinese court takes a passive stand in financial cases due to the strict reading, interpretation and application of the law, significant influences from the public policy and regulatory orientation, and concerns for overall social stability and security. First, the existence of the specific institution in Chinese judiciary system, the Committee on Political and Legal Affair (the CPLA), largely constrains the discretion of the court and brings about more political influence. Delegated by the CCP, the CPLA is responsible for formulating policies on the legal affairs, reviewing court decisions on cases with significant social influence, and supervising the performance of the judiciary officials and judges at different levels (Lv, 2010). However, due to its composition and political discourses, the CPLA may be more oriented towards the political interests regarding the legal issues, which separate them from the professional judges who focus more on the legitimacy and justice in hearing the cases. This may bring hindrance to the court and influences its independence. Specifically, the CPLA may wield overwhelming influence on the decisions by the courts, when it performs its coordination functions on complicated or new cases with significant social impacts, and intervenes directly as part of its legal monitoring responsibility (Yin, 2012).

Secondly, there are certain legislative impediments on the form of legal actions in China, which constrain the plaintiff from pursuing adequate relief against corporate malpractices in the stock market. As stimulated in *Several Rules on Civil Compensations Cases for Mis-statement Allegation in the Stock Market* (Chinese Supreme Court, 2002), for instance, the civil actions for securities market can be divided into the several or joint action, but does not include the form of the general class action. This largely encumbers the recourse by the injured parties, considering the higher costs and expenses for the joint actions, inconsistent court decisions, and unequal compensation for the losses. Meanwhile, it limits the court's motivation and power in influencing the practice of the listed corporations, such as the adequacy of information disclosure, the liabilities by the board directors and senior managers in breach of their fiduciary duties. Another barrier for the court's intervention comes from the specific pre-requisite procedures for civil actions, as the investors are not entitled to a valid civil action on securities cases unless there is an existing administrative penalty or criminal charge imposed on the listed corporations. However, such arrangement is generally not economically feasible for the plaintiff as the charged listed corporations may have run out of funds after paying the administrative penalties. These legislation deficiencies may largely restrain the competence of the court in exerting influence on the practice and governance structure of the listed corporations (Yang, 2010). Thirdly, the background, knowledge and experience of the judges may also confine the court's competence in intervening in financial cases. Increasingly, judges in present China largely graduate from law schools of known universities, frequently hold a JD or master degree in law, and are educated with some economic courses. However, compared with judges in the Anglo-Saxon model who have generally practiced laws for years as lawyers and may be specialized in economic and financial cases, Chinese judges may be comparatively less equipped in hearing highly technical and professional financial cases. Meanwhile, the comparatively insignificance of the precedents further weakens the judges' ability in handling the fairly practical cases.

In practice, these may bring extra difficulty in reading of the laws and legal enforcement on financial cases. In *Notice on Foreclosure, Detainment and Freezing of the Assets in the Execution by the People's Court* (Chinese Supreme Court, 2004), for instance, though the court can foreclose the real estate by the debtor of the bank who defaults in repaying the bank loans, it can not put such estate on auction, for sale, or as payment for repaying the debts, if such real estate is the fundamental living necessity for the debtor and his/her dependent family member. This barricades efficient enforcement on the real estate and hinders the bank in collecting non-performing mortgage loans from the defaulting individuals. Another case of judicial pessimism is represented in the court's attitude towards the transfer of credit right to the non-performing financial obligations owned by large-sized SOEs, as observed in *Summaries of Working Seminars on Cases of Transference of Non-Performing Rights to Financial Related Liabilities* (Chinese Supreme Court, 2009b). Legally, transfer of the credit right to non-performing liabilities to a new creditor falls into the private realm, which is completed by the private agreement between contracting parties. Only in exceptional cases where there is significant violation of social policies like unconsciousness does the court intervene. However, the Chinese Supreme Court sets fairly restrictive criteria upon the validity of the contract regarding the transfer of credit right to the non-performing financial obligations. It specifies not only the additional procedures like application for approval, official registration, and submission for official record, but also the substantive scrutiny of the fairness regarding the valuation of transferred credits and related assets. And such judicial scrutiny and requirements bring about more barricades for the new creditors in claiming the repayment for the debts through judicial means. Meanwhile, the debtor of the large-sized SOEs can counter-claim against the new creditors by challenging the validity of the contract on the credit transfer, which may lead to the burdensome lengthy litigation, increased cost and expenses, and the delay of clearance of the repayment to the new creditors. This controversial judicial interpretation justifies itself in considering the Chinese context, where the settlement of financial debts of over a billion RMB by SOEs is more than the simple settlement of credits and debts between private contracting business entities, but the transfer of voluminous state assets and reallocation of relevant interests. As 'Whether such transfer can be achieved in transparent, fair and justified procedures impacts upon the overall interests of the people and the state, and the effectiveness in the regulation and management of the state assets. In this context, it is inadequate in evaluating the transfer of the credit to such non-performing financial debts according to the general contract rule of free will and protection of private rights' (China, Supreme Court, 2009 b, p3).

### 6.4.2 Judicial activism

On the other hand, Chinese courts are fairly active in guiding, orienting, and participating in a great variety of financial activities by Chinese banking organizations through different means, which includes the influential court decisions, judicial guidance and advice. For instance, in 2009, the Supreme Court of Guangdong Province issued judicial advice to the key financial regulators, such as the Guangzhou Branch of PBC, the Guangzhou Bureau of CBRC, the Administrative Office on Financial Services of Guangdong Province, and instructed the banks should assure that their loan business cope with the latest changes in the legislation. Specifically, the court advised that the bank scrutinize the adequacy of the collaterals for bank loans, control and prevent credit risks caused by the void or invalid collaterals, and monitor closely the performance of duty of care by relevant bank employees (Huang, 2012). The Second Intermediate Appellate Court in Shanghai, on the other hand, issued specific judicial advice to Shanghai Bureau of CBRC regarding the illegal investment of voluminous bank loans in stock trading by Shanghai Branch of Guangda Bank, which amounted to 25 billion RMB. The court advised the Shanghai Bureau of CBRC take timing and efficient measures to ensure Guangda Bank immediately rectify its illegal practice and mitigate exposures to relevant credit risks (NetEase, July 25 th, 2005). Shanghai Supreme Court, on the other hand, provided a series of judicial advice in 2007 in preventing substantial risks in relevant stock transactions by Chinese banks, such as illegal stock trading by using the 'sensitive and delicate' investment, the deficient information disclosure and misstatement, and legal risks created by delegated wealth management (Li and Gao, 2007). And in this context, as a complementary to the financial regulators, Chinese court actually plays a 'backup supervisory' and facilitates the implementation of key financial policies.

Meanwhile, Chinese court plays an active role in promoting financial reforms. For instance, against the backdrop of drastic and innovative financial reforms in Wenzhou in 2012, the local appellate court of Wenzhou timely promulgated *Several Opinions on Judicial Support on Establishing the Experimental Region for Comprehensive Financial Reform in Wenzhou,* which well promoted the development of many private banking and loan business (Stock Times, May 22 nd, 2012). The opinions by the court specifically clarified and legitimized the new patterns of private financing and investment in China, and designed a creative registration process which required the official registration and record of the private borrowing activities that could be used as valid evidence in case of default or non-performing of the loans. Moreover, the court reinforced the protection for private investors, their legitimate rights, and their investment in new types of financial institutions, such as banks at county or village levels, small-amount loan companies, and the rural financial cooperatives. In addition, limitations on shareholdings by private investors in these financial institutions were to be lifted. However, the court also stress upon the balance between the financial innovation and prevention of financial risks, and avoided major financial cases which might possibly impact on the overall financial reform (Stock Times, May 22 nd, 2012).

### 6.5 Bank and international influence

Increasingly, international influences of various kinds play significant role in shaping and changing the discourse of corporate governance in banking organizations in China, such as China's increasing membership in international economic organizations, opening up to foreign financial institutions, and the fast-growing international expansion by Chinese banks. By participating in, negotiating, and co-drafting the principles, rules and frameworks in key international financial organizations, Chinese financial regulators increasingly 'import' the international financial discourses into the governance structure of Chinese banking organizations. Up to 2013, for example, CBRC had integrated almost all the key principles and guidance by BIS regarding risk management in banking organizations, which covers the capital adequacy, credit risk, liquidity risk, market risk, legal risk, etc. For example, Based upon BIS I, II and III, CBRC modifies *Guideline on Regulation of Liquidity Risk of Commercial Banks* (CBRC, 2009) and drafts *Principles on Regulation of Liquidity Risk by Commercial Banks* (CBRC, 2010). As one of the most significant guidance on risk managements for Chinese banking industry, these guidance and principles adopted the Basel liquidity risk management framework and reinforced the use of mix of qualitative and quantitative methods in identifying, assessing, monitoring and controlling liquidity risks on all key aspects of the business activities by Chinese banks. And, they also pertained to the establishment of the dynamic and multi-layer monitoring criteria, workable framework, and a series of monitoring tools. By integrating the macro prudential regulation and micro supervision into risk management of Chinese banks, these norms specifically required the financial regulators and the banks to cooperate and monitor the influences on the liquidity situation of Chinese banking system, which might be caused by adjustments in macro economic and financial policies and changes in the financial markets (even those seemingly insignificant minor ones).

Secondly, the increasing presence of foreign banks in China, deregulation upon their entrance and business activities, and intensified competition by these 'outside' banks also exert great influence on bank governance in China. Up to September 2011, more than 47 countries and regions had established banking agency in China, and become engaged in a great varieties of banking activities, such as financing for SMEs, agriculture, airline and transportation, wealth management, and international settlement. This embraces 39 registered foreign banks (with 247 branches and affiliates), one foreign financial and accounting firm，93 branches and 207 offices of foreign banks (CBRC, 2011b). Among the 39 registered foreign banks, the total bank asset for any of the top five had well exceeded one thousand billion RMB. With national treatment, the foreign banks enjoy equal rights as Chinese domestic banks regarding the banking business in RMB and foreign currency for corporate and individual clients, and are subject to same banking regulations regarding the capital adequacy, constraint over credit concentration, liquidity, etc (CBRC, 2011b). With the fast expansion of their networks, the foreign banks have established their business operation in 48 cities, covering almost all the provinces and municipalities except Tibet Autonomous Zone, Gansu Province, Qinghai Province and Ningxia Province. Up to September 2011, the total assets of foreign banks in China had reached 2.06 trillion RMB, with a compound annual growth rate of 19% since 2001. Meanwhile, the foreign banks had developed more than 240 various financial products in China, from individual loan products like 'Happy Loan' and 'Modern Loan', to the wealth management products, and consulting service for Chinese enterprises on international expansion. Moreover, foreign banks are more actively engaged in the financial derivatives markets and take up around 34.6% of the total transactions (CBRC, 2011b).

The increasing presence of the foreign banks in China brings about fierce competitions to Chinese banks in key economic regions and major banking business. The former focuses on the developed regions like Yangtze Triangular Zone, Zhujiang Triangular Zone, and regions along Bohai Sea. The latter involves financial business in trade financing, financing for the real estate industry and SMEs, individual loans, and wealth management products. For instance, foreign banks are expanding fast in coastal and metropolitan cities of China, acquiring foreign and Chinese enterprises and financial institutions with great potentials, and competing for brokerage and investment banking business. Meanwhile, the foreign banks are taking advantages of the domestic banks by attracting their experienced employees with higher pay. These set great pressures on Chinese banking industry and motivate Chinese banks to enhance their corporate governance for better performance and competitiveness, such as the more efficient ownership structure, better compensation and incentive mechanism for excellent personnel, and sound risk management mechanism and internal control system. Meanwhile, advanced financial technology, financial innovations, and new financial products are also actively developed and promoted industrial wide (Wang and Cao, 2005).

**Table 6.3 2011 International Business Expansion by the Sampled Bank (including Hong Kong, Macau and Taiwan), Unit: Billion USD**

| Bank | The number of overseas branches and subsidiaries | The coverage of overseas countries and regions | Overseas total assets Unit: Billion USD | Percentage of the overseas total assets in the total assets of the banking group % | Increased percentage compared with last year % |
|---|---|---|---|---|---|
| Bank A | 71 | 13 | *4,212.12 | 3.61% | *67.74% |
| Bank B | 239 | 33 | 1,247.29 | 5.1% | 64.7%, |
| Bank C | Not known | 32 | 4,086 | 21.76% | 26.15% |
| Bank D | 7 | 7 | 1,247.03 | 1.07% | Not known |

* is the total of overseas operational business assets, and the increase rate against last is also based on such category of assets. The overseas total assets by Bank A in 2011 is 4,431.88 billion USD

Source: Annual reports of the sampled banks, 2012

Another international impact on the discourse of the bank governance in China comes from the increasing overseas expansion and financial globalization by Chinese banking organizations, which aim to provide financing to Chinese companies operating overseas and facilitate trading by foreign investors interested in exposure to Chinese Yuan. As illustrated in Table 6.3, Bank C, based on its extensive international networks and long history of international banking and finance, has prioritized global expansion as its key business strategy. Up to 2011, its overseas branches had covered 32 countries and regions outside the mainland of China, and the total overseas asset reached to 4,086 billion USD and took 21.76% in its total asset (Bank C, 2012a). Bank B, stressing on the significance of the international business in its strategic development planning, has been expanding its global operation at an unprecedented pace in the past few years. And up to 2011, it overseas branches had risen to 239, covering 33 countries and regions. Meanwhile, its overseas total asset reached 1,247.29 billion USD, increasing by 64.7% compared with 2010, and took 5.1% in the total asset of the bank group (Bank B, 2012a).

In the internationalization process, Chinese banks are subject to various investigations and stricter requirement on enhancing the governance structure by the host country. For instance, in gaining access to US financial markets, whether it involves the acquisition of the established financial institutions or setting up new branches or subsidiaries, Chinese banking organizations are subject to the scrutiny on their corporate governance structure by officials and specialist form relevant regulators like US SEC and Federal Reserve. For instance, before Bank B was approved to acquire 80% stake in the US subsidiary of Bank of East Asia (A Hong Kong Company with 13 branches in New York and California), or Bank D was allowed to set up its branch in New York City and Bank C to set up its branch in Chicago, they underwent a series of strict tests on their corporate governance structure by US financial regulators. Meanwhile, Bank M, a large sized highly privatized Chinese commercial bank, was refused by US Federal Reserve on buying into UCBH Holding Inc. (the holding company for United Commercial bank), because of the defects of the bank's governance arrangements in risk management, and anti-money laundering procedures (Wall Street Journal, May 12 th, 2012).

Other international influence on corporate governance in Chinese banks may come from the appointment of foreigners or professionals with strong international background as the bank's board directors and senior management, increasing overseas training and exchange programs with foreign banks, and recruitment of employees with overseas academic background or working experience. For instance, as to be discussed in Chapter Seven, the hiring of board of directors with international background is popular in the sampled banks, with each having over 20% of the board directors from outside of the mainland of China. Meanwhile, Chinese banks have developed long-term overseas training or exchange programs to enrich the international experience of their managers and employees. For instance, Bank A has established strategic cooperation relationship with JP Morgan and periodically sent its middle-ranked managers to USA for around half year of training and on-job learning.

## 6.6 Implication for paradigm and specific governance structure

The legitimacy of corporate governance in Chinese banks, summarized as the bank's proactive role in real economy, strict financial regulation and control, paradoxical legal intervention, and increasing international influence, poses strong influence on the formation of the next level discourse, the paradigm of bank governance in China. For instance, the paradigm of the governance arrangement in Chinese banks presents a hybrid nature due to the 'blended' legitimacy discourses which integrate some of the characteristics of the CME, SME and LME. With the banks' integration into the real economy and active financing for the development of industrial sectors and the enterprises (SOEs and SMEs), Chinese banks frequently pursue a long-term, sustainable profitability rather than short-run best performance. And, serious concerns are given to the protection of the interests of a wide range of stakeholders, such as the sustainable economy, the creditors and depositors, the regulators, the employees, and the society at large. Such paradigm of the stakeholder model is reinforced by the strong regulatory discourse in China through close and strict financial regulation. By policy orientations, regulatory guidance and working conferences, Chinese financial regulators may efficiently coordinate Chinese banks with sustainable economic development, financial stability, and protection of the interests of various stakeholders. Meanwhile, though to a limited extent, the paradigm of the stakeholder model is strengthened by the court's intervention *ex ante*. By stressing upon the significance of the social stability and financial sustainability, the court actively orients the bank towards the protection of the interests of different constituencies, even those of the bank's debtors. Moreover, a parallel paradigm of the state-affected model may be present in China due to the discourse of a more intervening role by the financial regulator, especially in cases of financial uncertainty and the implementation of key national development strategies. For instance, in accordance with relevant financial regulations and red-taps, Chinese banks are directed towards issuing voluminous loans to certain industrial sectors, the infrastructure projects, and under-developed regions, though such investment, economically, is less profitable. On the other hand, however, the discourse of the financial deregulation and international influence promotes the paradigm of the shareholder primacy. For instance, with the progression of the financial deregulation, Chinese banks lay specific emphasis on enhancing profitability and best performance. Meanwhile, with intensive competitions within the banking industry and from other non-banking financial institutions such as stock brokers and trust corporations, Chinese banks are now under greater pressure to compete, maximize its profits, and bring better investment returns to the shareholders. The international influence, either caused by the competition by the foreign banks or Chinese banks' global expansion, also reinforces the paradigm of the shareholder primacy model in Chinese bank governance.

Moreover, the legitimacy of corporate governance in Chinese banks provides important implications for the frame of specific governance structure in Chinese banking organizations. For instance, with the close connection between the bank and the real economy and strong impacts by the regulatory discourse, the bank board in China is more oriented towards serving the economic development, promoting the interests of various stakeholders, rather than maximizing the profitability of the bank and the best investment returns to the shareholders. And, the intensive financial regulation may also influence the regulation on executive pay in Chinese banks. For instance, the financial regulator may direct the composition of the compensation package, specific ratio of different variable pays, and an implicit cap on the total remuneration. Regarding risk management, Chinese banks generally present a moderate risk appetite, specific concerns on certain credit risk exposures, and more direct lending relationship with the corporate and individual clients. For instance, the existing limitation on competitions within and beyond the banking industry and regulatory orientation for the long-term profitability and financial stability set less pressure on the banks to take more risks (for the sake of higher returns) to achieve short-term maximized profitability. On the flip side, however, the bank's close integration into the real economy and the regulator' orientation for financing the economic development may bring about extra risks, such as credit risks by local governments, enterprises or industrial sectors. And, the strong financial regulation also influences the constitution of the legal obligations in Chinese bank, such as the specific compliance criterion, the measurement and evaluation.

## 6.7 Chapter conclusion

Focusing on the institutional setting in Chinese context, this chapter explores the legitimacy discourse of corporate governance in banking organizations in China. Against the backdrop of a hybrid nature of CME, SME, and LME, Chinese banks gain their legitimacy from the integration into the national economy, the close connections with major industries, and the intertwining relationship with SOEs and SMEs. For financial regulations, a paralleled discourse of the close control and de-regulation is present in Chinese banking industry, which greatly influences the bank governance in China as well. Though Chinese court apparently plays a limited role in shaping the discourse of governance structure of Chinese banks, it is proactive in intervening *ex ante* in the bank's business operation by various judiciary measures. And, with the increasing involvement in financial globalization, whether by means of Chinese banks' international expansion or increasing presence of foreign banks in China, international influence shows great strength in reshaping the governance structure of Chinese banking organizations. In sum, as the discourse at the background the cognition, the legitimacy of banks in China provides significant implications for the paradigm and frame of bank governance in Chinese context, which will be discussed in the following chapters.

