A Review of Corporate Governance in China

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Abstract
The 2005 policy decision to change the status of non-tradable state and non-state shares into tradable A shares ushers in a new era in the stock markets of China. Over time all of these shares will be tradable and potentially transferred to foreign and domestic private sector investors. These changes have the potential to significantly alter the monitoring and control of the majority of listed firms that until now have been controlled by tightly held blockholders of non-tradable shares. It is therefore timely to reassess the corporate governance of Chinese listed firms. This paper reviews the theoretical and empirical corporate governance literature in China.

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1. Introduction

China’s long period of programmatic reforms initiated in the late 1970s appears now to be more focused on market reform in the post-WTO environment and the opening of the financial sector to greater foreign competition.

In the late of 1970s, China initiated an extended period of pragmatic reform ushering in a period of dynamic economic growth. The restructuring of the economy and the resulting efficiency gains have contributed to a more than tenfold increase in GDP since 1978, and in China becoming the second-largest economy in the world after the US in 2006, when measured on a purchasing power parity (PPP) basis (CIA, 2007). The Economist (2008) reports that China’s gross domestic product (GDP) grew 11.4 percent year-on-year to 24.66 trillion Yuan (3.43 trillion U.S. dollars) in 2007. To achieve this goal, over the past three decades China has dramatically changed many aspects of its economy. Corporate governance, being a major aspect of the corporate reform program, is not an unfamiliar to investors in China. The reform of the corporate governance system is now recognised as a vital component of the success of the economic reform in China.

In defining corporate governance in China, Clarke (2006) considers it as the set of rules and practices regulating relationships among participants in post-traditional Chinese business enterprise and that which governs decision making within that enterprise. Corporate governance in China tends to regulate relationships among all parties with interest in the business organization. Although post-traditional enterprises are no longer as tightly controlled by the state as they once were, most Chinese studies pay more attention to the two primary types of firms in China: state-owned enterprises (SOEs) and publicly held companies (PHCs). This paper reviews Chinese corporate governance and will focus on PHCs while recognising the bulk of listed firms remain within the control of the state either directly or indirectly.

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1 A post-traditional enterprise is an enterprise that is no longer tightly controlled by the state through the traditional planning system.
This chapter is organized as follows: Section 2 contains a review of corporate governance. Section 3 provides the information of corporate governance research in China. Section 4 briefly explains the two corporate governance codes in China. Section 5 describes issues with current corporate governance system in China. Finally, a summary and the conclusions are presented in Section 6.

2. Review of Corporate Governance
Recent corporate scandals around the world have highlighted deficiencies in corporate governance systems. The impact of these business events has forced a radical reassessment of how companies are directed. Mallin (2004) argues that corporate governance is a relatively new and evolving area and its development has been affected by theories from a number of disciplines including finance, economics, accounting, law, management, and organizational behaviour. The types of questions raised when we consider corporate governance are: How do investors secure a return on their investment? What is the proper level of authority for management in making business decisions? What is the appropriate level of residual rights allocated to managers? How do investors make sure that managers are not self-serving, nor misappropriate the assets? How do shareholders influence strategic decisions and the business operations of the company? How do investors influence managers’ behaviour? None of these questions are easy to answer, because none of the existing corporate governance models can resolve all these issues completely.

Shleifer and Vishny's (1997) paper is regarded as the first major attempt to consolidate the key theoretical influences on corporate governance. Their paper examines the overall corporate governance system around the world, and investigates investors’ protection and ownership concentration in particular. They posit that the key element of corporate governance is to provide good returns to investors on their financial investment. Therefore, legal protection of investor rights is considered one of the key issues of corporate governance, and countries with good corporate governance systems usually provide relatively better protection to investors. There is a prevailing view that strong legal protection of investor interest has made diffuse ownership feasible under the
common-law system, such as in US, UK and commonwealth countries (La Porta et al. 1998). In non common-law countries, legal protection for investor interests is typically vested with concentrated, rather than diffuse ownership (Gul and Zhao, 2000).

Generally speaking, corporate governance has been classified into two major categories: internal and external governance (Denis and McConnell, 2003; Gillan, 2006). Internal governance normally includes features of boards of directors, ownership and control, and managerial incentive mechanisms. On the other hand, external governance covers issues relate to the external market and government policies and regulations (Gillan, 2006). Denis and McConnell (2003) provide an excellent summary of corporate governance research. They posit that there are two major generations of corporate governance research. The first research generation focused on the internal governance mechanism, and tried to determine whether these internal mechanisms, such as board of directors, executive compensation and ownership and control, affect firm performance in individual countries. The second generation is more likely to consider the influence from external forces, such as market and legal and regulatory issues, on the structure and effectiveness of corporate governance around the world. The research of the second generation begins with the work of La Porta et al. (1998). Researchers now pay more attention to the relationship between the legal system and corporate governance mechanisms.

Recently, corporate governance has received much attention in Asia, particularly after the 1997 Asia financial crisis. Johnson et al. (2000) point out that poor corporate governance had a significant effect on the extent of currency deprecations and stock market declines in the Asian crisis. Their findings indicate that countries with weak legal protection of shareholder rights and poor enforcement were more susceptible to a fall in asset values and a collapse of the exchange rate. Eiteman et al. (2001) also support the notion that a weak corporate governance system was one of the major causes of the Asian financial crisis. The importance of legal protection to creditors and minority shareholders is also emphasized by La Porta et al. (1997).

