China's banking sector Reform from corporate governance perspectives

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CHINA'S BANKING SECTOR REFORM FROM CORPORATE GOVERNANCE PERSPECTIVES

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Abstract: Firm corporate governance issues in China have been extensively studied since the early 1990s while corporate governance issues in Chinese banks have been ignored. To assist in filling in this gap, by using the corporate governance conceptual framework of firms, this paper carefully examines the governance problems that continue to plague the Chinese banking sector and then argues that state ownership or state concentrated ownership of Chinese banks may be the primary factor contributing to ineffective corporate governance in the Chinese banking sector. In order to solve ineffective governance problems in the Chinese banking sector, privatization may eventually be necessary.

INTRODUCTION

Corporate governance issues have been extensively studied in China since the early 1990s, when the corporate governance concept was first introduced from the West. However, the literature has tended to focus on the corporate governance issue of state-owned enterprises (e.g., Wu, 1994; Zhang, 1997; Lin, C., 2001; Tenev et al., 2002; Tian & Estrin, 2005; Xu et al., 2005) while ignoring that of the Chinese banks. The present research assists in filling in this gap. Using the corporate governance conceptual framework of firms, the governance problems that continue to plague the Chinese banking sector (especially the state-owned commercial banks) are carefully examined. Based on the theoretical discussion of the corporate governance issues of Chinese banks (especially those relevant to the state-owned commercial banks), this research argues that state ownership or state concentrated ownership of Chinese banks may be the primary factor contributing to ineffective corporate governance in the Chinese banking sector. In order to reduce political and agency costs, and solve the insider control problem facing the state-owned commercial banks, privatization may eventually be necessary for the establishment of effective Chinese banking corporate governance with the market supporting institutions, such as the rule of law.

LITERATURE REVIEW

The corporate governance literature is replete with studies involving firms in the non-financial sector. In contrast, the issue of banking corporate governance appears to be under-researched. Even in developed economies, researchers have only recently turned their attention towards the bank governance issues (e.g., Denis & McConnell, 2003; Levine, 2003; Macey & O'Hara, 2003; Caprio et al., 2004; Arun & Turner, 2004).

The concept of corporate governance was first introduced to China from the West in 1993, and since 1999, the concept has been officially cited in major Chinese government documents and by government agencies (e.g., Zhou, 2004; Zhang, 2004). The China Securities Regulatory Commission (CSRC) and China

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Banking Regulatory Commission (CBRC) have even gone so far as to issue guidelines on corporate governance regarding both firms and banks (Shi & Weisert, 2002). The academic study of corporate governance issues related to Chinese state-owned enterprises has been growing very rapidly in recent years (e.g., Wu, 1994; Zhang, 1997; Ferri, 2003; Tenev et al., 2002; Clarke, 2003; Tian & Estrin, 2005; Xu et al., 2005), in contrast, very few studies have been done on the corporate governance and ownership issues of Chinese banks. This paper attempts to help fill this gap. Utilizing corporate governance concepts, this paper analyzes the corporate governance and related ownership issues of the Chinese banks, especially those of China's big four state commercial banks.

This paper is organized in the following manner. Section two briefly introduces the general concepts and issues of corporate governance. Section three discusses governance and ownership issues facing the Chinese banking sector in the context of ongoing banking reform. The last section provides some policy implications and ends with conclusions.

CORPORATE GOVERNANCE: CONCEPTUAL FRAMEWORK

Generally, there are two major definitions of corporate governance in the academic field. In a narrow sense, corporate governance is considered as the mechanism through which shareholders are assured that managers will act in their best interest (Levine, 2003; Arun & Turner, 2004). In a broad view, corporate governance is viewed as the mechanisms by which financial suppliers control managers so as to ensure their capital cannot be expropriated and that they maximize investment return (e. g., Shleifer & Vishny, 1997; Oman, 2001).

Regardless of how corporate governance is defined, there are two major issues that concern it: the agency problem and insider control problem. First, the agency problem is possibly the central element of corporate governance (e.g., OECD, 2004). It concerns the unwillingness of some firm mangers to consistently act in the stockholders' best interests. It is believed that it results from the separation of ownership and control whereby the managers operate the firm in terms of their interests, not those of shareholders (Jensen & Meckling, 1976; Fama & Jensen, 1983; Henderson, 1986). The agency problem also presents managers with opportunities to build their own empires while neglecting shareholder responsibilities (Levine, 2003). In order to solve the agency problem, it has been argued that product market competition (including takeovers) force firm managers to listen to shareholders who pressure them to act with self discipline (e.g., Alchian, 1950; Jensen, 1988; Kose & Simi, 2000). However, Shleifer and Vishny (1997) argue that product market competition is probably the most powerful force driving economic efficiency in the world. However, they doubt it alone is not sufficient to solve the corporate governance problems. To solve the agency problem caused by management control, Jensen (1993) suggests that it may be necessary to strengthen corporate governance internally, especially by enhancing the roles of both directorial boards and large shareholders involved in the corporate governance.

The insider control problem may also arise from the power of certain controlling shareholders over minority shareholders due to information asymmetries, the costly process of monitoring and a weak legal system (e.g., OECD, 2004). Controlling shareholders may influence management for their own benefits at the expense of small investors' interests (Gillan & Starks, 2003). If the interests of small investors are not properly protected by the legal system, they might lose confidence and incentives to make investments, resulting in a hindering of the capital market development. In order to solve the insider control problem, some (e.g., OECD, 2004) argue that it is necessary to increase the role of market competition as well as the legal system in order to protect the minority investors' interests equitably.