# Chapter Seven Corporate Governance in Banking Organizations in China (II): Paradigm

## 7.1 Introduction

Following the previous chapter on the discursive institutions of legitimacy in corporate governance of banking organizations in China, the present chapter considers the paradigm which is at work in constituting the bank governance in Chinese context. The chapter necessarily draws on the previous exploration on the paradigms of generic corporate governance in Chapter Two, and paradigms of corporate governance in banking organizations in Chapter Three. On initial examination, the paradigm of corporate governance in Chinese banking is a hybrid that draws upon elements of both the shareholder primacy and stakeholder model. However, in order to understand the specific form taken by this hybridity, it is necessary to explore the ways in which the broader discourses and institutions that legitimate banking practices in China function to produce uniquely Chinese characteristics. By examining these discourses and institutions, it will be shown that an enhanced shareholder primacy model has developed in China. With the Chinese state as a majority shareholder of the banks, the desire to balance the maximization of shareholder interests with stakeholders' interests has emerged as a core paradigm. The diversified stakeholder discourse, on the other hand, highlights bank's serious concern for interests of a great variety of stakeholders, from the general economy to the individual employees, from the regulators to the clients, and from the environmental protection to the social welfare at large.

## 7.2 The enhanced shareholder primacy theory in China

### 7.2.1 The paradigm of the enhanced shareholder primacy

As discussed in Chapter Two, the shareholder primacy theory of corporate governance, typically found in the Anglo-Saxon model countries, is best characterized by the maximization of the shareholder's interests, and the mitigation in the agency costs (Jensen and Meckling, 1976). But due to many specialties of the banking industry like high-leverage capital structure, opaqueness in financial information and strict financial regulation, as discussed in Chapter Four, this model deviates in corporate governance in banking organizations, which are characterized with the acuteness of the agency problem, and the aggregated conflict of interests between the shareholders and other stakeholder, typically the fixed claimants like the depositors.

The paradigm of the shareholder primacy in corporate governance in Chinese banks, in contrast with the Anglo-Saxon model, takes on a hybrid specialty, especially considering the presence of the state as the controlling or majority shareholder, directly or indirectly. On one side, as the key investment contributors and residual claimers for final losses, the bank's shareholders are entitled to protection for their interests and proper returns to the investment (Zhang, 1996). And, the paradigm of the general shareholder primacy motivates Chinese banks to bring in the best investment returns for the investors, and maintain increasing profitability. This is reinforced by the fact that all the sampled banks in this study are listed corporations, and subject to strong market discipline and monitoring. For instance, Bank B announces its objective of 'creating value as an outstanding company and rewarding our shareholders with a steady growth' (Bank B, 2012b, p12-13). Bank D stresses 'further reinforcement on increasing the bank's value, --- and sustainable growth for the shareholders' (Bank D, 2012b). And, Bank A 'is greatly concerned with the overall interests of the shareholders, particularly the interests and claims by minority shareholders'. Meanwhile, it aims to 'provide equal treatment to all shareholders, consider the opinions and advice by the investors to enhance the bank's management and operation, and protect henceforth the shareholders' interests' (Bank A, 2012b, p20).

On the flip side, however, major deviations can also be found in the paradigm of the shareholder primacy in Chinese banks. Specifically, serious concerns are voiced by the banks with regard to the large stakes held in them by the state, the state's implicit unlimited shareholder liability, and the financial stability consequences. In this context, the shareholder primacy discourse in China can be said to have developed into an enhanced shareholder primacy paradigm that is distinguished from the Anglo-Saxon model. For instance, all the sampled banks stress upon the sustainable profitability, the long-term development, and continuous growth for the shareholders' value instead of the short-term maximized profits (Bank B, 2012b; Bank A, 2012b). Meanwhile, there is special emphasis on the protection of the investment by the state. For instance, Bank C emphasizes in particular its orientation in 'the preservation and increase of the value of the state assets' (Bank C, 2012b, p22).

The enhanced shareholder primacy in Chinese bank governance is found to largely attribute to the presence of the state as the controlling or largest shareholder. First, as the majority shareholder and major residual claimer, the state is entitled to protection for its interests and proper returns to its investment. This is reinforced by the implicit restrictions upon the transferability of the state's shareholding, which locks it up as the key and long-term investor. Meanwhile, in times of economic uncertainties or financial crisis, the state may even increase its investment in the major banks. As illustrated in Table 7.1, a large investment is vested by the state in some of the largest commercial banks. And even for banks which are not directly owned by the state, many of the large shareholders are SOEs or local governments, which lead to the 'indirect' ownership of the state.

**Table 7.1 2012 Investment in Large Banking Organizations by CHI On Behalf of the State, Unit: Billion**

| Bank | Nature | Total Shareholding | Shareholding by CHI | Percentage of the Shareholding by CHI |
|---|---|---|---|---|
| Bank A | State-owned, Joint-equity Commercial Bank | 2500.11 | 1428.36 | 57.13% |
| Bank B | State-owned Joint-equity Commercial Bank | 3490.83 | 1236.94 | 35.43% |
| Bank C | State-owned Joint-equity Commercial Bank | 2791.47 | 1887.01 | 67.60% |
| Bank D | State-owned Joint-equity Commercial Bank | 3247.94 | 1303.10 | 40.12% |

Source: CHI website, 2012

Secondly, the enhanced shareholder primacy in China draws on further importance considering the specialized status of the state as the controlling shareholder. Distinguished from other general shareholders of the bank, the state frequently acts as the implicit and unlimited liability investor, who provides the deposit insurance for the invested banks. More than often, the creditors and depositors, in their understanding of the banking organizations in China, base their transactions on the state credit instead of the credit of the specific individual bank, though most of the Chinese banks are now independent legal entities. And, in the event of voluminous non-performing loans, financial hardship, or nearing insolvency by Chinese banks, the state, as the majority shareholder, frequently injects extra capital, sets up specific mechanisms to deal with the bad assets, and maintain the resilience of the bank. In this context, the enhanced shareholder primacy takes on extra significance in Chinese banks, as the maximization of the shareholders' interests and the continuous profitability of the bank will not only affect the welfare of the investors, but the systematic financial stability, national economy, and in due course even the state solvency.

### 7.2.2 The agency problem

As discussed in Chapter Two, the agency problem in corporate governance arises from the separation of ownership from control of the corporation, with the investors owning the corporation while the managers controlling it (Berle and Means, 1932; Jensen Meckling, 1976; Shleifer Vishny, 1986; Demsetz Lehn, 1985; Eisenhardt, 1989). The management, as an 'economically rational person', may always maximize his own interests by expropriating shareholders (Jensen Meckling, 1976). The agency problem in corporate governance of banking organizations is further aggravated, as discussed in Chapter Four, and characterized with acuteness, the aggregated conflict of interests between the shareholders and other stakeholder, and less efficient monitoring.

Regarding the agency problem in corporate governance in Chinese banking organizations, specialties are present due to the existence of the controlling state ownership, such as the long chain of delegation, the lack of efficient monitoring, and the involvement of multiple agents. Theoretically and legally, Chinese state-owned banks are owned by the people in general. However, due to the impossibility for the public to practically own and manage the bank, the power to manage the bank, as well as its legal ownership, is delegated to the state as the public's agent, who further re-delegates such power to more specified legal entities, such as the government department or CHI. This necessarily leads to a long and multi-facet chain of agency relationship, from the people at large as the principal, to the state, and in turn the specific agency or department in the government, the CHI, and finally to the board of directors and senior management of the bank. The participation of varied agents in this long chain of delegation further amplifies the agency problem. For instance, as the agent of the state, CHI is not liable for the losses by the invested banks and can not 'feel the pain' as the true owner in case of the banks' insolvency. In the absence of the true owner and lack of efficient monitoring, the banks' management can easily run the bank at their own will and maximize their interests at the owner's costs. Meanwhile, agency problem of another kind may take place within the bank. Legally, the head office of the bank acts as the legal person and takes ultimate responsibility to the shareholders. And, in the context of the bank's wide coverage of geographic areas, it has to delegate the powers downwards to various branches at different levels and in various localities. However, the losses incurred by these branches are to be born by the head office due to its independent legal entity status. In this sense, the relationship between the head office and the branches resembles that of the traditional principle-agent.

## 7.3 The diversified stakeholder theory

### 7.3.1 General theory on stakeholders

In parallel with the enhanced shareholder primacy theory, there is a paradigm of the diversified stakeholder theory in corporate governance in Chinese banks. As discussed in Chapter Two, the dominant theory in general corporate governance in the Continental model countries like Germany and Japan, is the stakeholder theory, which focuses upon equal protection for the corporate stakeholders (Freeman, 2004), and the accountability of the management in implementing a balanced business strategy to achieve a long-term growth of the corporation (Freeman, 1984). In the context of corporate governance in banking organizations, as discussed in Chapter Four, the paradigm of the stakeholder theory takes on more importance due to the specialty of the banking industry, such as the extra high debt-to-equity ratio, the exuberated conflict of interests between the fixed claimants (creditors and depositors) and shareholders, and less effective monitoring by the investors or deposit insurance agencies. The immense economic and social impacts by the banks, coupled with their unique role in the domestic or even international economy which is readily observable in the 2007-2009 financial crises, make the banks more accountable to the public, the government and the economy.

The paradigm of the stakeholder theory in the context of corporate governance in Chinese banks, considering the legitimacy discourses of bank governance as discussed in Chapter Six, is found to be a more diversified discourse. First, it is well paralleled with the enhanced shareholder primacy theory when the major shareholder is largely the state, which does care about the welfares of other stakeholders in the society which it governs and administrates. Secondly, it pertains to a great variety of stakeholders and promotes their interests by various means, such facilitating their participation, responding to their concerns and demands, and helping achieve a sustainable, harmonious and win-win situation. Bank B, for instance, explicitly illustrates the demands by different stakeholders and the bank's due responses, as illustrated in Table 7.2. Meanwhile, Chinese banking organizations

**Table 7.2 2011 Bank B CSR Report on Protection for Different Stakeholders**

| | Expectation and needs | Responses of ICBC |
|---|---|---|
| Government | Enhance sustainable and sound development of the economy<br>Facilitate the public fiscal plan and serve the development objectives of the government | Earnestly carry out macro-economic policies, optimize resource allocation function, and support the sustainable development of the real economy, support the financial development, stable tax growth and provision of job opportunities for SMEs, agriculture, rural areas and farmers, and ethnic minority regions |
| Regulatory authorities | Operate in a compliant manner and conduct fair competition<br>Maintain stability of the financial system | Strengthen compliance management, creditworthy operation<br>Improve corporate governance, strengthen development of internal control, and promote the implementation of the New Basel Capital Accord |
| Shareholders | Gain satisfactory returns and market value<br>Fully understand the operating status of the Bank | Sustain healthy and stable operations, enhance profitability<br>Strengthen investor relation management and ensure timely disclosure of information |
| Customers | Convenient and efficient financial products and services<br>Comfortable business environment | Develop E-banking, optimize transaction process and innovate products and services<br>Improve service quality, focus on customer experiences, upgrade and restructure branches |
| Partners | Fair procurement<br>Honesty and mutual benefits | Adopt a fair and transparent procurement mechanism<br>Stick to the principle of equality, mutual benefits and harmony |
| Employees | Good career planning and development opportunities<br>Complete protection of rights and interests | Carry out human resources enhancement project, optimize employees training system<br>Improve remuneration and incentive, insurance and benefits systems |
| Communities | Pay attention to community development<br>Safe and healthy living environment | Conduct voluntary activities, help vulnerable groups, participate in social welfare undertakings<br>Ensure safe operation, promote financial knowledge and environmental protection publicity |
| Environment | Pay close attention to climatic change and support low-carbon economy<br>Advocate energy conservation and emission reduction<br>Establish a conservation-minded society | Promote green credit, E-banking and green financing channels<br>Advocate green office, green procurement, carry out environmental protection and public benefit activities |

Source: Bank B, 2012b

**Table 7.3 2011 Bank B CSR Exchange Programs with Stakeholders**

**Responsibility Exchanges**

| Time | Sponsor | Conference |
|---|---|---|
| January | Ministry of Environmental Protection, etc. | 2011 China Low Carbon Economy Forum |
| March | Ministry of Environmental Protection | Discussion on green credit guide for steel, papermaking and coal industries |
| April | World Wide Fund for Nature | Finance, Environment and Development Forum |
| May | China Beijing International High-tech Expo | 2011 Summit Forum on Finance |
| May | CBRC | Discussion on "International Comparative Study on Green Credit" |
| September | Global Reporting Initiative | Press Conference on Sustainable Development Reporting Guidelines (G3.1) |
| September | Ministry of Environmental Protection | Launching Meeting and Symposium on Assessment Project for Evidence-based Green Credit Policy |
| October | China Banking Association | Social Responsibility Training and Working Meeting |
| October | United Nations Environment Programme | "Summit Forum on Global Sustainable Finance" and trainings on social and environmental risks |
| November | CBRC | Seminar on "Green Credit Guidelines" |
| December | ICBC | Experts from the Ministry of Environmental Protection, Development Research Center of the State Council, industry associations and universities were invited to provide lectures or have discussions in ICBC on green credit in steel, nonferrous metal, coal, cement, papermaking and service industries. |

Source: el at Bank B, 2012b

actively initiates the CSR Exchange Programs with relevant stakeholders, such as various regulators, enterprises, and non-profit organizations (NPOs), observed in Table 7.3.

The paradigm of the stakeholder theory in Chinese banks is further manifested in independent opinions by external auditing or consulting firms, who monitor and advise upon the performance of CSR by Chinese banking organizations. For instance, Price Waterhouse Coopers house (PWC), in evaluating the delivery of CSR by Bank C in 2011, stated 'the Bank (Bank C) identifies the key stakeholders and understands their demands and concerns. In addition, in forming the development strategy, formulating business policies and delivering daily operations, Bank C takes into account the expectations of the stakeholders and the banks influence upon them' (Bank C, 2012b, p155). Also, in evaluating the responsiveness of the Bank C to the needs by the stakeholders, PWC stated 'considering the special business characteristics, relevant departments in Bank C have set up diversified communication channels for better communication between internal and external stakeholders to reinforce corporate governance, enhancement in risk management, product innovation and optimization of the business procedures, which well respond to the main demands by the stakeholders' (Bank C, 2012b, p148).

Deloitte, in providing the third party's opinion upon CSR by Bank D in 2011, stated that 'based upon the extent of influence and significance, Bank D identifies the relevant stakeholders by various communication mechanisms, sort out their expectations. Considering the influence from the bank's business operation and management upon the decision making by the stakeholders, Bank D figure out the substantive issues and responses actively to relevant stakeholders' (Bank D, 2012b, p152). Furthermore, Deloitte pointed out that 'the Bank has adopted a good preparation procedures for the CSR report, collect relevant information in supporting the disclosure of its performance of CSR in the economic, social and environmental fields' (Bank D, 2012b, p152). Similar assurance opinions by external auditing or consulting firms can be observed in CSR reports by other sampled banks (Bank A, 2012b; Bank B, 2012b).

However, it is sometimes a challenge for Chinese banks to coordinate the interests by the varied stakeholders. For instance, the state may focus upon the healthy and sustainable economic development, social progress and national prosperity. The regulators may demand the legal compliance, preventions against the risks, and maintenance of a sound financial system. The clients, at the top of the security of their deposits, may pursue profitable and sustainable financial products and services, timing responses to their claims, and improvement of the financial services. The employees may care more for better welfares, career advancement, and better professional opportunities. The society at large may look forward to a better social environment, more charitable donations, and social harmony. And the concerns for the environment extend to the environmental protection, energy saving, and promotion of green finance (Bank A, 2012b). In this context, the paradigm of the stakeholder theory in Chinese banks is frequently manifested under the harmonious umbrella of corporate social responsibility (CSR), which is a much wider concept and integrated into the banks' business agenda, strategic development, and daily operations.

### 7.3.2 Stakeholders of different kinds

*State and regulator as the stakeholders*

When the state is treated as a key stakeholder, Chinese banks are largely involved in supporting the national economic planning, strategic development, and economic coordination, which color the banks with strong mark of public interests. This is rare in the Anglo-Saxon model countries like US and UK where financial disintermediation dominates, but similar to the State-affected model countries like France and Japan, and the CME model countries like Germany, where banks largely perform the financial intermediary functions and are actively involved in the national economy. As discussed in Chapter Six, Chinese banks are frequently oriented towards the macro economic policies, implementing industrial policies, and actively supporting the development of the real economy. These can be readily observed in the bank's active posture in financing the development of the industries, provide funding to the SOEs, and developing specific financial assistance to SMEs (CBA, 2011). Another stakeholder of Chinese banks, though less popular, is the financial regulator, such as CBRC, PBC, and the Ministry of Finance. Representing the state and the public at large, these special stakeholders are primarily responsible for the financial stability, preventing against financial risks of various kinds, and ensuring the bank's compliance with laws, principles and rules at different levels. In practice, Chinese banks mainly implement their responsibility to the financial regulators by their complying business operations, anti-money laundering, and anti-corruption, which will be further explored in Chapter Nine.

*Protection of the employees' interests*

As one of the key stakeholders in Chinese banks, employees take a significant place in the paradigm of corporate governance in banking organizations in China. Based upon applicable Chinese laws and rules, such as labor law and labor contract law, and the bank's internal principles and guidance, a framework is developed in Chinese banks for the protection of the employees' rights and interests, which embraces the general meeting of the employee representatives aiming at the employees' involvement in the bank management, the establishment of a fair and efficient compensation system, the 'career ladder' for employee's professional advancement (CBA, 2011).

First, the 'voice' of the employees is expected to be 'heard' by the bank's board of directors and senior management. Mainly by means of the general meeting of the employees' representatives, who are legitimately elected by all the employees, Chinese banks actively promote employees' involvement in managing the bank, better access to related information, and monitoring over the bank's business activities. In Bank C, for example, around 61.76% of its branches set up the collective negotiation mechanism, and 'One to One' liaison mechanism which effectively facilitate the communication between the management and the employees. And, the 'Reception Day' by the head of the branch and the Forum by the employees' representatives also contribute to the democracy in the bank's management (Bank C, 2011b). Bank A, on the other hand, has established three-tier general meetings of the employees, at the levels of the head office, the branch and the subsidiary. In 2010's annual meeting, for example, around 365 representatives of the bank's employees and other special representatives were invited to review the progress of the stock option plan for the employees, the bank's pension plan, and the report on the mutual funds among the employees. Some internal rules were also reviewed such as the *Rules for Penalizing the Violation of Duties by Bank A Employees (Revision)* and the *Rules of Mutual Funds by Bank A Employees (Revision)*. Meanwhile, up to 125 proposals from employees had been collected (Bank A, 2011b).

Secondly, Chinese banks have been continuously enhancing the compensation mechanism for their employees, such as contracts tailored for different posts, various welfare packages like complementary social insurance, enterprise pension, and extra medical care insurance. Meanwhile, a set of carefully designed periodical medical examinations, vocation leave, and standardized working place safety is implemented for the sake of the employees' health and safety (CBA, 2011). Bank B, for instance, develops a mature and effective annual medical examination system for all the employees, promotes individualized life style based upon health survey, and plans vaccination programs against seasonal epidemics. Meanwhile, regarding the mental stress caused by intensive banking business, Bank B holds periodical seminars targeted at the employees' mental health (Bank B, 2012b). Moreover, a diversified framework for the employees' career advancement is set in place. For instance, Bank C has categorized three different groups of posts, including management, banking practice and technology support, which orients the employees' career advancement based on the needs by the bank and the individual specialties. And, an interpretative *Implementation Guidance for Qualified Post Training* is issued for further guidance (Bank C, 2012b).