Claessens and Fan (2002) provide a comprehensive corporate governance review in Asia
and confirm the limited protection of minority rights and highly concentrated ownership in Asia. Firms are normally controlled by one or more shareholders, thus the separation of management from ownership is rare and family controlled corporations are prevalent in East Asian countries. For example, the largest ten families control half of the total value of listed corporate assets in Indonesia, Philippines and Thailand (Claessens et al. 2000). Traditionally, some large Korean business groups (Chaebols), such as Hyundai, Samsung and Daewoo, were also family based (Ehrlich and Kang, 1999). In China, listed corporations are normally controlled by State and financial institutions, and tradable A-shares accounts for only a small part of total shares outstanding (Li and Naughton, 2007). Another interesting phenomenon in Asian countries is a pyramid ownership structure, which is defined as owning a controlling holding of the stock of one corporation which in turn holds a controlling interest in another, a process that can be repeated a number of times (Claessens et al. 2000). This raises some important questions. Why is ownership concentration more prevalent in East Asian countries? And why is significant corporate wealth in East Asia concentrated among a few families? Generally speaking, block ownership is attractive to blockholders when they can attain private benefits from controlling the firm (Shleifer and Vishny, 1997). On the other hand, investors may feel confident that their benefits are well protected through block shareholdings, especially in some countries without well functioning investor protection law and effective enforcement (La Porta et al., 1999).

Corporate governance issues have come to the fore in China particularly since the late 1970s, because the development of the corporate governance system is recognized as a vital component of the restructuring of SOEs. Before the economic reforms, Chinese industry was dominated by state ownership, and SOEs were the major economic contributors. Managers in SOEs were required to fulfil the production plans specified by the government rather than maximize the investment returns for the only investor — the state. The governance structure of SOEs was an integral part of the general government framework. At that time, SOEs were characterized by low productivity and efficiency, high input and low output.
Since the late 1970s, many trials were carried out to improve the overall financial performance and work efficiency of SOEs: profit retention, profit contracting and tax on profit (Liew, 1997). The opening of the Chinese capital market eventually accelerated the development of corporate governance in China. In addition, the introduction of a set of Laws provided a legal foundation for SOE reform, including SOE Law, Company Law, and Securities Law. These laws required corporations to form three statutory corporate governing bodies: the shareholders, the board of directors, and the board of supervisors. Shareholders meet at least once per year at the annual meeting as well as special shareholder meetings to vote on the company’s development strategy, investment plan and other important issues. The major responsibility of the board of directors is to minimize the costs that arise from the separation of ownership and decision control of the modern corporation (Fama and Jensen, 1983). The major function of the board of supervisors is to supervise directors and senior managers to make sure that they fulfil their responsibilities. In 2001 and 2004, the authority issued the “Code of Corporate Governance for Listed Companies in China” and the “Provisional Code of Corporate Governance for Security Companies”. These two Codes add many features of corporate governance that exist in some of the major economies of the world. Since China has become one of the key members in the world economy, it is important to have a deeper understanding of the current corporate governance system in China and the corporate governance studies related to the Chinese market. What has been lacking in this process is a sound theoretical framework to embrace the unique social/practical/economic environment of China.

3. Corporate Governance Research in China
In recent years, there has been a proliferation of corporate governance literature relating to China. There are two main streams. The first can be defined as descriptive of practice of prescriptive tests that recommend forms and best practice, examples include Hovey and Naughton (2007) and IFC (2005). The second represents more mainstream academic research exploring the evolution of corporate governance, particularly focusing on the growing number of listed firms. The literature ranges from traditional quantitative empirical work (Hovey et al., 2003; Firth et al., 2006; Dahya et al., 2003; Xu and Wang,
1999) and predominating qualitative studies that involve surveys and interviews (Mar and Young, 2001; Tobin, 2005).

### 3.1 Internal Governance

#### 3.1.1 Board of Directors

Issues related to boards of directors have been well documented. The major responsibility of board of directors is to minimize costs that arise from the separation of ownership and decision control of the modern corporation (Fama and Jensen, 1983). The board of directors receives its authority for internal control and other decisions from the stockholders of corporations. The major responsibilities of the board are to hire, fire, monitor and compensate management, and ensure that shareholders’ wealth is maximized. Traditionally, corporate board research globally has mainly focused on the relationship between board size (Yermack, 1996; Bhagat and Black, 2002), management compensation (Core et al., 1999; Martin and Thomas, 2005), board composition (Rosenstein and Wyatt, 1990; Bhagat and Black, 2002), the separation of CEO and chair (Bhagat and Black, 2002; Dahya et al., 2002) and firm performance and other strategic decisions, such as CEO turnover and takeover activities. Hermalin and Weisbach (2003) provide a comprehensive review in this area.

The findings of empirical research can be summarised as follows: (1) a board with more outside directors is not associated with superior firm valuation, but is associated with better decision making, such as CEO appointment, executive compensation, and CEO turnover; (2) there is no conclusive answer to the relationship between board size, the separation of CEO and chair, and firm performance. Recently, more attention has been paid to the evolution and determinates of board size and structure (Lehn, et al., 2003; Linck et al., 2008), busy boards (Fich and Shivdasani, 2006), and board interlocks (Larcker et al., 2005) in the corporate governance literature.

Turning to the Chinese studies, Liang and Li (1999) indicate that outside directors are positively associated with higher returns on investment in China, meanwhile, duality of titles and board size have no explanatory power on firm performance. Recently, Chen et
al. (2006) find that when there is a high proportion of external directors they are less likely to engage in fraud, which is consistent with the international literature. Chen et al. (2006) also argue that the combination of CEO and chair tends to lead to higher instances of fraud. A plausible explanation of this finding is that managers with more power are likely to abuse their positions and engage in fraudulent activities. However, based on their findings, Li and Naughton (2007) argue that board size and board composition do not impact on firm performance. One possible explanation might come from the launch of new policies and rules in the Chinese stock market in recent years. New policies detail the regulations covering board independence for all public firms. With the introduction of the requirement for greater board independence, board size typically increased as a consequence. Therefore these board variables are no longer distinguishable to investors. Alternatively, a theoretical explanation could be that the factors are endogenous and therefore do not have explanatory potential (Harris and Raviv, 2004; Hermalin and Weisbach, 2003). Clarke (2006) also questions the efficiency of outside directors in China because the unclear structure and their function is not clearly defined.