**Table 7.4 2009-2010 Training Sessions for Employees in Chinese Banks**

| Year | No. of Training Sessions (Unit: Ten Thousand ) | Attendance (Unit: Ten Thousand ) | Costs and Expenses (Unit: Ten Thousand RMB ) | Person/day |
|---|---|---|---|---|
| 2009 | 23.94 | 1036.60 | 0.17 | 7.01 |
| 2010 | 28.85 | 1243.00 | 0.21 | 9.24 |
| Increased by | 20.50 | 19.71 | 20.45 | 31.80 |

Source: CBA, 2011

Meanwhile, various training programs are initiated for employees in Chinese banking organizations to update their financial knowledge, improve their skills and expertise, and enhance their competence for increasingly complicated banking business. For instance, Bank C issues its *Internal Plan for 2009-2012 Training and Development Programs*, which designs a 'step-by-step' training program for bank employees in different departments. Internet and distance learning programs over 300 different subjects are also provided throughout the bank group (Bank C, 2012b). As illustrated in Table 7.4, in 2010, Chinese banking industry held over 2,885,000 training programs and sessions at different levels, with attendance over by 12,430,000 bank employees.

Other mechanisms for the benefits of the employees are also developed in Chinese banking industry, such as humanity care programs, happiness survey, and mutual assistance fund. For example, in Bank A, a wide range of survey on young employees was conducted in 2010 at the headquarter as well as 15 key branches, which focused upon the employees' tolerance for stress, degree of happiness, and their cognition about the bank. The survey intended for a better understanding of the needs of the employees and provided henceforth efficient solutions (Bank A, 2011). And, in most of Chinese banks, an internal mutual assistance system, such as mutual funding, is established to create a humanitarian and harmonious environment for the employees. In Jiangsu Branch of Bank A, for instance, a 'Five Caring' project was set up to provide special care for troubled employees and their families, which pertained to the health conditions of their children and family members, family economic situations, and accommodations (Bank A, 2011). In 2010 alone, funding of special care for employees in Chinese banking industry amounted to 20.17 billion RMB (CBA, 2011).

*Customers as key stakeholder*

In achieving a sustainable economic development and social progress, corporate governance in Chinese banks lays specific stress on protecting the interests of the bank's clients, specifically the creditors and depositors. From 2010, Chinese banking industry had launched a campaign and made a commitment of 'Fair Dealing' with customers to develop 'credible and friendly' banking practices, which was targeted at protecting the customers' rights and interests, keeping the public aware of various financial risks, and performing properly the bank's CSR (CBA, 2011). These embraced reinforced self-discipline and internal regulation, strict legal compliance, and integration of the ideology of 'premium service' into the bank's business strategy and daily operation. Meanwhile, a series of norms and rules were issued by CBA industrial wide, such as *Norms for Retail Business Services in Chinese*

*Banking Industry*, *Model Illustrations for Banking Financial Products*, and *Six Consensus on Reinforcing Self-regulation of Banking Fees*.

Secondly, Chinese banks are actively engaged in promoting financial literacy for the banks' customers. The fast economic development, the complicated financial innovations, and the varying banking products and services pose increasing risks to the bank's clients, most of whom have limited financial knowledge. In this context, Chinese banks take various measures to disseminate the basics of financial knowledge and educate the public on the general banking business and possible risk exposures. For instance, the banks integrate the financial essentials into the daily operation, such as wealth management, identifying the fake currency, and awareness about money laundering, which help the customers better understand the general banking business, recognize exposures to relevant financial risks, and select proper financial products and services (CBA, 2011). Bank B, for example, developed a program of 'Knowledge Popularization on Investment and Wealth Management through Ten Thousand Kilometers' in 2010, which aimed to educate the public on private investment. And up to the end of 2010, such events and programs had reached around 20,000 and were attended by over 1 million customers (Bank B, 2011).

Meanwhile, the campaign on financial education for the public is reinforced by the regulatory discourses. For instance, in 2010, sponsored by CRBC and assisted by CBA, a wide range of education programs on basics of banking and finance was launched in Beijing, which was purported to popularize the general financial knowledge to the public, help the public understand, identify and prevent relevant financial risks, and promote healthy and sustainable development of the banking industry and harmonious society (CBA, 2011). Themed on 'Harmonious Finance and Better Life', representatives from the members of CBA, largely the large commercial banks, promised the banks' commitment to promoting financial literacy, providing necessary education programs, and protecting the customers' interest. And around 1.4 million bank employees and 180,000 different bank branches and subsidiaries were involved, covering around 9.3 billion people (CBA, 2011). Meanwhile, CBA initiated other significant events on the subjects of safety of digital banking, introduction on general banking services and financial products for the household, and organized programs for better communication between the banking industry and the public. Further moves by the banks pertain to radio and television programs, internet forums and wealth management seminars, and consulting outlets in the community (CBA, 2011).

Thirdly, better transparency and sufficient information disclosure are required on Chinese banks for effective protection of the bank's clients. For instance, in designing and marketing the financial products, Chinese banks are mandated to disclose adequate information and improve transparency on possible risk exposures through proper channels. Bank B, for example, specifically stresses upon its business principle of 'suitable products tailored to the customers' and 'calculable cost, controllable risk and full information disclosure', and is specifically concerned with the bank's 'credibility related to personal wealth management business in terms of strict permission of products, improved risk assessment, full disclosure of risks and enhanced personnel management' (Bank B, 2012b, p93). In all materials related to a specific financial product or service, like the contracts, product manuals and legal documents, Bank B uses clear and simple language to describe fully the risks of financial products, varied investment returns in different situations, and relevant risks under various circumstances. Meanwhile, Bank B develops a specific management system and 'if the risk property of customer does not match with the selected financial product, the system will issue risk alert to the customer, execute control over the transaction, and disclose fully the risks of financial products and services.' (Bank B, 2012b, p94)

Fourthly, Chinese banks formulate a friendly, intelligent and efficient responsive system for customer services. At the industrial level, CBA issued the *Standards for the Operation of Customers' Service Center in Chinese Banking Industry* in 2010, which provided industrial self-regulation and discipline upon the service quality, crisis management, and complaint resolution by Chinese banks. And *Rules for Joint Meeting by Customer Service Centers* (Draft) (CBA, 2010), on the other hand, was issued to standardize the practices of the customer's center in the banks. In this context, most of the Chinese banks update their call center services, which change from the traditional passive support service pattern to a more interactive diversified service and extend to marketing, sales and customer relationship (CBA, 2011). Meanwhile, an efficient responsive mechanism is set in place to deal with the customers' complaints, improve the service quality, and enhance the customers' satisfaction, such as scheduled procedures for complaints registration, procession, resolution and review. For instance, in Bank B, the customer service and complaints solution system is designed to synchronize and update the processing of the customer's complaint, its solution, and related feed back. This includes the periodical analysis on customers' complaints, traceable monitoring, and services through the call centers and websites. Moreover, a complementary monitoring system helps expedite the solution of significant and emergent issues, and issues briefings on daily monitoring on the customers' complaints. By the end of 2010, the settlement of the customers' complaints in Bank B had reached a satisfactory 100% (Bank B, 2012b). Moreover, a survey mechanism on the customers' satisfaction is widely established in Chinese banking industry for better understanding of the customers' needs and personal experience about the banking services, which is designed to facilitate an independent and objective assessment of the service quality, sort out the hidden problems, and make timely rectifications (CBA, 2011).

*Green credit economy*

Another 'invisibly visible' stakeholder of the bank is the environment. By integrating Green Credit into the banks' strategic planning, business operation, and daily operation, Chinese banks are increasingly engaged in promoting sustainable economic development, supporting the low carbon economy, and improving the environmental conditions. In practice, these pertain to the formation of internal Green Credit policy, identification and prevention of the environmental risks, upgrading of the industrial structure (by expanding credits to new energy and environmental protection industries), and compliance with the environmental protocol and standards at both national and international levels. Moreover, Chinese banking organizations have been actively implementing the low carbon finance strategy and repressing credits to 'Highly Polluting, Highly Energy Consuming, and Over Capacity' industries (CBA, 2011). As illustrated in Table 7.1, there has been a continuous increase of bank loans issued to the energy saving and environmental protection programs in China, covering more key green credit projects and clients.

First, the regulatory discourses on environmental protection exert great influence on the paradigm of Green Credit by Chinese banks. For instance, CBRC has issued many guidance and regulations on the green economy, such as *Opinions on Guiding the Credit Extension regarding Energy Saving and Pollution Reduction* (CBRC, 2007), *Guidance on Green Credit* (CBRC, No.4, 2012), which are well echoed by Chinese banks in formulating their own green credit policies. For instance, Bank B formulated in 2011 its *Outline for the Implementation of Green Credit*, which set the basic discourses, principles and implementation guidance for its green credit strategy. In practice, these include the establishment of Green Credit system in the bank's lending policy, the list management on the clients, and related financial innovations. Meanwhile, specific internal principles related to environmental protection, energy conservation and emission reduction are developed, such as *Notice on Optimizing and Improving the Green Credit Classification of Corporate Customers*, *Notice on Printing and Distributing the Post-credit Management Procedure for Environmental Protection Industries under Key Attention*, and *Notice* *on Strengthening the Risk Control on Enterprises with Outdated Capacities* (Bank B, 2012b).

**Table 7.5 Statistics for energy saving and environmental protection programs by financial institutions in Chinese banking industry 2007-2010**

| Year | The total amount of energy saving and environmental protection programs (RMB 100 million) | The percentage of energy saving and environmental protection programs in total outstanding loan (%) | The number of energy saving and environmental protection programs | The number or clients for energy saving and environmental protection programs |
|---|---|---|---|---|
| 2007 | 3,411.00 | 2.70 | 2,715 | 3,505 |
| 2008 | 3,710.16 | 3.11 | 2,983 | 3,615 |
| 2009 | 8,560.46 | 8.93 | 6,412 | 4,099 |

* And in 2010, according to incomplete statistics, the total loans for energy saving and environmental protection programs increase by 1.71% than 2009, with the balance of the loan increasing by 18.07% and the number of clients increasing by 11.2%.

Source: CBA, 2011

**Table 7.6 Statistics on Loans to Green Economic Areas by Bank B 2011**

• Statistical Table on Loans to Green Economic Areas

Unit: RMB100 millions

| Area | Loan balance at the end of the reporting period |
|---|---|
| Energy saving and emission reduction | 1,696 |
| Clean energy development and utilization | 2,082 |
| Ecology, historical and cultural conservation | 1,398 |
| Comprehensive resource utilization | 728 |
| Total green economic areas | 5,904 |

Source: Bank B, 2012b

Secondly, at the operational level, various measures are taken by Chinese banks to strengthen the Green Credit practice. For instance, Bank B stresses upon financial support for national strategic projects involving energy saving, environmental protection, and reconstruction and upgrade programs with advanced energy-saving and environment-friendly technologies. And, the bank prioritizes its lending to clients engaged in environmental projects in the fields of new energy, energy saving, environmental protection, and comprehensive resource utilization, as illustrated in Table 7.6. Meanwhile, various green credit products are initiated by the bank related to carbon emission, energy saving and related fields (Bank B, 2012b). Bank D, on the other hand, eagerly supports the development of the Green Industry, Green Agriculture and tertiary industries. It specifically focuses on recycling, energy-saving and environmentally friendly projects, and sewage disposal. By the end of 2011, targeted at its goal specified in the 'Eleventh Five-Year Plan', a total of RMB88.168 billion had been granted by Bank D to 599 energy-saving and environmental protection projects (Bank D, 2012b). Meanwhile, Bank D continues promoting its Clean Development Mechanism (CDM) financial consultancy business and since 2008, it had provided financial support to 18 CDM projects which covered 3 main business areas of water power, wind power, and bio-electricity (Bank D, 2012b).

Thirdly, for better understanding and timely implementation of the Green Credit policy, Chinese banks integrate into their business operation a great variety of standards and protocols targeted at low carbon economy. And, a wide range of cooperation is initiated between Chinese banking industry and relevant government agencies and environmental organizations. At the same time, follow-up training programs are promoted industrial wide, which are subjected on the credit guidance, industrial policies, credit approval procedures, and international standards. For instance, actively engaged in various forums, conferences, and workshops by regulatory authorities and environmental protection organizations, Bank B promotes the practice of Green Credit and enhances its employees' awareness of low-carbon economy. In 2011, Bank B participated in the 'Finance, Environment & Development' forum, the '2011 China Low-carbon Economy Forum' and the 'Global Sustainable Finance Summit' sponsored by CBRC, the Ministry of Science and Technology and the United Nations Environment Program. Also, experts from the Chinese People's Political Consultative Conference were invited to illustrate China's energy development strategy and planning in China's Twelfth Five-year Plan for the energy sectors. (Bank B, 2012b).

Fourthly, Green Credit practice in Chinese banks also pertains to the repression of bank lending to industries classified as 'Highly Polluting, Highly Energy Consuming and Over Capacity'. Many measures are developed for this purpose, such as 'list management' and biased pricing of loans based upon differentiated risks. For instance, Bank B in 2011, by improving classification system for Green Credit, reinforced its monitoring upon environmental risks, post-credit inspection, and control over customers from industries with serious environmental concerns. And, the Green Credit Standard is enhanced and a single-vote veto credit policy is established accordingly, which aims to scrutinize the projects and veto the unqualified ones failing to meet the set environmental standards. By the end of 2011, loans extended to over capacity industries had been reduced by approximately 0.4 percentage point within two years (Bank B, 2012b). In Bank D, similar measures are developed, such as intensive management over the credit line, centralized credit approval, and strict list management. And the bank's overall Green Credit policies in 2011 basically covered all the industries categorized as 'Highly Polluting, Highly Energy Consuming and Over Capacity', such as polysilicon, plate glass, and manufacturing for wind power equipment. Meanwhile, the bank also implemented the single-vote veto mechanism and in 2011, and a total of 106 credit applications amounting to RMB 4.157 billion was rejected due to non-compliance with environmental protection standards. Furthermore, 1,099 clients in aforesaid industries were delisted in 2011 with a repayment of RMB 44.427 billion in total loans (Bank D, 2012b). Further environmental moves by Chinese banking industry can be observed in the bank's efforts to create a green operational environment, such as the increase of self-service banking business, internet and mobile banking, which facilitates reducing the workload at the counters, henceforth alleviating energy consumptions and emissions of pollutants from vehicle to and from the physical bank branches. Meanwhile, Chinese banks are increasingly stressing on the green business operation and low carbon working environment, and have issued relevant guidance, principles or notice to construct a green working environment and promote a green culture throughout the bank group (CBA, 2011). .

*Charitable donation*

Taking the society as a stakeholder, Chinese banking organizations have been actively engaged in philanthropic and charitable mission, such as generous financial assistance during and *ex post* the natural disasters, efforts in the elimination of poverty, and continuous volunteering and charitable donations, which aim to perform their citizenship and help with the establishment of a harmonious society. First, Chinese banks have issued general principles regarding the charitable mission as an integrated part of their business operation. For instance, Bank B specifies the principle of 'Rooted in society, Rewarding society and Serving society', which covers a wide range of philanthropic activities to enhance the public welfare, such as disaster and poverty relief, culture and education events, and community services (Bank B, 2012b). Bank A, on the other hand, specifies its mission in 'being concerned with social needs and participating in charitable missions' and label its achievement for CSR as 'Sharing', which represents the bank's orientation on philanthropic missions (Bank A, 2012b, p52).

Secondly, Chinese banks take various financial means in relieving the losses in the periods of the natural disasters, and financing the following up recovery and reconstruction. These pertain to the timely charitable donations, emergent financing services, special credit expansion, and fast channels for transferring of charitable donations from the public. For instance, immediately after the 2008 unprecedented earthquake in Wenchun, Sichun Province, Bank B set up temporary mobile banks, such as 'Tenet bank', 'Mobile van bank' and 'Movable plank house bank' to expedite the transfer of the charitable donations (Bank B, 2009). Moreover, fast-way channels for transferring and remitting charitable donations were established to proceed the charitable donations free of charge, such as the 'Green Donation Channel' for donations from home and abroad (Bank C, 2009; Bank B, 2009). Help-desks at the bank's outlets were also installed to advise on services concerning disaster relief remittance (Bank B, 2009). And, to expedite the emergency loans to the suffered areas, special fast channels for the credit approval and disbursement were innovated by Chinese banks, which facilitated financial assistance to the suffered areas at first instance and alleviated the following adverse influences (Bank B, 2009). And, extra bank loans were also issued targeted at the disaster relief projects, such as loans related to the recovery, rebuilding and rehabilitation in the disaster-stricken areas. Meanwhile, Chinese banks helped underwrite and issue special bonds and debentures to provide extra funding to the suffered areas (Bank C, 2009). Regarding the non-performing corporate or individual loans of different kinds issued before the disaster, a 'Four No' policy by the financial regulator was implemented by Chinese banks, which embraced no penalty of interests for over due payment, no record for default credit, no effects on the corporate or individual clients applying for other financial support targeted at the disaster area, and no penalty for delayed collection on the repayment of debts or fees (CBA, 2009).

Thirdly, alleviation of poverty in underdeveloped areas frequently stands on the top of the agenda by Chinese banking organizations, which include extensive financial support for the local economy, charitable donations to education, and commitment to philanthropic medical care. By investing financial resources, providing intelligence support and financial services, Chinese banking industry constantly contributes to the economic development in the poor areas. For instance, Bank B has designed a comprehensive mechanism to help the poverty area develop the local economy, covering the special project financing, intelligence support, hygiene improvement, technology support and financial assistance in case of natural calamity. Up to 2011, for instance, an aggregate of 7.64 million RMB had been invested by the bank for biogas green energy development in Linjia Village, Changchi Town, Nanjiang County and Chaya Township, Wanyuan City of Sichuan Province, which greatly improved the living standards and sanitary conditions of the local community. For developing the viable green economy, RMB660, 000 was further donated by Bank B to the edible tree fungus cultivation project in Chenhe Township, Tongjiang County, Sichuan Province (Bank B, 2012b). Bank C, from 2002 to 2010, had continuously invested around 28.19 million RMB in selected undeveloped areas of Yongchun, Changwu, Gouyi and Chunhua in Xianyang City of Shanxi Province on school buildings, hygiene projects, water power projects and rehabilitation projects (Bank C, 2012b).

Meanwhile, Chinese banks have been providing a great variety of charitable donations, financial assistance, and special bank loans for educations at different levels in the poverty areas. For instance, Bank A develops a set of charitable programs for education in poor areas targeted at the poverty stricken families. From 1996 to 2011, 7.80 million RMB had been donated for building primary schools under the Hope Project, covering 38 primary schools, 73 libraries and playgrounds. And from 2007 to 2013, a total of 1.2 billion RMB was planned for donation to assist senior high school students from poverty households on their study, with 89 million RMB already dispatched. And from 2009 to 2014, a total of 60 million RMB is planned for donation to assist minority university students from poor families for their university study, with 22 million RMB dispatched and 7,833 students benefited (Bank A, 2012b). Bank B, up to 2011, had invested RMB 3.77 million in aggregate to improve education conditions in poor areas, such as financial assistance to rural teachers and university students from poverty-stricken households, rebuilding schools, and renovating the local education facilities and local infrastructures (Bank B, 2012b). Bank C, specifically, develops a wide range of financial products and services to students form poverty households for their university study. By the end of 2011, an aggregate of 170 billion RMB loans had been issued, benefiting 1.3 million university students from 476 universities and higher education institutions (Bank C, 2012b). Moreover, charitable medical missions of various kinds are also facilitated by Chinese banks to the underdeveloped areas. From 2007-2011, Bank B had donated aggregately RMB 9.1 million in eyesight recovery treatment and over 3,300 cataract patients in poverty received the medical treatment (Bank B, 2012b). And in 2011, 7 million RMB was donated by Bank A under the 'Heath Care Mobile Van' project targeted at physical examination, medical treatment and health care services for women in poor areas in Gansu Province, Qinghai Province and Xinjiang Autonomous Zone (Bank A, 2012b).

In sum, the paralleled paradigm discourse of the enhanced shareholder primacy and diversified stakeholder theory in Chinese banks provides significant implications on the development of the frame of specific governance structure in Chinese banking organizations. For instance, the paradigm of the enhanced shareholder primacy influences greatly the composition of the bank board and its orientation. Due to the existence of the state as the majority shareholder, the non-executive directors representing the state takes a higher percentage in the board of directors, and the board of directors of the bank is more oriented towards long-term sustainable profitability and concerns for national economic development. Meanwhile, the enhanced shareholder primacy impacts on risk management in Chinese banks. On one side, the discourse on protecting the sustainable interests of the shareholders and maintaining and increasing the value of the national assets of the state requires the bank to take moderate risk appetites. On the flip side, however, orientation by the state as the majority shareholder towards economic growth may result in excessive risk exposures for financing certain industries and local governments, which in turn lead to serious concerns on certain category of risks. Moreover, the paradigm of the diversified stakeholder theory may also influence the arrangement of specific governance structure in Chinese banks. For instance, such stakeholder discourse impacts on the composition of the supervisory board of directors by requiring the presence of certain ratio of employee representatives. And, it also directs the board of directors of Chinese banks towards careful consideration on protecting the interests of various stakeholders when setting the bank's business strategy, such as serving the real economy and expanding the green credit. Regarding risk management, Chinese banks generally have a lower risk tolerance due to concerns for a wide range of constituencies, such as the banks' long-term clients, the employees, the economic development, and the financial stability. Meanwhile, the paradigm of the stakeholder model, with its emphasis on the banks' responsibility to the regulator as a stakeholder, may influence the legal obligations of the bank, especially the duty of legal compliance.

### 7.4 Chapter conclusion

Echoing the hybrid nature of the legitimacy discussed in Chapter Six, the paradigm of corporate governance in Chinese banks exhibits a paralleled discourse of the enhanced shareholder primacy model and diversified stakeholder model. On one side, Chinese banks are oriented towards achieving sustainable profitability and bringing adequate investment return to the shareholders. Specifically, the banks' performance for profitability is measured with the maintaining and increasing the value of national assets by the state invested in the bank, due to the presence of the state as the majority shareholder. On the other hand, Chinese banks are guided by the discourse of performing a wide range of CSR, which aims to protect the interests of various stakeholders, such as the economic development, the regulator, the employees, the clients, and the society at large. With the presence of the state as the controlling shareholder, these two paradigms can be harmonized to some extent. The paradigm of corporate governance in Chinese banks poses great influences on various aspects of the specific governance structure in Chinese banking industry and will be explored in the following Chapter Eight and Nine.

# Chapter Eight Corporate Governance in Banking Organizations In China (III): Frame (1)

## 8.1 Introduction

Putting together the puzzles from all the previous chapters, Chapter Eight starts to explore and explain how the discourses of legitimacy and paradigm, as discussed in Chapter Six and Seven, are manifested in the specific governance structure in Chinese banks. Reflecting on the generic corporate governance elaborated in Chapter Two and corporate governance in banking organizations in Chapter Five, the chapter studies the organization and behavior of the board of directors and regulation on executive pay in Chinese banks. The former pertains to the orientation the board of directors, its composition, the board size and its independence. Illustrating the hybrid of the paradigm discourses of the enhanced shareholder primacy and diversified stakeholder theory and relevant legitimacy discourses, the board of directors in Chinese banks can be observed to be oriented towards sustainable profitability to the shareholders, active support for economic development, and balance of interests of various stakeholders. Similar representation of discourses of legitimacy and paradigm are demonstrated in the board composition, the board size, and the board independence. The regulation on executive pay in Chinese banks, on the other hand, explores the composition of the executive pay, specific regulatory mechanisms and arrangement, and coordination between Chinese banks and financial regulators. Such pay regulation reflects the embeddedness of legitimacy discourse of close financial regulation, exemplified by mandate on the composition, ratio, and terms of payment in the compensation package. Meanwhile, the pay regulation in Chinese banks illustrates the paradigm discourse of the diversified stakeholder theory by adequate fixed salary and generous welfare package, which is designed for the long-termism by the bank executives. Also, it presents the concern for the stakeholders' interests by setting the social indicator as a compulsory standard for appraising the executives' performance.

## 8.2 The board of directors --- organization and behavior

Manifesting the discourses of legitimacy and paradigm of corporate governance in Chinese banking organizations as discussed in Chapter Six and Seven, the organization and behavior of the board of directors in Chinese banks illustrate the constitutive role of specific ideas in the frame of bank governance in China, which embrace the orientation of the bank board, its composition, the independence and relevant impediments. As discussed in Chapter Five, the orientation of the bank board plays a key role in the bank's corporate governance arrangement. Implicated by the legitimacy and paradigm discourses of corporate governance in Chinese banking organizations, such as the bank's intertwining with the real economy, close financial regulation, and paralleled considerations for the shareholders and stakeholders, the boards of directors in Chinese banks set their 'tone' at persistently serving and supporting the sustainable development of the real economy, pursuing the bank's long-term profitability, achieving good corporate governance, and enhanced risk management. Meanwhile, the bank board lays specific emphasis on providing sustainable financial services for its clients, promoting training programs and career advancement for the employees, and innovating new banking business and financial products for green economy(Bank B, 2012a; Bank C, 2012a; Bank A, 2012a; Bank D, 2012a).

### 8.2.1 Organization of the board of directors

Echoing the influences of the international discourses, the board of directors in Chinese banks presents a hybrid feature of the Anglo-Saxon and Continental model. On one side, there is a two tiered board system composed of the board of directors and the supervisory board, which appears similar to that of the Continental model. On the flip side, however, there is a complete one-tier structure of the board of directors that comprises executive directors, non-executive directors, and outside directors, which is less different from the bank board in the Anglo-Saxon model. Nevertheless, the arrangement of the board of directors in Chinese banks is distinguished from these two models. For instance, though there is a two tier bank board structure in Chinese banks, the supervisory board is less powerful, limited in functions, and not authorized to elect the board directors. Moreover, the supervisory board is small in size and with fewer employee representatives (CBRC, 2011a). These differentiate Chinese bank boards from those in the Continental model. Meanwhile, Chinese bank boards are also different from those of the Anglo-Saxon model, exemplified by the limited proportion of the outside directors and a higher proportion of non-executive directors representing the state (CBRC, 2011a).

The composition of the board of directors in Chinese banks embraces the executive directors, non-executive directors and outside directors. As the key component of the managing body in Chinese banks, executive directors are inside senior executive officers responsible for managing the bank, including the board chairman, CEO and other senior managers. Non-executive directors are largely representatives delegated from the majority shareholders such as CHI, and do not take any managing posts in the bank. Outside directors come from 'external', with

**Table 8.1 2011 Statistics on Board of Directors of Sampled Banks in China in 2011**

| Category of bank | Bank | Board size (total) | Executive directors | Non-executive directors | Outside directors | Directors with banking experience | Directors with government official background | Duality of CEO and the board chairman |
|---|---|---|---|---|---|---|---|---|
| Commercial banks | Bank A | 15 | 4 | 6 | 5 | 6 | 6 | N |
| | Proportion in the board (%) | 100% | 26.67% | 40% | 33.33% | 40% | 40% | |
| | Bank B | 16 | 4 | 6 | 6 | 7 | 7 | N |
| | Proportion in the board (%) | 100% | 25% | 37.5% | 37.5% | 43.75% | 43.75% | |
| | Bank C | 16 | 4 | 6 | 6 | 9 | 10 | N |
| | Proportion in the board (%) | 100% | 25% | 37.5% | 37.5% | 56.25% | 62.50% | |

**Table 8.1 2011 Statistics on Board of Directors of Sampled Banks in China in 2011 --- Continued**

| Category of bank | Bank | Board size (total) | Executive directors | Non-executive directors | Outside directors | Directors with banking experience | Directors with government official background | Duality of CEO and the board chairman |
|---|---|---|---|---|---|---|---|---|
| | Bank D | 13 | 3 | 6 | 4 | 5 | 9 | N |
| | Proportion in the board (%) | 100% | 23.08% | 46.15% | 30.77% | 38.46% | 69.23% | |
| Total | | 60 | 15 | 24 | 21 | 27 | 32 | |
| Average | | 15 | 3.75 | 6 | 5.25 | 6.75 | 8 | |
| Average proportion in the board % | | 100% | 25% | 40% | 35% | 45% | 53% | |

Source: Bank A, 2012a; Bank B, 2012a; Bank C, 2012a; Bank D, 2012a no any affiliations or interests to the bank or its controlling shareholders, and are expected to provide objective and independent opinions to the board of the bank (CBRC, 2011a).

As illustrated in Table 8.1, the averaged executive director in the sampled banks is 3.75, with the averaged proportion of 25%. Most of the executive directors in the sampled banks are experienced banking practitioners, who have been working for a long period of time in the same bank, other comparable banks (similar nature and size), or financial regulators like PBC, CBRC (Bank B, 2012a; Bank A, 2012a; Bank C, 2012a; Bank D, 2012a). For instance, in Bank A, most of the executive directors have rich experience in working as the bank's CEO, the head of the bank's branch, or take posts in key bank departments like credit approval, risk management, and auditing, which enable them to be both competent bank leaders and experienced financial experts (Bank A, 2012a). Moreover, all of the Bank A's executive directors have been working in the banking industry for over 15 years and few of them have ever popped out of the 'dominant institution' (the state-related agencies) and the banking industry. Such industrial and institutional continuity reinforces their capability in leading the bank in the present financial system in China, though maybe at the expense of their creativity and entrepreneurship. Advanced financial education background is another characteristic of the executive directors in Bank A, as all of the executive directors are awarded the master's degree in finance, economics or management. Such strong academic background enables them to have a better understanding of the fast changing banking world (Bank A, 2012a).

Non-executive directors in Chinese banks, on the other hand, provide the advising and monitoring functions to the bank board. In the sampled banks, they are mainly delegated by CHI and represent the interests of the state as the largest shareholders. As observed in Table 8.1, the non-executive directors take the largest proportion in the sampled bank, which is averaged at 6 and 40% as the averaged proportion. Maybe as a coincidence, all the sampled banks have the same number of the non-executive directors, though the proportion is a bit higher in Bank D which is 46.5%, considering its smaller board size. In contrast with the executive directors, the non-executive directors are more diversified in their backgrounds and working experience. For instance, in Bank A, some of the non-executive directors have profound backgrounds as senior officials from financial regulators, others are senior practitioners from large banking organizations, insurance corporations, law firms. Such diversified backgrounds may facilitate a more efficient business decision to the bank board and a panorama view to avoid industrial bias (Bank A, 2012a).

As observed in Table 8.1, the average of the outside directors (in the narrow senses which excludes the non-executive directors delegated from the controlling shareholders) in the sampled banks is 5.5 and the averaged proportion is 35%. Due to same institutional settings and regulatory requirement, the number and proportion of the outside directors are less variant within the sampled banks, with Bank B and Bank C higher with 6 outside directors and Bank D lower with only 4. Compared with the executive and non-executive directors, the outside directors are even more diversified in their backgrounds and expertise, which comprise known experts, professionals, and academia in the fields of finance, accounting or taxation. More than often, they have strong international backgrounds. In Bank A, for instance, 2 out of 5 are foreign directors, with another 2 from Hong Kong. It is expected that their diversity and international background may bring more 'fresh air' to the board room of Chinese banks. In contrast with the non-executive directors, the opinions of the independent directors are more respected by the bank board and senior management (Bank A, 2012a).

Meanwhile, the composition of Chinese bank board presents a high collective financial expertise and official background. As illustrated in Table 8.1, it is found that directors with years of banking experience and practices is averaged at 6.75, with the averaged proportion of 45%. This is a very sound and relaxing figure considering the limited years of development of corporate governance in Chinese banking organizations. Another interesting specialty of the Chinese bank board is the high proportion of directors with strong official backgrounds, either domestic or international. In the sampled banks, for instance, such directors are averaged at 8 and the average proportion reaches 53%. This is largely due to the selection of the samples which are large sized state-owned commercial banks, the senior managers of which are appointed by the financial regulators and the non-executive directors are all from CHI on behalf of the state. Meanwhile, some of the outside directors, who are assumed to be less influenced by Chinese regulators, used to be senior government officials in Hong Kong or other countries.

In general, a large board size is prevalent in Chinese banking organizations, especially in large sized commercial banks. As illustrated in table 8.1, the average board size in the sampled bank is 15, with Bank B and Bank C larger of 16 while Bank D smaller of 13. Such averaged board size is a little bigger than the finding by Yv and He (2012) in 52 listed commercial banks in China from 2004-2009, which was around 14 in average. In general, the averaged board size of 14 in Chinese banking industry in the aforesaid research is much bigger than that of non-financial corporations which is around 9.59 in China. And it is also bigger than financial holding groups in USA which is averaged at 12.9 (YV and He, 2012; Pathan and

Skully, 2010; He and Zhou, 2010).

The composition of the board of directors in Chinese banks is observed to manifest the discourses of the paradigm and legitimacy as discussed in Chapter Six and Seven. For instance, with increasing stress on better bank performance as in the paradigm discourse of the enhanced shareholder primacy, most of the board directors, either executive, non-executive or outside, are equipped with rich banking or financial expertise, years of experience in Chinese or international banking industry, and good knowledge and academic background on banking and finance. Implicated by the dominance of the state as the controlling shareholder, there is a prominent high proportion of non-executive directors (representing the state) sitting on the bank board, which can ensure the protection of the state's interests and the orientation towards developing national economy. The increasing presence of the outside directors, on the other hand, echoes the international influence and self-discipline in the context of financial de-regulation. It also illustrates the emphasis on the financial expertise of the board directors, as the many of the outside directors in the sampled banks are selected internationally and expected to bring to the board valuable experience and updated banking practice from the developed economies. Meanwhile, the arrangement of the bank board in China reflects the discourse of financial de-regulation. For instance, experienced banking professionals, rather than government officials, play key roles in corporate governance of the bank and the increasing proportion of outside directors bring more market mechanisms into Chinese banks. Moreover, the large board size in Chinese banks demonstrates the paradigm discourse of the enhanced shareholder primacy. On one side, to guarantee the control of state as the majority shareholder, there is a high proportion of the non-executive directors sitting at the board and execute the wills of the state. On the other hand, there is increasing employment of outside directors to reinforce the board's expertise, monitoring, and better business decision making process.

### 8.2.2 The board independence

Another major issue in bank governance in China is the board independence, which pertains to the proportion of the outside directors, the criteria of the independence of the board directors, and the duality of the CEO and board chairman. As illustrated in Table 8.1, the averaged outside director is 5.5, with the average proportion of 35%. This is much higher than the averaged proportion of outside directors in Chinese banks in a wider range, which is around 22%, and higher than that of non-financial corporations which is around 23.7%, (YV and He, 2012; Pathan and Skully, 2010; He and Zhou, 2010). Comparing the board independence between the large sized commercial banks and the smaller ones, it is found that the former presents a higher board independence (Yv and He, 2012). And, elaborated in Chapter Two, the duality of the chairman of the board of directors and CEO may greatly limit the board independence and adversely affect the bank's performance. In this context, as illustrated in Table 8.1, these two roles are strictly separated in the sampled banks, which intend to enhance the board's independence and its efficacy in monitoring. Furthermore, the potential duality of these two posts, which means CEO may become the board chairman after his term expires or vise visa, is rarely found in Chinese banking organizations. In a wider range survey by Bai (2010) of 14 share-holding commercial banks, it is found that the duality of CEO and board chairman is fairly limited.

The board independence in Chinese banks is reinforced by more independent board committees. For instance, various functional board committees are established to off-set the adverse effects caused by the large size of the board and insufficient outside directors. In the sampled banks, these board committees embrace the strategic development committee, audit committee, risk management committee, nomination committee, compensation committee, and related transaction control committee. Except for the strategic development committee which is frequently led by the chairman of the board, all other committees in the sampled banks are chaired by the independent directors. Meanwhile, a majority of these committee members are also outside directors. In this context, a better independence of the bank board can be achieved (Bank B, 2012 a; Bank C, 2012 a; Bank A, 2012 a; Bank D, 2012 a). Moreover, the paralleled supervisory board in Chinese banks may complement the independence of the board. For instance, the supervisory board in the sampled banks is in charge of monitoring major issues related to the bank governance such as the significant business decisions, risk management, and internal control. Specifically, it exercises effective supervision over the board of directors and senior management, which includes their appointment procedures, evaluation of their performance, and formation of the compensation policy. Meanwhile, the presence of the outside supervisory board directors improves the independence of the supervisory board and strengthens its monitoring functions, which in turn enhances the independence of the bank board in China (CBRC, 2011; Bank B, 2012 a).

Last but not the least, there are strict criterions on the independence of the board directors in Chinese banks, especially the outside directors. For instance, a board director is not allowed to take posts in other financial institutions which may have potential conflict of interests with the bank he acts as a board director. If he takes any posts in other financial institutions, he should duly inform the bank and promises that no conflict of interests of any kinds will be incurred. In case a board director is personally related to the present or planned contracts, transactions or deals, he should timely inform the board of directors of the nature and extent of his involvement, and be excluded when such issues are reviewed. For outside directors, he is specifically not allowed to take posts in over two banks and the maximum of his term in a certain bank should not exceed 6 years (CBRC, 2011). And, the issues of the independence of the bank board directors will be further explored in Chapter Nine.

The arrangement of the board independence in Chinese banks is understood as the hybrid of the Anglo-Saxon model and Continental model. For instance, the increasing proportion of the outside directors, the separation of posts between CEO and the board chairman, the independence of the board committees, and the stricter standards on the board directors is a reflection of the influence of the Anglo-Saxon model. On the other hand, however, the function of the supervisory board for monitoring and the existence of the outside supervisory directors manifest the impacts of the Continental model. Meanwhile, the emphasized board independence in Chinese banks is a good representation of the paradigm discourse of the enhanced shareholder primacy, which prefers efficient monitoring on the management by more independent board structure.

However, impediments of different kinds are observed with regard to the independence of the board of directors in Chinese banks. Typically, the institutional settings in China may limit such board independence, such as constraints on the monitoring function of the board, the overwhelming power by the majority shareholder, and the substitutive 'administrative governance' options by financial regulators. In contrast with the Anglo-Saxon model, the monitoring function of the Chinese bank board tends to be limited. And, there are certain limitations on the proportion of the outside directors in Chinese banks due to the costs it may bring. For instance, the mechanism of the outside directors can pose high costs for the large-sized banks with long tradition and high capital leverage, which carries more severe internal information asymmetry, higher cost of information flow from the internal directors to the outside directors, and higher cost of the coordination between the directors. And these may lead to adverse influence on the board's efficiency. Meanwhile, the increase in the outside directors may further stimulate the conflicts between different parties within the board room (Yv and He, 2012).

Moreover, as the majority shareholder, the state may influence the board independence, specifically in case of policy objectives when the state is more inclined to limit the independence of the bank board to avoid unnecessary challenges to its dominance on significant decisions. This is reinforced by the higher proportion of non-executive directors on behalf of the state, who are expected to oversee the state's influence upon such significant decisions and key business strategies by the bank board. Moreover, the independence of the bank board may sometimes yield to the 'administrative governance' by the financial regulators. For instance, the regulator may reshape the composition of the board of directors of the bank, the internal control, and the executive compensation with more intervening administrative governance measures (Hong and Zhou, 2008).

Other factors may also impact upon the board independence of Chinese banks. For instance, the institutional and cultural homogeneity of the non-executive directors, outside directors (from domestic) and their executive counterparts, most of whom come from and bear the strong marks of the dominant political and economic institutions (such as professors from public universities, executives from other large state-owned banks, and government officials), will further constrain the board independence as they may subconsciously lose their independent standing due to the shared institutional paradigm. Meanwhile, the presence of the CCP membership by many of the board directors will necessarily affect the board independence, as such directors may become more politically affiliated and oriented towards the prevailing policies. The few dissenting opinions by the non-executive and outside directors regarding significant board decisions, specifically, may represent the limited board independence due to the limited challenging powers (Bank B, 2012a; Bank A, 2012a; Bank C, 2012a; Bank D, 2012a).