Another interesting board topic in China is the role of the supervisory board. Chinese listed companies adopt a two-tier board structure, a Board of Directors and a Supervisory Board. Xiao et al. (2004) and Dahya et al. (2003) question the usefulness of the supervisory board and suggest further improvement of the supervisory board’s independency and function enforcement. Clarke (2006) also states that the board of supervisors has been unable to play the monitoring role in Chinese companies simply because the supervisory board has no significant powers to monitor the daily business operations and appoint senior management members.

3.1.2 Ownership and Control: State and Institutional Ownership

The relationship between ownership structure and firm performance has been well documented. Recently, much of the research focuses on the behaviour of blockholders. Holderness (2003) reports that insiders control approximately 20 percent of the ownership of listed corporations in the U.S.. La Porta et al. (1998) also posit that ownership is heavily concentrated in developing economies. Claessens et al. (2000) find
that more than two-thirds of firms are controlled by a single shareholder, that the separation of management from ownership is rare and family controlled corporations are very common in East Asian countries. Faccio et al. (2001) report that family ownership in East Asia leads to severe conflicts with other stakeholders and poor firm performance. However, Anderson and Reeb (2003) argue that family owned firms perform better than nonfamily owned firms in the well regulated and transparent markets, because family ownership can reduce agency problems. Denis and McConnell (2003) conclude that concentrated ownership most often has a positive effect on firm value, in that large-block shareholders can monitor and control the company’s daily business activities to minimize agency costs. Holderness (2003) also confirms that block ownership can be motivated by the benefits of control, such as the decision rights and personal privileges.

In China, the major shareholders are likely to be institutions and the state rather than individuals, and the majority of publicly traded companies are state-controlled (Claessens and Fan, 2002). Prior studies have investigated the relationship between state ownership and firm performance in China, and find that firm accounting performance is negatively related to the level of direct state ownership (Xu and Wang, 1999; Qi et al. 2000; Hovey et al. 2003). If the state controls the company, it is not surprising that politicians and state-controlling owners sit on most board seats. The likelihood of finding a director representing minority shareholders is very small. The possible explanation of this phenomenon is that local politicians can use their connections to influence both the market and the firms under their jurisdictions, because at this stage the Chinese economy remains relationship-based, and firms can benefit from the services provided by politicians in creating economic rents and enforcing transactions (Claessens and Fan, 2002). Mallin and Rong (1998) also argue that guanxi (personal relationships) still plays an important role in business practices in China.

Another unique feature of the Chinese corporate governance model is large institutional shareholdings. As mentioned above, tradable A-shares only represent a small proportion of the total shares outstanding. In China, institutional shares, normally referred to as legal person shares, have two types of holdings: state legal person shares and legal person
shares. State legal person shares are shares held by other state owned institutions or enterprises, and legal person shares are shares held by non-state owned institutions or enterprises. However, most previous studies treat these two types of ownership as the same (Xu and Wang, 1999). Private legal person shareholders have distinguishing characters from state institutional shareholders and individual shareholders. Unlike state institutional shareholders, they can be assumed to be better motivated and more concerned with the financial performance of the companies. Moreover, they are elected to the board of directors and to the supervisory board, rather than being appointed. Typically they have more working experience in industry than that of state directors. Besides having voting power on important issues such as the selection of the management team and dividend policies, they can access corporate inside information and have the right to question management at any time about operations of the firm. Most previous studies of the Chinese market that identify legal person institutional holdings separately from direct state ownership find that holdings by legal persons are positively related to firm performance (Xu and Wang, 1999; Qi et al. 2000; Chen and Gong, 2000; Hovey et al. 2003).

Besides state, legal person, and tradable A-shares, Chinese stock companies also have employee shares, management shares and foreign shares. However, not many studies consider the influence of these types of shares, because normally these shares only account for a very small proportion of the total share outstanding, or only a few companies have these types of shares. Moreover, overseas investors can become holders of non-tradable shares through share issues by Chinese stock companies, but these shares are even less common than shares made to foreign investors of tradable shares. One of the major reasons might be that free market style mergers and acquisitions are not allowed. Xu and Wang (1999) indicate that there is no active takeover market in China. All major mergers and acquisitions are engineered by the state.

3.1.3 Managerial Incentives

Another major issue of corporate governance is that of determining the levels of the compensation of senior management teams, and the means by which they are made.
Normally managers receive their compensation in four ways in developed countries: salary, bonuses, perquisites and stock-based incentives. Tirole (2006) finds that the sensitivity of payment to performance has increased significantly since the early 1980s, and that stock options are becoming the most prevalent component of CEO compensation in the U.S. The evidence from other developed economies on this issue generally supports the U.S. evidence (Bryan et al., 2002).

Before the economic reforms began in the late 1970s, SOEs managers were paid based on a highly structured payment scale system. The state tightly controlled the major activities of SOEs, and all profits made by corporations were absorbed into the state budget and the state reallocated them wherever they saw fit (Shen, 1993). Managers of SOEs acted as government representatives and were paid based on their rank within the payment scale system. In other words, there was no incentive system to motivate managers to maximise the financial performance of the firm. However, the payment system has undergone dramatically changes since the late 1970s.

Management compensation in Chinese listed firms is now determined by the board of directors. In the early 1990s, more incentive motivated reward systems were introduced to SOEs. The most popular system was that the CEO’s compensation was made up of a cash salary and a performance bonus (Firth et al., 2006). However, the bonus payment system was not sufficiently flexible in practice. One of the major reasons was that the method of bonus payment was not clearly defined, and the formulae used in determining bonuses were not disclosed. Recently, listed Chinese firms have been encouraged to adopt a more practical approach to solve this problem, which is more performance related. It is worth noting that very few Chinese firms have executive stock option schemes.