### 8.2.3 The arrangement of the supervisory board

In contrast with the large sized supervisory board in the Continental model, Chinese banks develop a comparatively smaller sized supervisory board of directors. As illustrated in Table 8.2, the averaged supervisory board has 7 directors, with the largest of 9 in Bank A, and the smallest of 6 in Bank B and Bank D. Such supervisory board is also small compared with the board of directors in Chinese banks. Generally, the supervisory board in Chinese banks is composed of the shareholder representative directors, employee representative directors, and the outside directors. The shareholder representative directors are mainly delegated from the majority shareholder, namely by CHI in the sampled banks. The employee representative directors are elected through the general meeting of the bank employees. And, the outside directors are selected from practitioners with rich financial and economic experience and expertise. In Table 8.2, the averaged proportion of the shareholder representative directors in the sampled banks is

39.29%, with the Bank A the highest of 44.4%, and Bank D and Bank B lowest of 33.3%. By coincidence, and subject to the legal mandate, the averaged employee representative directors is 39.29%, with Bank D the highest of 66.7% and Bank C the lowest of 28.6%. The averaged outside supervisory directors, on the other hand, takes 21.43%, with the Bank B the highest of 33.3%, and Bank D the lowest of zero due to its lag-behind reform in governance structure (Bank B, 2012a; Bank A, 2012a; Bank C, 2012a; Bank D, 2012a).

**Table 8.2 Supervisory Board of Sampled Banks 2011**

| | Bank B | Bank A | Bank C | Bank D | Averaged |
|---|---|---|---|---|---|
| Shareholder representative | 2 | 4 | 3 | 2 | 3.6 |
| | 33.3% | 44.4% | 42.9% | 33.3% | 39.29% |
| Employee representative | 2 | 3 | 2 | 4 | 3.6 |
| | 33.3% | 33.3% | 28.6% | 66.7% | 39.29% |
| Outside supervisory directors | 2 | 2 | 2 | 0 | 1.5 |
| | 33.3% | 22.2% | 28.6% | 0% | 21.43% |
| Total | 6 | 9 | 7 | 6 | 7 |

Source: Bank A, 2012a; Bank B, 2012a; Bank C, 2012a; Bank D, 2012a

Manifesting the paradigm and legitimacy discourses as discussed, the arrangement of the supervisory board in Chinese banks presents the influence of the Continental model and certain Chinese specialty. For instance, the mandatory presence of the employee representative illustrates the labor participation and coordination feature in Chinese supervisory board and the protection of the interests of the employees as stakeholders. The outside supervisory directors, on the other hand, demonstrate further independent monitoring over the bank's board directors and senior management. And, the high proportion of the shareholder representatives at the supervisory board manifests the close control by the state as the majority shareholder. On the flip side, however, such arrangement illustrates a strong Chinese specialty. Distinguished from the Continental model, the supervisory board of directors in Chinese banks is less powerful considering its small size, limited participation by employee representatives and outsider directors, and fewer powers in monitoring the management. In some instances, the supervisory board may take an embarrassing stand as an internal monitoring department.

## 8.3 Regulation on executive compensation

### 8.3.1 Composition of the compensation

Another key component in corporate governance in Chinese banks relates to the regulation on the executive pay, which pertains to the composition of compensation for bank's executives, specific mechanisms and arrangements in the pay regulation, and coordination between banks and financial regulators. As discussed in Chapter Five, the composition of the executive pay can be categorized as the cash salary, the mid-and-long term incentives, and various welfares. Similar arrangement can be observed in the context of Chinese banks, but with varied priorities. Generally, the compensation in Chinese banks is defined as payment and other forms of expenditures by the bank for the services and contributions by the bank employees, including the basic compensation, the performance related compensation (PRC), mid-and-long term incentives, welfares, social insurances and other non monetary benefits(CBRC, 2010b).

The fixed salary, or the basic salary, is the payment to bank employees based upon their workload, service tenure, responsibility of the post, and the risks taken. Largely, it is decided by the bank in accordance with the mandatory principles and limited below 35% of the total compensation. PRC, on the other hand, is mainly determined according to the annual assessment of the performance by the bank employees, which takes into account of the various risks, costs and trade-offs, and is expected to be consistent with the bank's sustainable development. Specifically, PRC should not exceed three times of the basic salary. The welfare package, as an important component of the total compensation for bank employees in China, covers varied social insurances, pensions, and funding for accommodation, which is co-paid by the bank employees and the bank according to the specified ratios (CBRC, 2010b). As illustrate in Table 8.3, for instance, the welfare package in Bank B takes a very high proportion in the overall compensation for the bank executives, which reaches around 21.42 % (Bank B, 2012a).

For the variable compensation, mainly the mid-and-long term incentive plans, Chinese banks are expected to be cautious that the total of such compensation shall not adversely influence the bank's sustainable increase in its capital. In contrast with the Anglo-Saxon model where shareholding and options are widely used as efficient incentives for the bank's executives, as discussed in Chapter Five, Chinese banks rarely use such mid-and-long term investment plans as the key part of the remuneration for the executives. And, with very few exceptions in the sampled banks (such as the employee shareholding plan which was already halted), the directors and executives in Chinese banking organizations do not hold any stocks and debenture investment in their own banks (Bank B, 2012a; Bank A, 2012a; Bank C, 2012a; Bank D, 2012a). For instance, illustrated in Table 8.3, no shareholding or options are vested to the executives in Bank B in their compensation package (Bank B, 2012a).

Meanwhile, there are further restrictions on executive pay in Chinese banks. For example, the board chairman and senior management are not allowed to procure any payment from the bank's affiliated institutions or any other business entities, considering the potential conflict of interests, excessive risks and insider trading. As illustrated in Table 8.3, none of the bank executives in Bank B receives such compensation. Moreover, the overall compensation package for executives in Chinese banks is comparatively low. In Table 8.3, the highest pay for executives in Bank B before tax, excluding the international employees, is 1.117 million RMB and the lowest is 0.917 million RMB, with the average of around 0.97 million RMB (Bank B, 2012a). Such income is fairly low in contrast with executive pay in banking organizations in either the Continental or Anglo-Saxon model countries.

Apart from the tangible compensation as discussed, the intangible compensation, grounded in the pay culture of Chinese banking industry, is present, which includes the political prestige and advancement, job security, career reputation, and social recognition. For instance, political advancement may frequently function as a significant incentive for senior management in the large-sized banks in China. Traditionally, the senior executives of the bank, typically the board chairman and head of the bank, enjoy prominent political prestige and administrative rank as senior government officials. In the sampled banks, for example, the heads of bank are entitled to comparable political and administrative status as deputy minister in the Ministry of Finance. Other senior managers of the head office and the head of the bank's tier-one branch, on the flip side, may have their administrative ranks as well, which match relevant administrative posts in the government. In this context, the political advancement and good political reputation can become fairly important motivations for senior management in Chinese banking organizations. Meanwhile, there is a 'change of post', though not frequently, between financial regulators and the large-sized state-owned commercial banks. For instance, G, who used to be the deputy head of PBC and Head of Administrative Bureau of Foreign Currency, was assigned to act as the board chairman of Bank A and then he was reassigned as the chairman of China Securities Regulatory Commission (CSRC) in 2012. X, who used to be the board chairman of Bank C, is reassigned as the chairman of CSRC in 2013 (Xinhua Net, June 13, 2011).

**Table 8.3 2011 Bank B Compensation for Senior Management**

**Unit: 10 thousand RMB**

| Post | Compensation paid (before tax) | Social insurances, funding for accommodation, pension and supplementary medical insurance paid by bank | Compensation from part- time posts | Shareholding of the bank at the end of the fiscal year | Total of compensation before tax | Compensation paid by shareholder or other affiliated institutions |
|---|---|---|---|---|---|---|
| Board Chairman& Executive Director | 87.6 | 24.1 | 0 | 0 | 111.7 | 0 |
| Deputy Board Chairman& Executive Director | 80.8 | 22.0 | 0 | 0 | 102.8 | 0 |
| Chairman of Supervisory Board | 78.6 | 21.8 | 0 | 0 | 100.4 | 0 |
| Deputy CEO & Executive Director | 75.0 | 21.2 | 0 | 0 | 96.2 | 0 |
| Deputy CEO & Executive Director | 75.0 | 21.2 | 0 | 0 | 96.2 | 0 |
| Deputy CEO | 75.0 | 21.2 | 0 | 0 | 96.2 | 0 |

**Table 8.3 2011 Bank B Compensation for Senior Management --- Continued**

**Unit: 10 thousand RMB**

| Post | Compensation paid (before tax) | Social insurances, funding for accommodation, pension and supplementary medical insurance paid by bank | Compensation from part- time posts | Shareholding of the bank at the end of the fiscal year | Total of compensation before tax | Compensation paid by shareholder or other affiliated institutions |
|---|---|---|---|---|---|---|
| Chairman of Disciplinary Committee | 75.0 | 21.2 | 0 | 0 | 96.2 | 0 |
| Deputy CEO | 75.0 | 21.2 | 0 | 0 | 96.2 | 0 |
| Deputy CEO | 75.0 | 16.4 | 0 | 0 | 91.4 | 0 |
| Senior Manager | 73.1 | 19.3 | 0 | 0 | 92.4 | 0 |
| CRO | 72.5 | 20.6 | 0 | 0 | 93.1 | 0 |
| CIO | 72.5 | 19.2 | 0 | 0 | 91.7 | 0 |
| Secretary of Board of Directors | 72.5 | 17.7 | 0 | 0 | 90.2 | 0 |

Source: Bank B, 2012a

The implicit career attachment also plays an important role in the composition of executive pay in Chinese banks. In contrast with the Anglo-Saxon model where the bank managers are fairly mobile and change their job frequently, Chinese bank executives are much more stable and may choose to stay in the same bank for a very long period of time. And, many of them may work in the same financial institution for their whole life. Such career attachment by Chinese bank managers is based on the discourse that a job in the (same) bank, especially the large-sized one, is the best choice for their career development. Meanwhile, a strong job security is provided by Chinese banks. Unless in exceptional situations, the bank will not fire or downsize the executives, even in times of financial difficulties. Though there is a trend of increasing mobility of young bank employees from the state-owned large banks to highly privately or foreign owned banks due to higher pay, there is 'still water' in the 'pond' of the Chinese bank executives. Other benefits of working in the bank pertain to higher individual financial credit, good career reputation, and social prestige.

The composition of executive pay in Chinese banks is shown to manifest a hybrid paradigm of the enhanced shareholder primacy and diversified stakeholder theory and legitimacy discourse of close financial regulation. For instance, reflecting the state as the controlling shareholder and its effective control over the management, shareholding as the component of executive compensation is less used in Chinese banks, which shows the similarity to the Continental model. Meanwhile, this also represents the legitimacy discourse of strict financial regulation. From the regulatory perspective, the merit of the shareholding incentives is suspected. For instance, in July, 2008, State-owned Assets Supervision and Administration Commission and the Ministry of Finance jointly issued *The Notice on Regulating Relevant Issues Regarding the Implementation of Options as Incentives in State Controlled Listed Corporations*, which explicitly constrained the abuses of options as incentives in state-owned listed corporations. Specifically, stock option plans as incentives were not allowed in state-controlled listed financial enterprises unless approved by relevant financial regulators. In contrast, a high proportion of performance related bonus is employed as efficient incentive for the bank executives. Meanwhile, there is an adequate proportion of fixed salary, a generous welfare package and implicit job security, which illustrates the arrangement for the long-termism by and for the bank executives in China, resembling that of the Continental model countries. The political advancement by the senior bank executives in China, as an implicit but effective compensation incentive, reflects a strong attribute of the hybrid to the State-affected model.

The overall low remuneration package for Chinese bank executives also illustrates the legitimacy discourse of strict control by the financial regulators and some attributes of the State-affected model. Traditionally, the executive pay in Chinese banks is subject to influences and limitations by different regulators, such as the government statistic agency, the State-owned Assets Supervision and Administration Commission. For instance, in January of 2009, the Ministry of Finance issued *Regulations upon the Compensation Plan for the Senior Management in State-owned and State-controlled Financial Enterprises (consultative pap*er), which was targeted towards the compensation for senior management in financial related SOEs and set a ceiling of 2.8 million RMB before tax (However, the final official version of this regulative document was not officially promulgated and publicized). And frequently, the total remuneration for Chinese bank executives is compared with those of senior government officials with comparable administrative ranks. For instance, the CEO of Bank C presented a good understanding regarding the limitation on executive pay in large state owned commercial banks, 'As far as I am concerned, I am satisfied (with the present compensation plan). For example, compared with senior officials in the Ministry of Finance who are no less capable than me and whose workload is no less intensive, their pay is much lower.' (Xinhua Net, June 13 rd , 2011).

### 8.3.2 Regulation on executive pay

As discussed in Chapter Five, various measures are developed for regulation on executive pay in banking organizations, such as the limitation on fixed salary, the bonus cap, 'say on pay' by the shareholders, and the strict disclosure requirement, etc. In Chinese context, however, pay regulation in banks mainly focuses on the explicit limitations upon the basic salary, deferred payment on PRC, 'claw-back' and retention of payment ( in cases of occurrence of the risks), and assessment by different indicators regarding the risk control. First, there is an explicit limitation on the basic salary of the bank executives, which should not exceed 35% of the total annual remuneration. This intends for avoiding and mitigating shirking problems by the bank management when the pay is less related to their output, typically observed in the poor performance by the management, the low profitability of the bank, and the waste to the bank's shareholders (CBRC, 2010b). Secondly, deferred payment is widely used for PRC considering the delayed effects of the risks. Generally, the time for the payment should match the duration of the financial risks taken, the changes in the risks, and the accomplishment of the targeted business objective. In this sense, only a fraction of the PRC, normally 1/3, is paid periodically to the bank executives, with the rest to be paid at the end of the fiscal year after annual assessment.

Regarding the mid-and-long term incentive plans, the payment will not be made until the end of the lock-up period, which will normally last over 3 years according to the durations of different risks. Specifically, payment for such incentive plans is subject to the board's approval. Furthermore, for senior managers and employees on key posts with substantial risk exposures, 40% of such PRC will be paid in deferred terms with time span of 3 years at minimum. For senior managers on key posts, the proportion of such deferred PRC can be increased to over 50% or even 60% if it is applicable. Specially, a limited proportion of payment will be made in the deferred payment duration to avoid the manipulated substantial payment at the beginning. Moreover, the claw-back clause is put in place for withdrawing the paid compensation under stated circumstances. For instance, in cases of excessive risk exposures and abnormal huge losses incurred in the risk duration, the bank is entitled to claw back all the PRC paid to the senior managers and relevant personals while retaining the rest of the unpaid PRC. Such clause is also applicable to personals already leaving the bank if it is within the risk duration (CBRC, 2010b).

Thirdly, a set of assessment indicators are employed as monitoring and regulative mechanisms upon the PRC to the bank executives, which pertains to the economic efficiency, risk cost control, and social responsibility. The economic efficiency indicator is determined according to mandatory requirements by relevant financial regulators. The risk cost control indicator takes into account a wide range of issues, like the capital adequacy, the rate of non-performing loans, and the leverage rate. For instance, the assessment of the cost for credit risks and market risks focuses on the allocation of the economic capital, the changes in the bank's capital, and the actual losses. And, the assessment of the cost for liquidity risk includes the liquidity coverage under the stress test and the cost of the liquidity resources. The social responsibility indicator, as another important component, extends to the legal compliance, the moral standards, enterprise value, and the customers' satisfaction (CBRC, 2010b).

The performance of these three indicators may greatly impact upon the overall PRC of the bank's employees. For example, if any one of these indicators is not satisfied, the average pay of the whole bank group shall not be higher than the previous year. If any two of the indicators are not achieved, there will be reduction in the average PRC of the whole bank group based on the bench mark of the year before, and reduction in PRC for senior managers should be higher than the average employees. Failing all the three indicators, apart from the restrictions of not satisfying any two of the indicators, the total volume of the basic salary for the coming year shall not be increased. Meanwhile, complementary monitoring mechanisms are also set in place, such as restrictions on purchasing insurance policy for the deferred part of the compensation, or the liability that may lower the relevance between the compensation and the risk (CBRC, 2010b).

Fourthly, there has been increasingly stricter requirement on information disclosure on executive compensation in Chinese banks. For example, the board of the bank is responsible for timely, objectively and fully disclosing all the relevant information regarding the compensation plan for the senior management, and sets it as a significant part of the information disclosure in the bank's annual report. These embrace the structure and authority of the board compensation committee, the total volume of the annual compensation, and the mapping of the compensation. The disclosure also pertains to the key standards between the compensation and the performance assessment, risk adjustment, and the non-monetary compensation (including the cases of claw back for due reasons). Other information disclosure includes the preparation for the annual compensation plan, the executives' performance of the indicators of the economic effects, risk control and social responsibilities, and exceptional situations (CBRC, 2010b).

Moreover, as efficient monitors, financial regulators in China supervise the implementation and efficacy of the compensation arrangement in Chinese banks, such as monitoring on the accomplishment of the key indicators, and internal control based on on-site inspections. For instance, with regard to under-performance of the afore-said indicators or risk controls like the inadequate compensation management structure, the regulators will impose disciplinary measures or penalties. Meanwhile, regarding special situations like approaching insolvency, the aforesaid compensation plan and pay level should be determined by the bailing-out institutions or regulators. These cover banks which are

- already being bailed out;
- facing significant reputation risks which may cause substantial adverse influences upon its sustainable operation;
- near bankruptcy or winding-up;
- received by another institution;
- closed (CBRC, 2010b)

At the firm level, the compensation committee in Chinese banks is expected to play a significant role in pay regulation, and be responsible for advising and setting the compensation plan for the bank, specifically for senior management, the board directors and the directors of supervisory board, and evaluation of their performance. The committee can be independent like in Bank B or merged with other committees like the nomination and compensation committee in Bank A (Bank B, 2012a; Bank

A, 2012a). More than often, an outside director with seniority and expertise will chair the committee. And, considering the efficiency in managing the executive compensation, 1/3 of the compensation committee members are professionals with rich accounting experience, and the committee is expected to be familiar with a great variety of risks from different business lines of the bank (CBRC, 2010b). Meanwhile, departments like the human resources, risk control, and legal compliance are responsible for facilitating the monitoring over the compensation practice, and should be strictly independent of the monitored business lines (CBRC, 2010b).

Regulation on executive pay in Chinese banks, as another key component of Chinese bank governance, is observed to have revealed the discourses of paradigm and legitimacy of corporate governance in Chinese banks as discussed in pervious chapters. For instance, the clear and restrictive arrangement for the proportion, standards, and terms of different elements in the executive compensation illustrates the strict financial control over Chinese banks. The deferred payment and 'claw back' clause on PRC, on the other hand, demonstrates the regulators' serious concerns regarding the excessive risk taking by the bank executives and the potential threat to the national financial stability. Moreover, reflecting the paradigm of the diversified stakeholder theory, regulation on executive pay in Chinese banks presents concerns for the stakeholders, such as the social indicator as a key assessment for the performance of the bank executives. And, the encouraged use of the PRC as the major component of the executive compensation, the emphasis on information disclosure, and the enhanced function of the compensation committee illustrates the increasing de-regulation and pro-market attitudes by Chinese financial regulators.

Meanwhile, regulation on executive pay presents a coordinated nature due to the increasing de-regulation by Chinese financial regulators. In designing the framework of regulation on executive pay in Chinese banks, the financial regulators, instead of being intrusive and dictating, take fairly cautious steps. For instance, CBRC had been conducting a series of research programs regarding executive pay in Chinese banking industry with the Ministry of Human Resources and Social Securities, the Ministry of Finance, and other related government agencies since 2008, which were oriented towards the sustainable development of the bank, better correlation between the executive pay and the bank's risk taking. Meanwhile, CBRC actively communicated with the senior management in Chinese banking institutions and consulted their opinions regarding pay regulation, such as the annual compensation plan which could be adjusted according to individual bank's situations and performance. On the part of senior managers from Chinese banks, whether the state-owned or shareholding, such regulative arrangement is not unacceptable, though many of them challenge the merits of the pay regulation and contend such regulatory limitation is more an impediment for the free market economy. Specifically, the pay regulation gains its ground considering the present monopolizing status by the large-sized state-owned commercial banks due to the duality of the of bank's senior management, the less developed market for professional banking managers, and the regulator's influence on their appointment.

### 8.4 Chapter conclusion

As the first cut of empirical analysis of frame in corporate governance in Chinese banks, Chapter Eight explores the issues of the board of directors and regulation on executive pay. The discussion on the board of directors in Chinese banks summarizes the structure of the board, its composition, the board size and independence, and how this specific governance structure represents the discourses of the paradigm and legitimacy as discussed in the previous chapters. The discussion on the regulation on executive pay in Chinese banks, on the other hand, explores the composition of the remuneration of the bank's executives, specific regulative measures, and the coordinated regulation process, which demonstrates the influence of the legitimacy and paradigm discourses as elaborated in Chapter Six and Seven. Continuing the discursive institutional analysis, the next chapter, Chapter Nine, will explore another two issues of corporate governance in Chinese banks, risk management and legal duties.

## Chapter Nine Corporate Governance in Banking Organizations In China (III): Frame (2)

### 9.1 Introduction

Continuing the discursive institutional analysis of the frame, Chapter Nine elaborates on another two key issues in corporate governance in Chinese banking organizations, risk management and legal duties. Manifesting the discourses of international influence and regulatory impacts, Chinese banks are developing a mature overall risk management framework, which embraces various components related to risk control and administration. Characterized with a moderate risk appetite, the sampled banks reveal the constitutive discourses of paradigm and legitimacy in Chinese banks, such as the concerns for sustainable profitability, long term development strategy, and support for real economy. The specific risk management mechanisms developed by Chinese banks, typically the credit risk management, manifest the impacts of the inter-relationship between Chinese banks and economy and strict financial regulation. The legal duties in Chinese banks include the compliance duty and the fiduciary duty. Representing mainly the paradigm discourses of the diversified stakeholder theory and the legitimacy discourse of financial regulation, the compliance duty analyzes how Chinese banks comply with the laws and regulations in their business operation, anti-money laundering campaigns, and anti-corruption efforts. The fiduciary duties in Chinese banks, on the other hand, explores how the duty of care, the duty of loyalty and the duty of disclosure are constituted by the regulatory discourses and manifest the paradigm discourses of the enhanced shareholder primacy.

### 9.2 Risk management

Similar to the discussion on risk management in Chapter Five, key risks in Chinese banks are categorized as the credit risk, market risk, liquidity risk, and operational risks. And, manifesting the legitimacy discourses elaborated in Chapter Six, risk management in Chinese banks reflects the strong international influence and regulatory orientation. For instance, in 2011, Chinese banking industry implemented the New Basel Capital Accord and well proceeded with Basel Pillar I, II and III, which were observable in the enhancement of the banks' risk management mechanism, relevant rules and procedures, IT systems, data and personnel. Specifically, a complete framework for the overall risk management under the New Basel Capital Accord is being established. According to the on-site assessment by

CBRC, most of the large sized commercial banks met the requirements and submitted the application for implementing the New Basel Capital Accord (Bank B, 2012a; Bank A, 2012a, Bank C, 2012a and Bank D, 2012a). Meanwhile, the regulatory discourse plays a dominant role in the 'landing' of the international influence in risk management in Chinese banks. For instance, CBRC actively facilitates the establishment of the overall framework of risk management for Chinese banks in accordance with BIS principles and rules, and issues timely related guidance, rules and principles. However, the coherence of the aforesaid discourses can only be achieved through joint efforts from Chinese banking organizations, typically the large commercial banks, which reflects the increasing de-regulation discourse on Chinese banks and the trend of coordination between the government and the financial institutions. For instance, in preparing these norms, CBRC invites representatives from major commercial banks and financial institutions, other relevant financial regulators, and academia for extensive consultation and discussion. In this process, the commercial banks take great initiatives to persuade the financial regulators and bargain for their advantages. Moreover, guidance by CBRC is partly an advisory model for guiding risk management in Chinese banks, and the bank-specific arrangement as well as the details of risk management is more subject to the discourses and initiatives by individual Chinese banks.

### 9.2.1 Overall risk management framework

Impacted by the international influence and regulatory discourses, the risk management system in Chinese banking organizations, in a wider sense, embraces a great variety of elements such as the internal control, auditing, and specific risk management mechanisms. First and foremost is the establishment of an overall risk management system, which is a product of the BIS influence and regulator 'translation'. Such comprehensive risk management framework is purported to extend to the overall process of the bank's business operation, control all the perceivable risks in the bank's business activities at various levels, and cover personnel from the board of directors, senior managers to the general employees. This overall risk management system is founded upon the principles of the compatibility between profits and risks, balance between efficiency and internal check and balance, mix of qualitative and quantitative methods, and the dynamic adaptability and steady operational process (Bank B 2012a). In Bank A, for example, the risk management committee under the board of directors takes full responsibility for formulating the bank group's risk strategy and policies, monitoring and evaluating the overall risk on a regular basis. With a centralized risk management structure, the bank develops a vertical risk management line, from 'head to hand' and through the channel of 'chief risk officer – risk supervisors – risk heads – risk managers'. At the head office level, for instance, the chief risk officer is responsible for the overall risk management and responsible to the board of the directors. The risk management department (headed by the chief risk officer) is mainly engaged in formulating risk management policies, conducting risk measurement and analysis. Meanwhile, there is a market risk management division and a risk management team for overseas entities within the risk management department. The credit management department is responsible for credit approval and credit risk monitoring. Other departments at the head office are responsible for their own risk management respectively. At the branch level, the tier-one branches for instance, the risk officers are responsible for heading the risk management and relevant credit approval issues and report directly to the chief risk officer. At lower levels of the branches, such as the tier-two branches and sub-branches, the risk officers are responsible for risk management in their respective branch or sub-branch (Bank A, 2012a). In this context, a matrix system of risk management is established in Bank A where two reporting lines are set for the risk management issues. The first reporting line goes vertically to the risk management officers at higher levels, while the second line extends horizontally to the management within their respective entities or business units. Moreover, an internal 'firewall' and a risk exposure reporting system are established to prevent the transmission of risks within the bank group (Bank A, 2012 a).

As another key component of risk management, internal control plays an increasingly significant role in Chinese banks, which are largely shaped by various policy discourses, such as *The Basic Norms for Enterprise Internal Control* (MoF, 2007), *The Guidance for Internal Control for Commercial Banks* (CBRC, 2007), and *The Guidance for Internal Control for Listed Corporations* (Shanghai Stock Exchange, 2006). In practice, these policy discourses are well echoed by Chinese banking organizations. For instance, Bank B formulates its *Plan for the Establishment of Internal Control System for 2012-2014*, drafts *The Strategic Planning for Bank B's Development for 2012-2014*, and reviews and issues its *Handbook of the Compliance Management for Commercial Banks*. And, based upon related policies and guidance by CBRC, a wide range of internal policies for specific risk management are also carefully drafted and implemented in Bank B (Bank B, 2012a). The internal control system, meanwhile, is joined by various departments of the bank, such as the board of the directors, the various board committees, and the IT department. The internal auditing system in Chinese banks, on the other hand, stresses on significant aspects of the bank operations, such as the financial profitability and efficiency, financial innovations, and risk exposures by the bank group. For a better quality of the internal control, renowned international auditing firms are hired to review and issue independent auditing opinions regarding the bank's risk management (Bank B, 2012a).

### 9.2.2 Risk appetite and specific risk management mechanism

As discussed in Chapter Five, distinguished as the starting point of risk management in banking organizations, risk appetite/tolerance is pivotal in deciding the overall risk strategy, mechanisms for risk management and control, and business operations of the bank. In the context of Chinese banking industry, risk appetite is shaped by many factors, such as expectations from key stakeholders like creditors and depositors, the state as the majority shareholder, and the orientation by the financial regulator. As observed in the sampled banks, moderate risk appetite is widely adopted in risk management in large-sized commercial banks. For instance, Bank D implements a 'stable' risk appetite which embraces strict compliance with laws, regulations and the new BIS capital agreement, and aims to achieve the balance of varied objectives, such as the financial stability, profitability, and sound liquidity. These are represented by the bank's business strategy of moderate risk taking for moderate profit returns, maintaining capital adequacy, and facilitating the overall enhancement in risk management to cope with its business expansion and financial innovation (Bank D, 2012a). Targeted at 'steady and stable business operations', Bank C stresses upon optimizing the allocation of the bank's capital, and maximizing the shareholders' interests within tolerable range of risks. By establishing a moderate risk appetite for the bank group, Bank C pursues the risk principles of 'Rationality, Steadiness and Prudence' and strikes a balance between the bank's risk taking and profitability (Bank C, 2012a, p54). Bank B, on the other hand, issues the internal *Regulations on Risk Preference (Trial)* and illustrates its overall risk appetite throughout the bank group in the framework of the overall risk management system. Targeted at the risk-adjusted maximization of profits, the bank reinforces the implementation of the risk preference, which is monitored by periodical reviews and the timely reporting system (Bank B, 2012a). And, in setting the risk appetite of the bank, Bank A pursues a steady and sustainable profitability strategy within tolerable range of various risks (Bank A, 2012a).

The specific risk appetite in risk managements in Chinese banks manifest the discourses of legitimacy and paradigm discussed in previous chapters. For instance, echoing the paradigm of the diversified stakeholder theory, Chinese banks take moderate risk appetites and concentrate on the long-term profitability, sustainable development, and steady growth. This is reinforced by the fact that the state acts as the large shareholder, who is more patient with the bank's performance and focuses on the bank's long term development and contribution to the national economy. Specifically, as the risk taking and maximized profitability is less related to the executive compensation in the sampled Chinese banks, the senior management is less motivated to take excessive risks which will bring about nothing worth to their personal interests. The low risk tolerance in Chinese banks is also a reflection of the legitimacy discourses. With great emphasis on financial stability, the regulators maintain a close supervision over the bank's risk taking and restrict the banks from excessive risky activities. Meanwhile, as the banking industry is heavily regulated in China, such as the market entrance control, restrictions on financial innovations, and control over interests rate (though such control is being removed gradually), competitions among the banks are comparatively limited, and the bank board and management are under less stress to compete and have less incentives to take in higher risks for the sake of best performance and maximized profits to safeguard their post (as what happens in US). Furthermore, the general culture on risks in China, which is risk-averse rather risk loving, also influences the discourse on the risk appetite in Chinese banks.

To deal with various risk exposures, specific risk management mechanisms are developed by Chinese banking organizations, such as credit risk management, market risk management, liquidity risk management, and operational risk management. Among them, credit risk management is frequently prioritized, which is purported to adjust and optimize the structure of the bank's credit in accordance with policy orientations, fast changes in macro economic situations, and requirements by the financial regulators. Specifically, this involves credit policies on different industries and key financial products. Moreover, credit risk management in Chinese banks has to take into account of the preferential regional credit policy targeted at satisfying the needs of the local development, timely repayment for the bank loan, and optimization of the bank's monitoring and information system (Bank B, 2012a; Bank A, 2012a). For instance, there is increasingly stricter control over bank lending to the financing platform by the local government, the real estate industry, and enterprises categorized as 'High Polluting, High Energy Consuming, and Over Capacity' industries (Bank B, 2012a; Bank A, 2012a; Bank D, 2012a; Bank C, 2012a).

Regarding risk management in bank loans to the local government financing platform, for instance, various mechanisms are employed to mitigate the credit risk exposures. The sample banks, for instance, develop restrictive credit policy, centralization of the credit approval from the branches to the head office, and constraints upon the increase in bank loans to such local government financing platforms. For the outstanding government platform loans, the banks reinforce credit risk management, reconfirm the sources for the repayment, and initiate specific inspections (Bank B, 2012a; Bank C, 2012a; Bank D, 2012a). With regard to credit risk management on bank lending to the real estate industry, Chinese banks develop industrial-specific loan policy, which is purported to cope with latest changes in Chinese real estate market, and enhance the bank's capacity in managing the risk exposures. In practice, different measures are innovated, such as the quota management, limitation in the credit scale, and list management of the real estate developers. Meanwhile, Chinese banks impose higher standards for market entrance and stricter conditions for estate projects, optimize relevant loan products, and differentiate investment in various regions. Regarding loans to the on-going real estate projects, for example, stricter scrutiny and preventive measures are taken, such as complementary collaterals or guarantees for bank loans, periodical assessment of the value of the mortgage and the mortgage ratio, and the re-evaluation of the mortgaged assets (Bank B, 2012a; Bank C, 2012a; Bank D, 2012a).

For credit risk management in sectors related to environmental protection, there is increasing repression on bank loans to 'Highly Polluting, Highly Energy Consuming and Over Capacity' industries while strong support for green sectors (Bank B, 2012a; Bank C, 2012a; Bank D, 2012a). Meanwhile, industrial specific credit policy is set to strengthen the risk management for differentiated sectors, which efficiently adjusts the bank's loans in highly credit-concentrated sectors, supports the development of the emerging industries with national strategic importance, and updates the manufacturing and modern service industry in China (Bank B, 2012a). Another 'mine field' for credit risk management in Chinese banks is the newly increased loans to SMEs, which requires intensive risk control due to less mature market conditions and the credibility of SMEs. These pertain to the enhanced administration over approvals of SMEs related credit, consecutive supervision and analysis of such loans, and routine and structured monitoring and on-site inspections. Other measures embrace revising rules with regard to monitoring and managing SMEs loans, promoting digital management, and standardizing relevant business procedures and processes (Bank B, 2012a; Bank C, 2012a; Bank D, 2012a). Meanwhile, internal credit rating system is set up within the Chinese banks to achieve better quality control over loan assets, which, based on the possibility of expected repayment of the principals and interests of the bank loan, is categorized into 5 categorizes: normal, concerned, subprime, suspicious and losses. In practice, in Bank A and Bank B for example, a more specific 12 grading system is employed which takes into account of the number of the default months, the expected losses rate, the credit conditions, the adequacy of the guarantee, and other qualitative and quantitative factors (Bank A, 2012a; Bank B, 2012a).

The specific risk management mechanisms is shown to manifest the discourses of paradigm and legitimacy embedded in corporate governance in Chinese banks. For instance, implicated by the paradigm of the diversified stakeholder theory and legitimacy of bank's integration into the real economy, credit risk management in Chinese banks focuses on risk exposures to financing the economic development and local government. Echoing the close connection between the bank and industrial sectors, Chinese bank's credit risk management takes more concerns on the real estate industry and lending to the polluting and excessive energy consuming industries. And, resonating with the bank's support for enterprises, especially the SMEs, credit risk management in Chinese banks lays special emphasis on SMEs related lending. Meanwhile, the bank's credit risk management is also a representation of the strict financial regulation, such as restrictions on credits to the local government financial platform, the real estate industry, and the 'High Polluting, High Energy Consuming, and Over Capacity' industries.

## 9.3 Legal duties

Similar to legal duties in banking organizations as discussed in Chapter Five, legal duties in Chinese bank governance embrace the compliance duty at public law and fiduciary duty at private law. The former largely falls under the umbrella of extensive regulatory responsibilities, where financial regulators, like PBC, CBRC and MoF play key roles, and the violations of which will lead to disciplinary, administrative or even criminal penalties. The latter set of obligations embrace the duty of care, duty of loyalty and duty of disclosure, where the court plays a dominant function. However, given the powerful influence of the regulatory discourse in Chinese context, the fiduciary duty in Chinese banks is largely shaped by the financial regulator rather than the court. For instance, CBRC issues various guidance and principles on the fiduciary duty by Chinese banks' board directors and managers.

### 9.3.1 Legal compliance practices

The compliance duty, in Chinese context, is defined as the bank's business operation, activities and practice should comply with various formal or informal norms, such as laws, rules, regulations and principles. In a wider sense, it may include the duties under administrative ordinances, red-taps by ministries and regulators, industrial standards, operational rules and business ethics by self-governing organizations like industrial association or trade union. Frequently, the compliance duty falls into the terrain of compliance risk management targeted at controlling different legal risks faced by the bank. In practice, however, it extends far beyond and is closely intertwined with relevant issues like internal control, complied business operations, and fiduciary duty (CBRC, 2006).

As a key component of corporate governance in Chinese banks, the compliance duty is prioritized and integrated into the overall enterprise culture, the value of the bank, and its business ethics, honesty and integrity. Meanwhile, an effective dynamics is established between the self-disciplinary internal compliance practice and the external financial supervision. For instance, CBRC, by close monitoring, inspection and evaluation, supervises the validity and effectiveness of Chinese banks' compliance practice (CBRC, 2006). Meanwhile, the compliance duty involves various participants, including but limited to the board of directors, supervisory board, and managers at different levels. And, a specific department, frequently the compliance department or legal affair department, is established to be responsible for the compliance issues throughout the bank group.

Moreover, Chinese bank sets the compliance duty as one of its key social responsibilities, as discussed in Chapter Six. Firstly, the compliance duty is integrated into all business operations in Chinese banking organizations. For instance, Bank B, by strictly conforming to relevant laws, rules, and regulations, develops the principle of 'Regulated Conduct, Moderate Authorization, Sound Monitoring, Efficient Inspection and Effective Control' for its internal control, which aims for better performance of the compliance duty and sets up a sound culture of compliance throughout the bank group (Bank B, 2012b). Specifically, the bank enhances its *Basic Regulations for Internal Control*, which is targeted at fully 'explicating the codes of conduct, authorization management, standard regulations, supervision and inspection, accountability and penalty and internal control assessment' (Bank B, 2012b, p15). Regarding the business policy, Bank B stipulates *Basic Regulations for Compliance Management* which 'clarifies the organizational structure and managerial obligations of the Group's compliance management' (Bank B, 2012b, p22). Bank D reinforces its self-discipline practices, compliance with relevant laws and regulations, and active implementation of the internal control mechanism, which aims to boost its image as 'a responsible big bank'. Typically, in accordance with *The Self-discipline Convention of the Banking Industry of China* (CBA, 2009), Bank D aims to contribute to a sound financial market order, fair competitions, and sustainable development of banking institutions by initiating compliance programs like *Top 100 Model Outlets* (Bank D, 2012b). Bank A, by referring to *The Basic Norms for Enterprise Internal Control* (Ministry of Finance, 2007), assesses and evaluates its internal control system to diagnose the deficiencies which may substantially impact upon the operation and management of the bank. And, the bank lays specific emphasis on supervising compliance practices by domestic and international branches in the context of fast global expansion and increasing domestic subsidiaries (Bank A, 2012b). Moreover, diversified training programs are designed by Chinese banks regarding compliance practices. For instance, Bank B initiates campaigns of 'Year for Implementing Internal Control and Violation Prevention Systems' and 'Compliance Management and Prevention of Operational Risks' to enhance the employees' consciousness of legal compliance (Bank B, 2012b). Bank D, on the other hand, sponsors various events ranging from *Basic Management Upgrading Year*, *Compliance Culture and Prevention System Onsite Publicity*, to *Case Risk Inspections*, and has complemented over 6,000 compliance education sessions and 900 specific knowledge contests (Bank D, 2012b).

Secondly, the compliance duty in Chinese banks pertains to anti-money laundering (AML) and anti-terrorism financing. For instance, Bank B designs its own AML model which focuses on the customer identification, the global control list, and the overall monitoring system for domestic and overseas institutions (Bank B, 2012b). Specifically, the bank reinforces its reporting system on suspicious transactions and AML compliance management for the overseas subsidiaries and branches, sponsors AML training programs at different levels, and cooperates with financial regulators on AML investigations, all of which enhance the bank's risk control over potential money laundering activities. Bank A, on the other hand, designs a similar categorization system on risk rating on clients suspected of money-laundering, reinforces the monitoring and diagnosis systems, and improves reporting mechanism on suspicious financial activities. Moreover, a wide range of training programs are put in place to strengthen the bank employees' alert against the possible money laundering attempts (Bank A, 2012b).