There is a developing body of work regarding performance based approaches. Kato and Long (2006) find a significant relationship between the top executives’ compensation and shareholders’ value in China. Meanwhile, the sales growth rate also has significant relationship to executive compensation. Rui et al. (2002) find that CEO compensation is
significantly related to the return on assets, more so than for stock returns. In addition, firms with foreign shareholders tend to pay more to CEOs than firms controlled by the state. The explanation might be that foreign shareholders want to have the best available managers in the market and so the remuneration is higher. However, Liu and Otsuka (2004) argue that the new reward system has not brought the expected improvements in productivity. Mengistae and Xu (2004) conclude that little evidence of performance and compensation relationship has been found in their study. In addition, Firth et al. (2006) find that on average the sensitivity of pay to performance is low, and this raises questions about the effectiveness of incentive systems in China. These mixed results provide inconclusive evidence of the role of compensation in China.

3.2 External Governance

3.2.1 External Market
The literature on the market for corporate control indicates that external markets are important for facilitating mergers and takeovers of listed companies. In this context, well-functioning regulations and laws protect the benefits of investors, particularly small investors. Under this situation, it can be argued that high product market competition is the most powerful force toward economic efficiency. In the long-term, product market competition can force companies to minimize costs, upgrade technology and form suitable corporate structures to fit the needs of market (Shleifer and Vishny, 1997). In a market which facilitates the market for corporate control, the share ownership is widely dispersed. Therefore, the shareholder influence on management is weak. Unsatisfactory performance is often disciplined by shareholders selling and by subsequent takeovers.

However, takeover activity and an active external market are not always a component of the governance mechanisms around the world. China is a typical example. As mentioned before, free market style mergers and acquisitions are not allowed in China. In April 2005, the Chinese authorities announced the gradual floating of non-tradable state owned shares for all domestically listed companies. All listed companies are required to propose a reform plan to transfer the status of non-tradable shares and to develop a compensation package for existing tradable shareholders comprising flexible combinations of cash,
warrants and bonus shares. In addition, the authorities announced plans to allow foreign firms to acquire substantial holdings of tradable shares through the market, up to an initial limit of 10% of the target's stock. The central purpose of this reform is to convert non-tradable shares to tradable shares at a price acceptable to minority investors. Therefore, it is understandable that these sweeping ownership reforms will affect the performance of Chinese listed companies and through them the Chinese economy. The reforms are also having a major impact on the investing community and financial system in China. As a result, we are expecting a more active market for corporate control to develop with a significant impact on corporate governance practice.

### 3.2.2 Legal system

La Porta et al. (1998) argue that the legal system is a fundamentally important corporate governance issue. Early corporate governance studies normally focus on board structure, executive compensation, ownership structure or external control mechanisms. Recently, researchers have paid more attention to the importance of legal system (Denis and McConnell, 2003). In particular, they contend that strong legal protection for investor interests has made diffuse ownership feasible under the common-law system. They also argue that ownership is heavily concentrated in developing economies. In addition, La Porta et al. (1998) find that the concentration of ownership in the largest public companies is negatively related to investor protections, implying that small shareholders are unlikely to play a major role in countries that fail to protect their rights. La Porta et al. (2002b) find the evidence of higher valuation of firms in the countries with better protection of minority shareholders. The work of La Porta et al. (1998) set in motion of train of empirical studies that continues to this day.

Allen et al. (2005) examine China’s legal system based on the definitions of the measures employed in La Porta et al. (1998). They find that apparently China falls in between the English–origin countries and French-origin countries, implying China has the middle level of investors’ protection. However, the poor record of law enforcement and severe corruption problem put China at the bottom of the list of countries analysed, regardless of its legal origins. Allen et al. (2005) state that China is the one of the worst countries in
terms of political freedom and property rights protection, consistent with the findings of La Porta et al.’ (2004). In addition, the Chinese government still has the power to intervene in the practice of law enforcement. In the other words, China still does not have an independent and effective judicial system and sufficient number of qualified legal professionals (Allen et al., 2005). Yet, China is still enjoying one of the highest economic growth rates in the world; therefore, one could conclude that the legal system is not necessarily one of the fundamental factors restricting economic development. In short, Allen et al. (2005) conclude that China’s legal system is not ahead of any of the other major emerging economies despite its remarkable economic achievements. This implies that at this stage, without strict enforcement, corporate governance rules and regulations lack any creditable role in the domestic market. It is the voluntary adoption of best practice that has the potential to make a difference (Li and Naughton, 2007).

3.2.3 Financial system
The Chinese financial system has played an important role in supporting the nation’s economy growth, and it has undergone a significant change in the last two decades. This section provides a descriptive study of the Chinese financial system, and issues associated with the system.

3.2.3.1 The Chinese Banking Sector
Between 1950 and 1978, the People’s Bank of China (PBOC) was the only financial institution in China, and responsible for all government credit loans, income and expenses. After 1978, there has been substantial progress in the Chinese banking sector, such as monetary policy independence, banking autonomy and service diversification. Four state-owned banks were established and took over the commercial banking business from PBOC. Currently the Chinese banking sector is dominated by the “big four”: the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC) and the People’s Construction Bank of China (PCBC). The four state owned commercial banks collectively account for over fifty percent of the
total asset and liabilities (CBRC, 2007), and together with regional state owned banks dominate the banking sector. The PBOC and China Banking Regulatory Commission (CBRC) are two current regulatory bodies which are responsible for financial supervision, and policy issuing.

The banking system plays an important role in corporate governance in China. It is far from being a model similar to Japan or Germany where there banking sector is more directly involved in corporate governance and monitoring. In China, the banking sector has been closely involved with the corporate sector through relatively freely available lending, particularly to SOEs or listed firms with strong state connections. This relationship fosters weak corporate governance where banks are less inclined to monitor as is evident in the non-performing loan data. The absence of a viable corporate bond market reinforces the lack of financial market discipline on the corporate sector.

To date, the government still tightly controls the banking system in China. La Porta et al. (2002a) find that 99.45% of the top 10 largest commercial banks in China still are owned by the state and this ownership level is one the highest in the world. Generally speaking, government ownership of banks is high in countries with low level of per capita income, underdeveloped financial systems and inefficient government (Naughton and Hovey, 1999). Allen et al. (2007) also concludes that China’s financial system is dominated by a large, inefficient banking sector. The majority of loans are still allocated to the inefficient SOE sector, while the dynamic private sector relies more on borrowing from other sources (Allen et al., 2007). Recently IPOs by the banks have diluted this control and liberalization of foreign direct investment in regional banks is changing the Chinese banking landscape.

The most important problem of the Chinese banking sector remains the nonperforming loans (NPL hereafter) within the big four banks (Allen et al., 2005), and reducing NPL to sustainable levels is one of the most important tasks for China’s banking system in the

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2 Source: China Banking Regulatory Commission Website, http://www.cbrc.gov.cn
short term. According to CBRC, major banks in China carried NPLs of RMB 1.2 trillion on their balance sheets as of the 31 December 2006. Table 1 provides the overall information of China’s banking sector and reported distribution of NPLs across different types of financial institutions. As observed, the state owned commercial banks account for a substantial portion of the NPLs. As bad as the figures in Table 1 appear, they may be still significantly underestimated. Allen et al. (2007) argue that lack of clear classification of NPLs is a notable explanation. In addition, the official numbers of NPLs exclude the bad loans which have been transferred to the four state owned asset management companies (AMCs), discussed below.

### Table 1: Financial Institution in China and NPLs, December 31, 2007

<table>
<thead>
<tr>
<th></th>
<th>% of Total Assets &amp; Liabilities</th>
<th>NPLs (RMB Billion)</th>
<th>NPLs of Total Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Owned Commercial Banks</td>
<td>53.20%</td>
<td>1114.95</td>
<td>8.05%</td>
</tr>
<tr>
<td>Joint Stock Banks</td>
<td>13.80%</td>
<td>86.04</td>
<td>2.15%</td>
</tr>
<tr>
<td>City Commercial Banks</td>
<td>6.40%</td>
<td>51.15</td>
<td>3.04%</td>
</tr>
<tr>
<td>Other Financial Institutions</td>
<td>26.60%</td>
<td>16.28</td>
<td>4.53%</td>
</tr>
</tbody>
</table>

*Source: China Banking Regulatory Commission Website, http://www.cbrc.gov.cn*

Generally speaking, China’s huge NPLs burden is largely a result of poor lending decision to SOEs, and the lack of a commercial credit culture in major financial institutions. SOEs obtained the majority of this external funding from the banks, the big four in particular. However, the overall financial performance of SOEs is still not satisfactory. These banks often keep lending to underperforming SOEs even though they have little ability to repay, under perception that the ultimate losses will be covered by the government (Naughton and Hovey, 1999). The second major cause is the lack of a commercial credit culture in the Chinese banking sector. Senior managers of all major banks are typically appointed by the central government, so it is hard to believe that major banks have fully independent business activities. Major lending activities for infrastructure projects and social welfare subsidies sometimes are under the mandate of the government; therefore profitability is not the most important issue in the associated
decision making. As a result, lending processes and risk management skills are far from meeting international standards. Therefore, Allen et al. (2005) conclude that China’s financial system is dominated by a large but inefficient banking sector.

To address NPLs problem, the Chinese government set up four AMCs in 1999 to manage and dispose of NPLs which were bought from the big four state-owned commercial banks. The AMCs have adopted a variety of approaches to solve the huge NPLs problem since 1999. The primary approaches adopted include debt for equity swaps, liquidation methods and securitizations. For the debt for equity swaps, AMCs are entitled to purchase NPLs from SOEs at the agreed price, and further monitor the business activities of SOEs. Liquidation methods include sale or leases of real property, direct sales of packaged or individual NPLs to investors, and bankruptcy settlement. Securitization is a process of transferring non-marketable assets to a special purpose vehicle and issuing securities to investors with a “guaranteed” stream of cash flows generated by the assets. Legal support of securitization has been provided by the introduction of Trust Law in 2001. Recent reports (PricewaterhouseCoopers, 2007) indicate that as of the end of 2006, the AMCs have resolved RMB 1.21 Trillion of the 1999 transfer loans. The total sales to foreign investors from 2001-2006 is more than RMB 212 billion, roughly USD 26.4 billion. In an effort to minimize loss and maximize recovery, the AMCs will also provide debtors with such services like management consulting, off-market mergers, spin-offs, restructuring, and IPO recommendations. Moreover, the Chinese central government has injected foreign currency reserves into these banks to improve the balance sheets. However, all these methods of NPL reductions cannot prevent new NPLs from originating in the banking system. If the NPLs keep accumulating, it might lead to a financial crisis. This could spill over into other sectors and trigger an economic recession. Therefore, more effective approaches might be to relinquish state majority control of state-owned banks, and increase the levels of competition and efficiency. In terms of corporate governance, the banking sector performance does little to improve the system. The lax lending by banks props up weak governance and offers little by way of market monitoring of the corporate sector.
3.2.3.2 The Chinese Equity Market