Thirdly, anti-corruption and establishment of a clean business environment are set at the top of the agenda by Chinese banks as part of their compliance duties. For instance, Bank B develops its own principles of 'striking at the root of problems and its harmful effects, taking precautious measures while imposing punishment' regarding corruption activities (Bank B, 2012b, p55). The bank stresses upon setting up efficient preventive systems and sanction measures to promote a sound operational environment, and a social image of good faith, honesty and compliance. Accordingly, many internal rules and guidance are formulated, such as *Administrative Measures for Preventing the Conflict of Interests*, *Regulations on Honest Operation by the Management*, and *Commitment of Honest Operation by the Managers* (Bank B, 2012b). Specifically, an 'Honest Management System' is innovated by Bank B which traces information of business conducts on 29,552 managers of the bank and supervises 1,975 subsidiaries and branches. In 2011, 1,677 inspections on commercial bribery were conducted and 1,245 measures were taken to regulate relevant transactions. And, 15,406 training sessions on combating against corruption and promoting honest conduct of business were organized, attended by 757,569 person/time of employees (Bank B, 2012b). Bank A, on the other hand, develops permanent monitoring mechanisms to prevent and mitigate corruption and illegal practices, along with designed training programs, educational exhibitions, case diagnosis as well as anti-corruption themed lectures and seminars, which intend to reinforce business ethics and the 'clean practice' throughout the bank group (Bank A, 2012b).

The arrangement of the duty of compliance in Chinese banks reveals the implication of the discourses of paradigm and legitimacy as discussed in Chapter Six and Seven. For instance, echoing the paradigm of the diversified stakeholder theory and CSR performance, Chinese banks hold themselves accountable to the regulator as one of their stakeholders and implement the duty of compliance, exemplified by legal practices in business operation, anti-money laundering, and anti-corruption. Meanwhile, the compliance duty by the bank also represents the paradigm discourse of the enhanced shareholder primacy, which is purported to protect the interests of the shareholders by constraining from profitable but illegal practices. Such compliance duty illustrates as well the legitimacy discourses of strong financial regulation and paralleled de-regulation. On one side, the compliance duty is largely shaped and constituted by the regulatory discourses and closely supervised by Chinese financial regulators. And, any violation will incur administrative penalties and punishment by the regulators. Moreover, the compliance duty is purported by the regulators to reinforce the stability and sustainability of Chinese financial system. On the flip side, however, the compliance duty shows a trend towards market-oriented self-discipline by Chinese banks, which reflects increasing financial de-regulation and less intervention by the state.

### 9.3.2 Fiduciary duties in corporate governance in banking organizations in China

Similar to the legal duties discussed in Chapter Two and Five, the fiduciary duty in corporate governance in Chinese banking organizations pertains to the board directors, the management, supervisory directors, and the controlling shareholders, and is generally categorized into the duty of care, duty of loyalty, and duty of disclosure. Specifically, the fiduciary duty in Chinese banks is expected to be performed in accordance with relevant laws, rules, regulations and articles of incorporation of the commercial bank (CBRC, 2011a).

*Duty of care*

In Chinese bank governance, the duty of care mainly covers issues like the qualifications of the board directors and senior managers (D&M), the duty of due diligence and adequate monitoring, and related personal liability in case of breach (CBRC, 2011a). As the fundamental of the duty of care, the qualifications of D&M in Chinese banks are stressed and expected to meet the regulatory requirements, which includes a good record of business ethics and reputation, possession of adequate knowledge, financial experience and expertise. It also pertains to a record of good practice in financial or economic professions, sound personal and family financial situations, and adequate independence in the financial institutions (CBRC, 2011a). Meanwhile, there are strict requirements upon the academic backgrounds and terms of financial practices by D&M according to relevant financial regulations and rules. Specifically, there are demanding requirements upon the qualifications of the outside directors in Chinese bank board (Bank B, 2008).

However, the qualification standards for D&M are not static, but dynamic. With fast-changing economic, financial and political environments, and increasingly complicated banking business and financial innovations, continuous update on the qualifications of D&M is indispensable. For instance, in 2011, the board directors of Bank B participated in specific survey and research programs in selected key business departments at the bank's head office and overseas branches for better understanding of the latest development in key banking business, such as the bank's competitiveness in deposits attraction, bank loans for SMEs, assets management, and upgrading of the internal (credit) rating system. The research programs intended to update the board directors of the information regarding the external economic and financial environment, business operation, and management processes within the bank, which might enable them to propose effective advice to the bank's management. Meanwhile, for improving D&M's qualifications and better performance, periodical training programs on different subjects are organized by financial regulators, such as training sessions for directors of listed corporations sponsored by Beijing Bureau of CSRC, which concentrates on prevention against the insider trading, better internal control system, and efficient performance by D&M (Bank B, 2012a). And, the bank's nomination committee under the board of directors and the financial regulators are engaged in examining and reviewing whether the standards of such qualifications are met. For the financial regulators, this involves reviews on practices by D&M candidates (which are recorded in the official financial supervisory information system), their personal files, and opinions consulted from other financial regulators or related administrative agencies. Meanwhile, the regulatory monitoring extends to D&M's personal credit records, his professional knowledge and capability, and other issues deemed appropriate by the financial regulators in accordance with the prudential supervision principles (CBRC, 2012).

Another important aspect of the duty of care by D&M in Chinese banks is due diligence, which requires D&M to perform their duties with adequate diligence and commitment, and be restrained from negligence, shirking or other kinds of reckless activities. In practice, these pertain to active attendance at the board meetings, completion effectively of required working hours, and understanding fully their due obligations (CBRC, 2011a). First, the directors are expected to input enough time to perform their duties. Basically, he is obliged to attend over 2/3 of the board meetings personally every year. In case of absence with due course, other qualified directors can be delegated, but with written consent. Annually, the outside directors are required to work at least 15 working days in the bank. And for outside directors acting as the head of auditing committee, related transaction control committee, and risk management committee, they are obliged to work at least 25 working days. The record of the performed minimum working hours, attendance at the board meetings, and presentation of independent opinions will be recorded in the directors' profiles, which will be used for assessing their performance (CBRC, 2011a).

In Bank B, for instance, the bank's executive directors, non-executive directors and outside directors well performed their duties of diligence in 2011 by full attendance at all the board meetings and meetings by board special committees, with the attendance rate reaching 100% (though this satisfactory percentage embraced those of delegated attendance), as illustrated in Table 9.1. The outside directors were also actively proposing independent opinions with regard to the bank's business development and strategic planning.

**Table 9.1 2011 Bank B Statistics on Attendance by Board Directors at Board Meetings and Meetings by Board Special Committees**

Times of attendance/Times of attendance mandated

| Directors | Board of Directors | Special Committees under the Board | | | | | |
|---|---|---|---|---|---|---|---|
| | | Strategic Committee | Auditing Committee | Risk Management Committee | Nomination Committee | Compensation Committee | Related Transaction Control Committee |
| Executive Directors | | | | | | | |
| A | 10/10 | 6/6 | | | | | |
| B | 10/10 | 6/6 | | | 2/2 | 3/3 | |
| C | 10/10 | | | 5/5 | | | |
| D | 10/10 | | | | | | 6/6 |
| Non-Executive Directors | | | | | | | |
| E | 10/10 | 6/6 | | | | 3/3 | |

**Table 9.1 2011 Bank B Statistics on Attendance by Board Directors at Board Meetings and Meetings by Board Special Committees --- Continued One**

Times of attendance/Times of attendance mandated

| Directors | Board of Directors | Special Committees under the Board | | | | | |
|---|---|---|---|---|---|---|---|
| | | Strategic Committee | Auditing Committee | Risk Management Committee | Nomination Committee | Compensation Committee | Related Transaction Control Committee |
| Non-Executive Directors | | | | | | | |
| F | 10/10 | 6/6 | | | | 3/3 | |
| G | 10/10 | | | 5/5 | 2/2 | | |
| H | 10/10 | | 6/6 | 5/5 | | | |
| I | 10/10 | | | 5/5 | 2/2 | | |
| J | 10/10 | 6/6 | 6/6 | 5/5 | | | |

**Table 9.1 2011 Bank B Statistics on Attendance by Board Directors at Board Meetings and Meetings by Board Special Committees --- Continued Two**

Times of attendance/Times of attendance mandated

| Directors | Board of Directors | Special Committees under the Board | | | | | |
|---|---|---|---|---|---|---|---|
| | | Strategic Committee | Auditing Committee | Risk Management Committee | Nomination Committee | Compensation Committee | Related Transaction Control Committee |
| Independent& Non-executive Directors | | | | | | | |
| H | 10/10 | 6/6 | 6/6 | 5/5 | 2/2 | 3/3 | 6/6 |
| I | 10/10 | 6/6 | 6/6 | 5/5 | 2/2 | 3/3 | |
| J | 10/10 | 6/6 | 6/6 | | 2/2 | 3/3 | 6/6 |
| K | 10/10 | | 6/6 | 5/5 | 2/2 | 3/3 | 6/6 |
| L | 10/10 | 6/6 | | 5/5 | 2/2 | | |
| M | 10/10 | | 6/6 | | | 3/3 | 6/6 |

Source: Bank B, 2012a

Meanwhile, the outside directors also initiated a wide-ranged on-site research program, which focused on the transition of the bank's business operation, organizational adjustment, risk management, internal control, and the compensation system. And, seminars on specific subjects were arranged with the bank's management for better communication and exchange of opinions (Bank B, 2012a).

Secondly, the duty of due diligence demands the bank's directors be capable of understanding and analyzing the complicated financial activities of the bank, its periodical reports, and various independent opinions (on the bank's operation) issued by the regulators, external auditors and the public. And, in performing their duties of due diligence, the board directors are expected to lay special emphasis on major issues of the banks, such as the formulation and implementation of the bank's business strategy, the appointment procedure and monitoring of the bank's senior management, the bank's risk preference, risk strategy and risk management, and the compensation plan and related assessment standards. For members in relevant board committees, they are obliged to constantly monitor the changes and influences of key issues in bank's business operation, and propose timely opinions to the committees (CBRC, 2010a)

Meanwhile, special duty of care can be observed for the non-executive directors, who are responsible for facilitating good communication between the bank and the controlling shareholders, and preventing prioritizing the interests of the majority shareholders over the bank and other (minority) investors. Regarding the implementation of the board's decisions by the senior management, especially when there are deficiencies such as the bank's relevant indicators do not meet the requirements of the prudential bank supervision or may possibly deviate in the foreseeable near future, the non-executive directors are obliged to require the bank to make due rectifications. Another issue within the non-executive's duty of care is efficient monitoring on transactions between the shareholders and the bank, which demands the establishment of a sound management system to guarantee the legality and reasonableness of such transactions. For the outside directors, on the other hand, they are obliged to present objective and independent opinions to be bank board, and lay special emphasis on the protection for the interests by the depositors and minority shareholders. Specially, the outside directors are expected to monitor the following issues with sufficient care, such as the legality and fairness of the related transactions, completeness and authenticity of the information disclosure, events which may incur substantial losses to the bank, and issues which may damage the interests of the depositors and the minority shareholders (CBRC, 2010a)

The performance of the duty of care by D&M in Chinese banks is accordingly appraised by the bank and financial regulators. Based on relevant guidance, Chinese banks are required to establish adequate monitoring and assessment system on the performance of duties by D&M, and an official record for tracing their practices. And, the assessment can be divided into different categories for varied stages, such as self-assessment, mutual assessment by peer directors, and assessment by the board of directors and the supervisor board. Meanwhile, CBRC will be supervising the assessment of performance by the bank and take relevant measures. For instance, if there is any non-compliance by the bank regarding its assessment system and processes, or the assessment result is largely untruthful, CBRC will impose penalty on the bank and demand rectification. Furthermore, on-site inspection is conducted by CBRC in Chinese banks according to relevant assessment reports. And, the aforesaid assessment results will be recorded timely in the official administration system (CBRC, 2010a).

*Duty of loyalty*

The duty of loyalty, in the context of bank governance in China, mainly pertains to the board directors, management and majority shareholders, and involves various issues of conflict of interests, such as holding posts in other competitive financial institutions, pursuit of undue benefits at the price of the bank's interests, and direct or indirect involvement in the present or planned contracts, transactions or arrangements with the bank (CBRC, 2011a). In particular, to prevent the instances of conflict of interests which may adversely affect D&M's duty of loyalty in his bank, the following situations are explicitly prohibited,

(i) By the time of his appointment, D&M or his spouse owns a large amount of unpaid debts, including those owned to the present financial institution to which he is to be appointed as D&M;

(ii) D&M or his relatives jointly hold over 5% of the stocks of the present financial institution and the total credit granted by this institution exceeds the fair value of the aforesaid stocks;

(iii) D&M and the institution he controls jointly hold over 5% of the stocks of the present financial institution and the total credit granted by this institution exceeds the fair value of the aforesaid stocks;

(iv) D&M or his spouse takes posts in other institutions which hold over 5% of the stocks of the present financial institution and the total credit granted by this institution exceeds the fair value of the aforesaid stocks unless such credit grant is not related to him or his spouse by any means;

(v) D&M's post in other institutions will conflict with his present or future post in the present financial institutions or greatly distract him from properly performing his duties in the present financial institution, such as working hours, working efficiency,

and other situations defined by CBRC in accordance with prudential regulation principles (CBRC, 2012).

And for outside directors, more restrictive conditions are imposed and the following conditions are not allowed,

(i) He and his spouse jointly hold over 1% of the stocks or options of the present financial institution;

(ii) He or his relatives take post in other institutions which hold shares in the present financial institutions;

(iii) He or his relatives take post in the present financial institutions, or other institutions controlled directly or indirectly by the present financial institution;

(iv) He or his relatives take post in institutions which default in repaying loans to the present financial institution;

(v) He or his relatives take post in institutions which have business relations or conflict of interests as creditors or debtors with the present financial institution due to their relationship at law, accounting, auditing, management consulting, guaranteeing or cooperation, which hinders the sound performance of his independence;

(vi) He or his relatives may be subject to great influences or control by the majority shareholders or senior management in the present financial institution which hinders his performance of independence,

and other situations defined by CBRC according to the financial prudential regulation principles. Furthermore, for senior management of the bank, he is prohibited from taking post in other economic institutions without any equity investment unless such institutions are affiliated to the banks and such post is approved by CBRC (CBRC, 2011a).

In practice, the duty of loyalty by D&M pertains to many aspects of the business operation of the bank. For instance, D&M is responsible for protecting the secrets of the bank and forbidden to procure any improper benefits or interests in performing his duties. Meanwhile, the director is not allowed to take advantage of his directorship to pursue his undue personal interests, or damage the bank's interests for the sake of the shareholders' interests (CBRC, 2010a). Moreover, D&M are not allowed to be involved in any transactions which may cause conflict of interests with the present bank. Specifically, if the director is personally directly or indirectly involved in the present or the future contract, transaction or arrangement with the bank, the nature and degree of his involvement should be notified to the control committees on related transactions and the director should be excluded when the transaction is being reviewed(CBRC, 2010a, 2011). For the duty of loyalty by specific category of directors, usually the non-executive directors who represent the controlling shareholders, they are expected to be actively engaged in promoting the communication between the majority shareholders and the bank. Particularly, related transactions between such controlling shareholders and the bank should be carefully considered, and complementary capital planning should be arranged to avoid risks upon the bank's capital adequacy (CBRC, 2011a).

*Duty of disclosure*

In contrast with generic firms, information disclosure by the banking organizations is highly sensitive and ambivalent. On one side, it is necessary and mandatory for the bank to disclose adequate information to protect the interests of the shareholders and stakeholders. On the flip side, however, due to the specialty of the bank, typically its highly leveraged capital structure, fast changing financial activities, 'unstable' balance sheet and complicated financial innovations, extensive information disclosure may cause serious problems and public panic, especially the systematic one like bank run which may pull down even the healthiest bank. Discussed in Chapter Two and Five, information disclosure can generally be divided into mandatory information disclosure and voluntary information disclosure. The former refers to the information which may significantly influence the investors in making their investment decisions and is mandated to be disclosed. The latter, based on the bank's free will and not involving sensitive financial information or business secrets, embodies information which may exert certain influences upon the shareholders and other stakeholders, such as the bank's development strategy, management orientation, and the relationship between the bank and other stakeholders. In general, the board directors, supervisory board directors, senior managers, and controlling shareholders of the bank are subject to the duty of disclosure. Meanwhile, information disclosure should conform to the principle of authenticity, accuracy, completeness and timeliness, and daily language is expected to be used, along with better access by the public (CBRC, 2011a).

In Bank B, for instance, the board of directors is responsible for information disclosure, which generally embraces the periodical reports, temporary reports, and other mandatory disclosure (Bank B, 2008). The periodical information disclosure comprises the bank's basic information, financial and accounting reports, risk management reports, and information regarding the bank's corporate governance and annual major events. Among them, disclosure on financial and accounting includes the bank's accounting sheet, its notes, and illustrations of the bank's financial conditions. The disclosure on the bank's risk management should include but not limited to, (1) the conditions of the bank's key risks such as the credit risk, liquidity risk, market risk, operational risk, reputation risk and national risk; (2) the risk control conditions, including the capability of the board of directors and senior management in monitoring and controlling the risks, relevant policies and processes of risk management, risk measurement, information system for risk management and monitoring, and internal control, and (3) risk assessment and measurement approach of the risk. Specifically, the bank should discuss with the external auditing institutions regarding the adequacy of information disclosure on its risk management (Bank B, 2008).

The duty of disclosure also embraces D&M's opinions on the periodical reports in forms of written confirmations. For instance, the supervisory board in Chinese banks is obliged to provide its opinions in written forms and presents whether the preparation and reviewing procedures of the periodical reports conform to relevant laws, regulations, and rules, and whether the periodical reports can truthfully, accurately and fully reveal the actual conditions of the bank. Specifically, D&M and the supervisory directors are responsible to provide their reasons in case they can not guarantee or hold dissenting opinions regarding the authenticity, accuracy, completeness of the periodical reports. Meanwhile, the supervisory board is responsible for monitoring the performance of duty of disclosure by D&M and the overall information disclosure by the bank. And in case of any illegality or breach of duty of disclosure, relevant investigation and solutions should be reported to the financial regulators (CBRC, 2011a).

In practice, the duty of disclosure varies for the board directors, senior management, supervisory directors, and the majority shareholder of the bank. In Bank B, the board directors are expected to guarantee that the disclosed information conform to the principle of authenticity, accuracy, completeness, and any mis-statement, misguiding or gross lapse of the information are prohibited. Legally, the board directors of the bank will take several and joint liabilities for the disclosed information if it is false or misleading. For the senior management, the duty of disclosure embraces reporting timely to the board of directors any material events occurring in the bank's business operation, financial conditions, and the changes in such disclosed issues. Meanwhile, the senior management is responsible for responding to inquiries by the board of directors regarding the bank's periodical reports, temporary reports and other relevant issues. They are also obliged to respond to inquiries by the board of directors on behalf of the shareholders and financial regulators, and provide relevant information. Meanwhile, in daily business operations and management activities, the senior management is expected to reinforce administration on information disclosure and its efficient implementation (Bank B, 2008). The duty of disclosure also pertains to the shareholders of the bank, especially the controlling shareholders. For example, the bank's controlling shareholder or shareholders with over 5% shareholding of the bank is obliged to timely notify the bank's information disclosure department or secretary to the board of directors if they notice or know any material information which is to be disclosed (Bank B, 2008).

As an effective monitoring system, the supervisory board and its members are responsible for reviewing and supervising the performance on the duty of disclosure by the board directors and senior management, including but not limited to periodical and contingent inspections on the implementation of the bank's information disclosure system, requirements upon the board of directors to rectify any defects regarding information disclosure, and issuing written opinions on periodical reports with regard to its compatibility with laws, regulations and rules. For the supervisory director, specifically, he is responsible for monitoring the performance of the duty of disclosure by the board directors and senior managers, observing the operation and progress of the bank's information disclosure, and initiating investigations in case of any verified violation or malpractice (Bank B, 2008).

However, there are exceptional instances when the information, though substantial and material, can be allowed to be delayed or even excluded from disclosure, if it is classified as uncertain, temporary business secrets, or other instances recognized by the stock exchange where the bank is listed, and the disclosure of which may damage the bank's interests, misguide the investors, or violate relevant laws, regulations or rules. In these circumstances, applications for delayed disclosure or exclusion can be filed to relevant regulators accordingly (Bank B, 2008). And, the board directors and senior managers will be exonerated from their duty of disclosure.

As another key component of the legal duties in the frame of corporate governance in Chinese banks, the fiduciary duty presents the constitutive discourses of legitimacy and paradigm explored in Chapter Six and Seven. Manifesting the paradigm discourse of the enhanced shareholder primacy, the fiduciary duty in Chinese banks lays increasing emphasis on legal protections for the investors. For instance, to bring about a better performance of the bank, the duty of care demands stricter qualifications of the D&M in Chinese banks and close assessment on their performance. To control the conflict of interests in various activities by the D&M

and the controlling shareholders, Chinese regulators set more stringent rules on the duty of loyalty such as the mandate on the independence of the D&M and limitations on related transactions. Meanwhile, the increasing attention to the duty of disclosure by the D&M in Chinese banks is purported to mitigate the information asymmetry between the bank management and the shareholders, hence providing sufficient material information to the investors and facilitate the implementation of the duty of care and duty of loyalty as well. Meanwhile, responding to the strong impacts of the regulatory discourses, the fiduciary duty in Chinese banks is largely founded upon, apart from the laws and statutes, the regulatory guidance, rules, and principles, while Chinese court is found to have limited influences. For instance, with regard to the duty of care, the qualifications and the standards of due diligence by the bank D&M are mainly prescribed and closely monitored by CBRC. Moreover, the performance of the duty of care by D&M is partly subject to the supervision and assessment by Chinese financial regulators. Regarding the duty of loyalty in Chinese banks, strong regulatory influence is prominent as well. For example, the financial regulator clarifies the qualification requirements of D&M and illustrates various prohibited situations that may adversely affect the performance of the duty of loyalty and incur the conflict of interests. And, the financial regulator, CBRC, specifies the duty of loyalty by the non-executive directors in Chinese banking organizations in the instances of related transactions between the bank and the controlling shareholders. Moreover, CBRC sets clear requirements on information disclosure by D&M of Chinese banks, which involve the key principles of disclosure and relevant standards.

### 9.4 Chapter Conclusion

By presenting an empirical analysis of the second set of issues of the frames in Chinese bank governance which covers risk management and legal obligations, this chapter has provided the final piece to the jigsaw of the present research. Greatly influenced by international and domestic regulatory discourses, risk management in Chinese banks focuses on the formation of the overall risk management framework, complementary functions of internal control and auditing, and moderate risk appetites. Specifically, subject to implications of the legitimacy discussed in Chapter Six, key risk management mechanisms in Chinese banks are closely related to risk exposures to the real economy, industrial sectors, and SMEs, which are readily observable in the bank's credit risk management. The legal duties in Chinese banks, on the other hand, pertain to the compliance duty at the public law and fiduciary duty at the private law, both of which are largely shaped by the regulatory discourses.

The former pertains to various compliance practices in the bank's business operations. The later, on the other hand, illustrates varied standards and requirements on the board of directors, senior managers, and the controlling shareholders in Chinese banks regarding their duty of care, duty of loyalty and duty of disclosure.

## Conclusion

### *Key Findings*

In conclusion, this thesis has drawn on insights from the discursive institutionalist works and the varieties of capitalism literature in order to explore corporate governance of banking organizations in China. With its three-tier canvass of discourses, proceeding from legitimacy, paradigm, to frame, the thesis demonstrates that corporate governance in Chinese banks is symbiotically linked to the specific Chinese national configuration. At the legitimacy level, bank governance in China is found to be justified by the relationship between the bank and the economy, the impacts of paralleled powerful financial regulation and de-regulative moves, and the increasing international influence. At the paradigm level, corporate governance in Chinese banks is illustrated to be shaped by a specific hybrid model with concerns for the shareholder primacy and broader stakeholder interest groups. At the level of the frame discourse, corporate governance in Chinese banking organizations is presented in the development of specific governance mechanism, typically represented by the organization and practice of the board of directors, regulation on executive pay, risk management, and legal duties.

The detailed empirical work undertaken suggests that the governance of Chinese banking organizations is best characterized as a part hybrid and part uniquely Chinese variety of capitalism. Hybrid is demonstrated through the mix of the shareholder model, the stakeholder model, and the state-affected model. In governance practice, there is represented by the mix of the models, such as the structure of the board of directors where there is a hybrid characteristic of the Anglo-Saxon model and the Continental model. On the other hand, the thesis finds evidence of an emerging 'Chinese model'. Embedded in China's institutional settings ideologically structured as the *Market Economy with Chinese Specialty*, the Chinese model is found to be characterized with the enhanced shareholder primacy theory, the paralleled diversified stakeholder theory, concerns for national economic development, and increasing international influence. In contrast with the generic shareholder primacy theory as popular in the Anglo-Saxon model, Chinese model of bank governance presents a distinctive nature of the enhanced shareholder primacy, in which the state acts the controlling/large shareholder (in large sized commercial banks) and the banks are oriented towards the balance of the best performance and sustainable development, and maintenance and increase of the state assets invested in the banks. In parallel, Chinese model emphasizes on protecting interests of diversified stakeholders and present serious concerns for a great variety of the bank's constituencies, from the state, regulator, depositor, to environment and society at large. Specifically, this model sorts out efficient solutions for coordinating the enhanced shareholder primacy and concerns for diversified stakeholders in the context of the state acting as influential bank shareholders. Moreover, Chinese model lays great emphasis on facilitating national economic strategy, regional economic development, and financial assistance to industries and sectors. Another feature of Chinese model is its 'opening' to international influence, which is comparatively less observed in other established models. With the spirit of 'Open Up to the Outside and Reform', Chinese model is positioned to welcome international norms and practice, which is reinforced by China's increasing presence and membership in international economic organizations and involvement in financial globalization, fast growth of foreign banks in China in number, geographic coverage, and financial activities, and expansion of Chinese banks in global financial market. All these features lead to the 'specialty' of corporate governance in Chinese banking organizations and henceforth produce the specific 'Chinese model'.

From the institutional perspective, the thesis finds that corporate governance in Chinese banks is a composite of three-level discourses and the dynamics within. At the level of legitimacy, bank governance in China gains its legitimate grounds by 'Serving the Real Economy', i.e., integration into the national economy, close connections with industrial sectors, and intertwining with enterprises. Regarding the constitutive role of the financial regulation, there is a parallel discourse of continued close control by the government and an increasing orientation for opting for deregulation. In terms of legal intervention, Chinese courts present a paradoxical characteristic of passivism and activism, and are frequently influenced by political discourses. Meanwhile, the discourse of international competition and influence is increasingly significant in legitimating particular corporate governance arrangements in China. As the idea at the background of the cognition, the legitimacy of corporate governance in Chinese banks is found to provide great implications in constituting the discourses of paradigm and frame. For instance, attributed to the hybrid nature of the legitimacy discourse, the paradigm discourse in Chinese bank governance exhibits a strong hybridization of the shareholder model, stakeholder model, and state-affected model. Meanwhile, such legitimacies may constitute specific bank governance structure in Chinese banks, such as the orientation of the bank board towards serving the real economy, preference for moderate risk appetites and specific risk exposures, and a social responsibility nature in the duty of legal compliance.

At the paradigm level, corporate governance in Chinese banks is found to be constituted by the paralleled discourses of the enhanced shareholder primacy theory and diversified stakeholder theory. The enhanced shareholder primacy theory, in Chinese context, is formed through the specific concerns for the state as a majority shareholder of the bank, the balance of the maximization of shareholder interests with stakeholders' interests, and a specific agency problem. The diversified stakeholder theory, on the other hand, highlights the bank's serious concerns for the interests of a great variety of stakeholders, from general economy to individual employees, from the regulators to the clients, and from the environmental protection to the social welfare at large. Such hybrid paradigm is found to provide significant implications on the development of the frame in Chinese bank governance. For instance, the enhanced shareholder primacy influences the arrangement of a high percentage of non-executive directors at the bank board representing the state, specific risk exposures to the real economy and industrial sectors, and the dis-encouragement of using shareholdings as part of the composition for executive pay. The paralleled paradigm of the diversified stakeholder theory, on the other hand, leads to the mandatory presence of employee representatives as supervisory directors, the board's orientation for protecting various shareholders, and comparatively less risky appetites by Chinese banks.

At the frame level, echoing the legitimacy and paradigm discourses as so discussed, the thesis illustrates a specific set of corporate governance structure developed in Chinese banks, which mainly includes the organization and behavior of the bank board, the regulation on executive pay, risk management, and legal duties. The present study shows, in the organization and behavior of the board of directors, Chinese banks have developed a comparatively large sized bank board with rich banking experience, good financial expertise, and increasing independence. Specifically, it is found that the bank board is oriented towards sustainable profitability to the shareholders, active support for the economic development, and the balance of interests among various stakeholders. The regulation on executive pay in Chinese banks exhibits that the remuneration composition is oriented towards the long-termism of the bank executives. Specially, the intangible element of political prestige and advancement plays a significant role as part of the compensation for the bank's senior executives. The special regulatory measures, on the other hand, reveal that the pay regulation is closely supervised and assessed by Chinese regulators. In risk management, the thesis demonstrates the risk management framework in Chinese banks is largely constituted by the international influence and regulatory discourses. In practice, the bank risk management is found to be characterized with moderate risk appetites and particular risk exposures to the real economy. Regarding the legal duties in Chinese banking organizations, the present study presents that there is a significant role of the regulatory discourse in shaping the compliance duty and the fiduciary duty. As the duty at the public law, the compliance duty is found in a wide range of practices like business operation, anti-money laundering moves, and anti-corruption efforts. The fiduciary duty, with its increasing significance in Chinese banks, demonstrates the standards and boundaries of the duty of care, duty of loyalty, and duty of disclosure.

As the discourse at the third level, the frames in the bank governance in China are observed to manifest the discourses of the paradigm and legitimacy. For instance, implicated by the enhanced shareholder primacy and the dominance of state as the controlling shareholder, a very high proportion of non-executive directors are set in the composition of the bank board. The increasing presence of the outside directors, on the other hand, echoes the international influence and reinforced self-discipline of the board of directors, though the institutional settings in China may limit the independence of the board to some extent. The frame of the regulation on executive pay, reflecting the state as the controlling shareholder and strict financial regulation, dis-encourages the use of shareholdings or options as the incentives for the bank executives. Instead, an adequate proportion of the fixed salary, generous welfare packages, and implicit job security resonate with the specialty of the paradigm of stakeholder model in Chinese bank governance. The specific regulatory measures on executive pay present the regulator's close control over Chinese banks and emphasis on the national financial stability. And, reflecting the paradigm of the stakeholder theory, pay regulation on Chinese banks also illustrates the concerns for the stakeholders, exemplified by the social indicator as a key assessment of the bank's performance. In risk management, echoing the paradigm of the stakeholder theory, Chinese banks take moderate risk appetites and concentrate on the long-term profitability and sustainable development. This also represents the concerns for the financial stability by the regulators and their close supervision over the banks' risk taking. For special risk managements, implicated by the paradigm of the stakeholder theory and legitimacy of bank's integration into the real economy, credit risk management in Chinese banks focuses on the risk exposures to the local financial platforms, the real estate industry, and to SMEs. In the frame of the legal duties, echoing the paradigm of the stakeholder theory and the CSR performance, Chinese banks hold themselves responsible to the regulator as one of their stakeholders and implement the duty of compliance. Moreover, the duty of compliance by Chinese banks illustrates the legitimacy discourses of the strong financial regulation and paralleled de-regulation. Manifesting the paradigm discourse of the enhanced shareholder primacy, the fiduciary duty in Chinese banks lays increasing emphasis on the legal protections for the investors, such as stricter requirements on the qualifications of D&M in Chinese banks, stringent rules on the duty of loyalty, and attention to the duty of disclosure. Meanwhile, responding to the strong influence of regulatory discourse, the fiduciary duty in Chinese banks is largely founded upon, apart from the laws and statutes, the regulatory guidance, mandates, and principles. Moreover, such fiduciary duty by D&M is frequently subject to the supervision and assessment by Chinese financial regulators.

*Limitations of the research*

In spite of the researcher's efforts, the present research project necessarily has certain limitations. For instance, the research mainly focused on four sampled Chinese banks as a case study of corporate governance in the Chinese banking industry, and the sample was small considering the total number of banks in China. Moreover, the sampled banks were all the large-sized financial institutions, and it was medium and small sized banks that were not included. And, regarding the ownership structure, though the sampled banks are listed commercial banks, they are largely dominated by the state as the controlling shareholder. Banks with other types of ownership structures, such as those with less state ownership or highly privatized, were not included in the study. That said, and considering the total assets of the sampled banks and their prestigious place in Chinese banking industry and national economy, their corporate governance arrangements are of particular significance to corporate governance in banking organizations in China. It is also the case that the sampled banks are the 'model' banks for Chinese banking institutions, and they are certainly prioritized by Chinese financial regulators and frequently consulted in the preparation of various principles and guidance regarding corporate governance in Chinese banks.

A second limitation of the research was the timeframe employed, as the main focus was upon a five year period study of the sampled banks, from 2008-2012. In this sense, some historical data was not included. However, as the thesis intends to study the contemporary constitution of corporate governance in Chinese banking organizations, such timeframe was sufficient to grasp the key arrangements and to identify processes of change set in train by the recent global financial crisis. Moreover, due to the relatively recent history of the sampled banks as public corporate entities, a longer sweep of historical data is not only incomplete but is also of limited value to the present research.

Another limitation in the research undertaken by this thesis relates to the focus on four key issues of corporate governance in Chinese banks; namely, the board of directors, the regulation of executive pay, risk management and legal obligation.

Other issues, such as transparency and the ownership structure, were not included in the research. Meanwhile, in discussing the aforesaid four issues, the thesis could have potentially explored each in greater detail. For instance, regarding the board of directors in Chinese banks, the research only briefly considered the board committees. Nevertheless, the present research explored the main and 'hottest' issues in the study of corporate governance in banking organizations in China, and the prioritization of these issues in the study was in part a reflection on the findings of the research process wherein representatives of banks and regulatory institutions identified and/or confirmed these issues as their principal concerns.

Finally, the present research has confronted certain methodological limitations. Due to confidentiality policies and sensitivity to external interviews in Chinese banking organizations, field work was reliant upon semi-structured and non-structured interviews. Other methods, such as non-participant observation, ethnography or survey, could not be employed in the study. It would, moreover, have been beneficial if the research process had included a greater number of interviews. However, interview methodology provided a highly effective basis for the present research, particularly as it enabled the study of the constitutive force of certain discursive institutions in corporate governance of banking organization in China. In addition, although the research interviews were comparatively limited in number, they were all undertaken with participants with roles and responsibilities closely connected to the present research.

To enhance the present research, improvements are planned for the future and allied research projects. For example, in order to further explore the general arguments made here about the constitution of corporate governance in Chinese banks, future research will consider a broader sample of banks. Specifically, the research will include the medium and small sized banks, and banks with less state influence such as the joint-equity commercial banks and highly privatized banks. Meanwhile, the future study may consider a longer time span for the sampled banks and collect more historical data, depending on the availability and accessibility of such data. For a deeper understanding of the governance practices in Chinese banks, the future research may include more key governance issues that have particular weight in Chinese context, such as the ownership structure and its influence on the bank's performance, and issues of transparency. It would also be possible for the further research to consider issues of risk management, for instance, in greater detail as national and global standards continue to evolve and change. The future research is expected to refine the research methodology as well, such as further interviews in more sampled banks, non-participation observation by means of joint research, etc.

Specifically, the future study may lay further emphasis on the quantitative method and take in more quantitative data for comparing with the qualitative data to achieve better viability.

*Policy Recommendation*

The thesis has argued that corporate governance in Chinese banking organizations should be understood as constituted through three levels of discursive institutions that I have termed legitimacy, paradigm, and frame. While primarily of academic importance, this argument and the findings which support it ensure that the thesis also holds important insights for financial regulators and banking practitioners. Though the model of the bank corporate governance promoted by international organizations or other developed economies may appear alluring, it may not be totally suitable for China considering the specific national configuration. In this context, a careful consideration of the legitimacy discourse should be explored as the starting point, such as Chinese bank's legitimacy in serving the real economy, integration into the national development strategy, close connection with the industrial sectors, and intertwining with the enterprises, SOEs or SMEs. Meanwhile, the constitutive role of the regulatory discourses should be given extra emphasis, considering both the close financial supervision and de-regulation in present China. The international discourse, on the other hand, may provide good references and lessons for Chinese banks, especially for those actively engaged in the global expansion. The legitimacy as discussed should be analyzed further for the formation of next two levels of discourses, the paradigm and frame. At the level of the paradigm, corporate governance in Chinese bank is constituted through orientations for priorities of the varied interest groups. In Chinese context, specifically, these may pertain to the increasingly significant enhanced shareholder primacy, and the stakeholder model. Particularly, a thorough study on whose interests should prevail and how to balance the interests between the shareholders (minority) and the stakeholders may be helpful in constituting the adequate governance structure in Chinese banks. At the level of frame, an overall governance arrangement should be constituted in the context of the specialty of Chinese banking industry, which covers the key issues like the balanced and more efficient board of director, better regulation on executive pay with proper incentives and concerns for risks, the more adaptive and efficient risk management system, and the effective legal obligation development. Specifically, though the arrangement of the specific governance structures in Chinese banks seem highly technical, serious concerns should be given for its resonance with the national paradigm and legitimacy discourse.

The discursive institutional analysis of corporate governance in Chinese banks may be helpful to Chinese regulators as well. In financial reforms targeted at improving the governance structure in Chinese banks, not only should the regulator consider how to enhance the particular governance mechanisms, but they need to consider the discourses at the level of the paradigm and legitimacy. For instance, the regulator should take into account what is the dominant discourse oriented in the bank group, whose interests are prioritized, and what is the significance of such paradigm on the development of the specific governance structure. More fundamentally, the regulator needs to explore the legitimacy discourse and seeks out the prevalent institutional settings for the bank governance, such as how the bank is positioned in the economy, what is the influence on the bank by the regulator and legal intervention, and what is the implication of the international discourse. And resiliently, the regulator should figure out how the legitimacy is projected onto the discourses of the paradigm and frame of the bank governance and henceforth propose adequate institutional changes.

## List of abbreviations

BIS Bank for International Settlements

CBA China Banking Association

CBRC China Banking Regulatory Commission

CCP Chinese Communist Party

CFWC Communist Party Central Financial Work Commission

CIRC China Insurance Regulatory Commission

CSRC China Securities Regulatory Commission

IMF International Monetary Fund

LTI Long-Term Incentive

MoF Ministry of Finance

NPLs Non-performing loans

PBC People's Bank of China

RMB Renminbi, Chinese currency

SAFE State Administration of Foreign Exchange

SASAC State-owned Assets Supervision and Administration Commission

SMEs Small and micro-sized enterprises

SOEs State owned enterprises

SHSE Shanghai Stock Exchange

SZSE Shenzhen Stock Exchange

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