In 1989, the State Council decided to establish two primary national stock exchanges markets. With the opening of the Shanghai and Shenzhen stock exchanges in 1990 and 1991 respectively, listed companies were able to raise funds from domestic and foreign investors. The primary initial purpose of opening the two stock exchanges was to raise funds for restructuring and fostering a more effective management system in SOEs selected for listings. Though the market was immature, the number of listed companies, trading volume and the total market capitalization grew quickly during the 1990s to become one of the largest in the region. According to the latest figures issued by the two stock exchanges as at April 2008, there are 690 companies listed on Shenzhen stock exchange with a total of 732 stocks issued, with having a total market value of more than RMB 4157.5 billion Yuan. As to the Shanghai stock exchange, in April 2008, 863 companies had stocks issued on it, for a total of 1,140 stocks issued with a total market value of more than RMB 17,198.8 billion Yuan. The emergence of the stock market characterizes a major change in the ideological framework of reforms in China, which represents an important constituent part of the process of ownership changes.

The National Development and Reform Commission (NDRC) and China Securities Regulatory Commission (CSRC) are the two official regulatory bodies responsible for monitoring stock exchange activities and security policy formulation. Until recently the NDRC and CSRC together determined how many shares in total should be issued each year in accordance with development objectives. As we can see, this process of selecting listing companies in China differed considerably from a mature market economy, where the decision to list an enterprise is normally governed by the listing rules of the stock exchange, and firms make listing decisions in collaboration with investments banking advisors.

China’s listed firms were burdened with poor corporate governance because of state control via majority ownership of shares. Some analysts argued that share prices had fallen over the several years because individual investors had no effective control over how firms were managed. As previously mentioned, the Chinese authorities announced
on 29 April 2005, that there would be a gradual market float of non-tradable state-owned shares for all domestically listed companies. The reforms undertaken involve a dramatic ownership structure change, by way of an increase in the supply of tradable company shares in the share market as it is rapidly opening to foreign strategic foreign investment by single share holding up to 10%. At this moment, the reform is still far from the final stage, so this might be a future research direction of Chinese corporate governance system. The gradual floating of all issued shares and the opening to foreign investors creates the potential for an active market for corporate control in China.

4. Corporate Governance Codes in China

In order to establish a complete modern enterprise system and standardize the operating process of listed companies and security companies, the CSRC has issued few regulations on corporate governance. In January 2001, the CSRC issued a “Code for Corporate Governance of Listed Companies” in China (hereinafter the LC Code). The Code is applicable to all listed companies within the boundary of the People’s Republic of China, and aims at the protection of investor’s interests and rights, the basic behaviour rules and moral standards for directors, supervisors, managers and other senior management members of listed companies. In January 2004, the CSRC issued a “Provisional Code of Corporate Governance for Security Companies” in China (hereinafter the SC Code). The Security Code is applicable to all listed companies with the boundary of the People’s Republic of China, and pays more attention to the operations of securities companies, ensuring the legitimate interests of shareholders, clients and other interested parties of the securities companies are well protected. These two Codes are the major measuring standard of evaluating whether a listed/security company has a good corporate governance structure. If major problems exist with the corporate governance structure of a listed/security company, the securities supervision and regulation authorities may instruct the company to make corrections in accordance with Codes.

The LC Code contains seven main chapters dealing with shareholder and shareholders’ meetings; the listed company and its controlling shareholders; directors and the board of directors; the supervisors and the supervisory board; performance assessments and
incentive and disciplinary systems; stakeholders; and information disclosure and transparency. The SC Code has a similar structure, and also addresses the issues related to management personnel and the basic principle of relationships between securities companies and clients. The brief summaries of the LC and SC Codes are as follows:

(1) Shareholder and shareholders’ meeting
A listed company should ensure fair treatment toward all shareholders, and all shareholders should enjoy the legal rights stipulated by laws, administrative regulations and the company’s articles of association. They should have redress through legal action if their rights are violated. The listed company should establish efficient channels of communication with its shareholders and shareholders should be informed of major matters that affect the company. Directors, supervisors and managers of companies should bear the liability of compensation if they breach laws and regulations. In related party transactions, these transitions should, in principle, be at market value.

Additional requirements related to security companies include requirements that shareholders and actual controllers of a security company have the qualifications required by the laws, administrative rules and CSRC regulations. Security companies and their major shareholders are required not to provide financing or guarantees to related parties or other shareholders directly or indirectly. Moreover, security companies are required to notify the CSRC if the company has a major change in the management team or ownership or having a heavy financial loss. There is also a legal requirement if a securities company suspects major illegal activities.

(2) Controlling shareholders
The controlling shareholders must comply with laws and regulations while exercising their rights as investors, and should be prevented from harming the listed company’s or other shareholder’s legal interests. Meanwhile the controlling shareholders have the right to nominate candidates for directorships and supervisory committee positions based on their professional skills, knowledge and experience. The decision-making rights belong to the general shareholders’ meeting or to the board of directors. Listed companies should
operate independently of their controlling shareholders in such aspects as personnel, assets and financial affairs. The board of directors, the supervisory committee and other internal offices of listed companies should operate in an independent manner.

(3) Directors and board of directors
The election of directors should be organized in a transparent, independent, open, and fair procedure. The detailed information about the candidates for directorship should be disclosed prior to the shareholders’ meeting. The election for directors should fully reflect the opinions of minority shareholders. The elected directors should “faithfully, honestly, and diligently” perform their duties for the best interests of the company and all shareholders, and they should contribute adequate time and energy to their duties. For the independent directors of a listed company, they should be independent from the listed company and its major shareholders and fulfil their duties faithfully and diligently. The board of directors should be made accountable to shareholders, should treat all shareholders equally, and should ensure that listed company complies with the relevant laws and regulations. The LC Code specified that by 30 June 2003, at least one-third of the board should be independent directors.

The SC Code, on the other hand, requires that inside directors of a securities company should not exceed half of the total directors, and appointing directors from outside professionals is encouraged. Independent directors of a security company should have the basic knowledge of securities markets and be familiar with relevant laws and regulations. They should be honest and creditable, and have more than 5 years’ working experience in related fields. The term of office of independent directors should be the same as that of other directors, but should not be renewed twice consecutively.

(4) Supervisors and supervisory board
The supervisory board of a listed or securities company should supervise the corporate finance, monitor directors’ performance, and protect the company’s and shareholders’ legal rights and interests. Supervisors should have professional knowledge or relevant work experience in such areas as law and accounting. The structure and the members of
the supervisory board should be able to independently and efficiently fulfil their duties. The supervisory board’s meeting should be minuted. The supervisory board may require the directors, management personnel or other related persons to attend the supervisory board meeting and answer the questions that the board is concerned about. Securities companies are encouraged to appoint outside professionals as their supervisors.

(5) **Performance assessments and incentive and disciplinary systems**

The performance of directors, supervisors, and management of a listed or security company should be assessed through a fair and transparent procedure, and evaluation processes should be conducted through a combination of self-review and peer review, and approved by the board of directors. The evaluation results and compensation of directors and supervisors should be reported to the shareholders’ meeting. The appointment and removal of senior staffs should comply with legal procedure in a fair, independent and transparent manner, and should be publicly announced. The compensation for management personnel should be related to the company’s performance and the individual’s work performance.

(6) **Stakeholders and clients relationship**

A listed or security company should respect the legal rights of the various stakeholder groups and provide the protection to the interest related parties, such as creditors, employees, consumers, suppliers, and communities. Employees in particular are encouraged to provide relevant feedback to improve the company’s overall performance.

Moreover, securities companies should observe the laws and regulations when providing products or services to clients, should give full disclosure of the contents and risks of the products or services, and should not infringe the client’s property rights, options, right to fair deals, right to be informed and other legitimate rights and interests. In addition, securities companies should not misappropriate the clients’ settlement funds for transactions, properties entrusted by the clients for management and the securities deposited by the clients in the company. Securities companies are encouraged to release
their audited annual financial report to the public and make sure the contents of such disclosure are true and accurate.

(7) Information and disclosure and transparency
A listed company should disclose all information that may impact on the decisions of shareholders and stakeholders. The importance of the provision of truthful, complete and timely information is emphasized. The disclosed information should be accessed by the shareholders and stakeholders in an economical, convenient and speedy manner. The corporate governance information of the company should be available to the public, plus the explanation if there is a gap between the company’s corporate governance and the Code. Furthermore, detailed information of major shareholders and changes of major shareholders should be available to the public accurately and in a timely manner.

To further strengthen the corporate governance activities in the Chinese market, the CSRC has issued a series of regulations called “Standards Concerning the Contents and Formats of Information Disclosure” in shares, bonds, and other types of securities issued since August 2003. These regulations aim to standardize the information disclosure activities for public offering of securities by the listed and securities companies and protect the legal rights and interests of investors.

5. Issues in the Current Corporate Governance Model in China
On the surface, these codes provide similar guidelines to those found in codes issued in many other parts of the world. This implies that Chinese listed firms and securities companies have a corporate governance system which is similar to the characteristics of a corporation in a mature market economy. However, Clarke (2003) argues that the fundamental dilemma of SOE reform stems from the state policy of maintaining a full or controlling ownership interest in enterprises in several sectors. On the one hand, the state wants the SOEs to be efficient, while wealth maximization is not the sole objective of SOEs, otherwise, there would be no rationale for maintaining state ownership. Claessens and Fan (2002) also argue that the issue of the ownership of a firm’s value is more complicated when the state is the controlling owner. First, the state is not the ultimate
owner, but the agent of the ultimate owners – the citizens. However, the motivation of value maximization is not an incentive for the state because of other political priorities, as well as the corruption that is evident in China (Che and Qian, 1998; Lin et al., 1997; Peng, 2001). Second, there are many different types of governmental agencies that control the equity stake of companies. For example, ownership controlled by the central government may have different incentives from ownership controlled by local or regional governments, or state institution ownership. Third, it is hard to distinguish the relationship between state ownership and firm performance, especially in socialist countries, such as China, because other institutional structures must also be taken into account. Faccio (2006) finds that companies with stronger links to the government have higher leverage, lower taxation, and higher market shares, but they underperform non-connected companies on accounting measures. Furthermore, she points out that this phenomenon is more popular in countries with higher levels of corruption, with barriers to foreign investment, and less transparent systems.

Several key problems in the Chinese corporate governance system are well documented (Hovey et al. 2003; Lin, 2004; Allen et al., 2005; Clarke, 2006). The first is the highly concentrated ownership structure. Companies with a widely dispersed ownership structure where no individual owns a controlling block of shares are virtually-non-existent (Clarke, 2006). Albeit, in China in instances where private blockholders own controlling blocks of shares, the findings of Hess et al. (2008) indicate that expropriation of minority investors does exist. Market liquidity is severely impeded because the state and legal person shares cannot be traded on the stock market because of trading restrictions, resulting in only around 35% of total shares being freely tradable. This has significantly reduced market liquidity and has become a major obstacle to market efficiency. In addition, those large investors may only act in their own interests at the expense of individual investors, suggesting individual shareholders’ interests are not well protected, irrespective of whether blockholders are state or private sector investors.

The second key problem is insider trading, self dealings, collusion and market manipulation, although the Chinese government has policies against these activities
The major cause of these issues is the absence of effective monitoring of companies by their directors and supervisory boards and of the market by regulatory authorities. In addition, at no stage in the chain of monitors are there appropriate incentives because the ultimate owner of SOEs and most listed firms is the state (Clarke, 2003). Moreover, to attract outside investors, companies were found to provide falsified financial information to the public in order to hide their efficiencies and mismanagement, and those companies definitely severely damaged the reputation of the Chinese stock market (China Economics Time, 2001).

The third major problem is the dysfunction of the board of directors, board of supervisors and other relevant committees (Tam, 2002; Schipani and Liu, 2002). By law, large shareholders have more power on directors’ appointments due to the one share one vote principle, and it is hard to see that directors represent minority shareholders’ interests even though the LC Code requires recognition of minority interests in appointment (Clarke, 2006). One of the major reasons is that politicians and state-controlling owners sit on most boards and committees because of the highly concentrated ownership structure. As a result, these boards and committees lack independency. Chen et al. (2002) find that around 80 percent of directors on Chinese boards are closely connected to the government or governmental agencies, and only a few are professionals (lawyer, accountants or finance experts). The likelihood of finding a director being concerned with or representing minority shareholders is very small. Moreover, Clarke (2006) claims that supervisory boards lack the power to control directors and the management team, and plays no important role in corporate governance in China.

The final key problem is the legal system (Tam, 2002; SSE, 2003). La Porta et al. (2003) find that enforcement of laws is more effective than just having strong regulations, and is particularly relevant to China. Allen et al. (2005) argue that the inefficiencies in the Chinese market can be attributed to poor and ineffective regulation and enforcement. Lin (2004) identifies four areas of weakness in the Chinese external governance structure: lack of information transparency and professional managers; weak legal enforcement; the absence of or weak monitoring by banks, professional organizations, and the media; and the
insignificant roles played by individual shareholders and small institutional shareholders. As a result, the Chinese stock market is characterized by: a short history; an extremely high (but volatile) growth rate; high government intervention; low transparency and weak investor protection.

To solve these problems, a number of suggestions have been proposed by researchers (Lin, 2004; Clarke, 2006; Allen et. al, 2007). Generally speaking, a well discussed suggestion is to make the non-tradable shares tradable. The limitations of large block of non-tradable shares have been well documented, and the Chinese authorities have previously attempted to resolve this problem in 1999 and 2001. However, these two attempts did not receive a positive market reaction as the proposals were not attractive to tradable shareholders. In 2005, the Chinese authorities made the third attempt to introduce a programme of gradual floatation of non-tradable shares for all domestically listed companies. More than 1500 listed companies are involved and each company was required to provide a compensation package for existing tradable shareholders comprising flexible combinations of cash, warrants and bonus shares and approved by the general shareholders’ meeting. While the bulk of state and legal person shares are now technically tradable, there are restrictions in place on the quantity that can be traded for a several more years. This ongoing reform will have an extensive impact on the investment community and financial system in China in the long run.

Second, the functions of board of directors and supervisors have to be clearly defined, strengthened and made more independent. To improve the quality of the board’s operations, more professional and/or independent directors and supervisors are required to sit on boards and minority shareholders’ interests should be explicitly considered during the process of director appointment. There is also a need to strengthen and enforce requirements to operate specialised committees of board of directors, such as corporate strategy committee, nomination committee, remuneration committee, and auditing committee. The LC Code is weak in this respect. The legal and regulatory system must be given greater powers to enforce. All these committees should be composed entirely of independent directors. Moreover, a more clearly defined performance related
compensation mechanism should be implemented for directors and supervisors.

Third, as observed above, China needs to have well functioning investor protection laws and more efficient legal enforcement systems. The enforcement of laws and regulations must be effective enough to deter irregularities in China. More specified explanations of laws and regulations should be implemented to minimise the legal “grey’ area. From the corporate governance aspect, the major concern is to monitor the expropriation of the investors by senior managers. Therefore, managers also should be properly motivated instead of expropriating investors by entrenching themselves by staying in their position even though they are not qualified for the job or are no longer effective, or any other means.

Fourth, there is a need to provide better protection for the interests of individual investors and enforce their rights. Several approaches need to be introduced: (1) enhancing shareholders’ voting mechanisms; (2) entitling shareholders to question the company’s business operations; (3) lowering the minimum required number of shares for the shareholders to raise proposals; (4) safeguarding the interests of minority shareholders; and (5) increasing the legal obligation of controlling shareholders (Lin, 2004).

The Chinese government appears to have realized the existing flaws in the current corporate governance system, and has implemented several policies to improve the market efficiency and the overall quality of public companies in China. Although there are many laws and regulations governing the corporate behaviour of companies, further attention should be paid to the political/legal will, efficiency and transparency of legal enforcement. Evolution in the corporate governance in China provides a framework for corporate governance experiments. We argue that China has undergone considerable corporate governance evolution but has yet to establish a unifying system that balances social-economic forces with the economy. China has a unique environment and the evolution of corporate management, supervision and governance is likely to continue to develop into a uniquely Chinese system. China has the opportunity to capture best international practice while controlling the excesses of the existing internal weaknesses.
6. Concluding Remarks
This chapter has reviewed the complex process of transition that China has experienced in enterprise reforms and the emergence of a system of corporate governance. Legal, institutional and regulatory reforms have accompanied this transition. The review has focused on the problems and challenges in implementing a corporate governance system in China. A central issue is the still powerful influence of the state in the corporate sector of the economy. We document the problems that remain and make suggestions for ongoing change. However, in conclusion we recognise that dramatic change in terms of enforcement and compliance will not happen overnight. Culture and systemic barriers remain powerful and the operation of an efficient and ethical corporate governance system that protects the interests of all parties is still an ambitious goal. However, we have observed the lack of what might be regarded as a best practice corporate governance system has not to date been an impediment to economic growth. The remarkable economic success of China in recent history has been achieved with a unique system of economic management and corporate regulation and governance.

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