THE GOVERNANCE ISSUES OF THE CHINESE BANKING

With the Chinese banking sector being increasingly liberalized in the past twenty years, bank managers in the Chinese banks have gradually gained more control rights over their business decisions (Zhang, 2000). The governance structure has been changing as the Chinese banks (e.g., BOC, CCB and regional commercial banks) are now encouraged to adopt a shareholding ownership structure. The governance issues and related ownership problem in the Chinese domestic banks have become more obvious than before.

Political Control and Agency Problems

Prior to the initiation of economic reform in the early 1980s, the Chinese banks were fully controlled by the state, which exercised control rights over all decisions ranging from operations to personnel (e.g., Zhang, 1998; Qian, 2001). On the one hand, this complete state involvement in the banking activities contributed to a lack of managerial incentives (La Porta et al., 2002). On the other hand, it fostered politically-motivated or misinformed business decisions (e.g., Sherif et al., 2002; Ferri, 2003; Hamid, 2005). As a result, lack of managerial incentives and full political controls (La Porta et al., 2002) in the pre-reform period contributed to poor performance and inefficiencies in the Chinese banking sector.

In the mid-1980s, China realized that the managerial incentive problem needed to be addressed. In order to increase the bank managerial incentives, the state started to allow bank managers more rights regarding business operating decisions (Zhang, 2000). This managerial right has produced mixed results. On the one hand, this resulted in improved business decisions, which contributed to better performance and higher levels of banking efficiencies. On the other hand, this contributed to agency problems. More business control rights meant that bank managers now enjoyed more actual authority. As mentioned before, bank managers might not always act in the bank's best interest, thus they might be strongly motivated to use their newly acquired power to serve their private interests. This actually occurred with Chinese banks during the reform period. The related agency problems such as corruption, misuse of power, and stripping of state bank's assets for private interest or benefits occasionally occurred in China (e.g., Tian & Estrin, 2005). Why has the Chinese state, which is the sole owner with the most controlling power over the Chinese banks, been so apparently challenged in effectively monitoring bank managers?

Researchers (e.g., Qian, 2001; Tian & Estrin, 2005; Xu et al., 2005) have argued that information asymmetry contributes to the Chinese political bureaucrats' inability to effectively monitor bank managers. Because those political bureaucrats lack direct involvement in banking operation, they tend to not be sufficiently well-informed to assess the effectiveness of bank managers' actions. As the sole shareholder, the Chinese government is especially challenged in monitoring the bank managers in that nation. Estrin and Perotin (1991) argue that the non-economic agenda of political bureaucrats contributes to their ineffectiveness at monitoring bank managers, because their political agenda tends to be contradictory to the economic agenda of bank profitability and efficiency. Moreover, they argue that the mixing of economic (commercial lending) and non-economic agendas (policy lending) in the Chinese banking sector during the reform period has complicated the bureaucrats' monitoring of bank managers. It increased the bureaucrats' difficulty in assessing bank managers' performance as bank managers are able to attribute their poor performance or bank failures to political influence (e.g., policy lending) or political interventions. As a result, government bureaucrats are discouraged from placing harden budget constraints on bank managers.

When the banks face dire circumstances, the state has to come to their rescue. Large amounts of public funds were funneled into the Chinese four state commercial banks between 1998 and 2003 (Tang, 2005), providing evidence that the state banking sector continues to face the soft-budget constraint problem.

Ambiguous property rights of Chinese banks also may contribute to the inability of political bureaucrats to effectively monitor bank managers (Zhang, 1997). Chinese banks belong to the state, which in China means banks are owned by the whole of the people, but no one person. Political bureaucrats represent the state, but are not the owners of the state banks. In a legal sense, they do not possess residual claimant rights. Hence, political bureaucrats may lack incentives to appoint competent managers when they select them, and they might also lack incentives to monitor bank managers (Zhang, 1999).

Table 1: Assets and Liabilities of the Banking Institutions in China as of December 31, 2003

Financial Institutions	Assets (100million RMB)	Share	Liabilities (100million RMB)	Share
All Banking institutions	276394.5	100.0	265741.0	100.0
Policy banks	21247.0	7.7	20290.5	7.6
SOCBs	151940.6	55.0	145762.0	54.9
JSCBs	38169.7	13.8	36831.0	13.9
City commercial banks	14621.7	5.3	14122.5	5.3
Rural commercial banks	384.8	0.1	380.1	0.1
UCCs	1468.3	0.5	1464.3	0.6
RCCs	26509.2	9.6	26646.2	10.0
NBFIs	9100.0	3.3	7682.6	2.9
Postal Savings	8984.4	3.3	8984.4	3.4
Foreign-funded FIs	3969.0	1.4	3577.3	1.3

Source: The China Banking Regulation Commission website: http://www.cbrc.gov.cn/english/index.htm.
Note: The banking institutions include policy banks, state-owned commercial banks (SOCBs), joint stock commercial banks (JSCBs), city commercial banks, rural commercial banks, urban credit cooperatives (UCCs), rural credit cooperatives (RCCs), non-bank financial institutions (NBFIs), postal savings institutions and foreign-funded financial institutions.

As mentioned above, due to an ineffective monitoring mechanism in the Chinese banking system, bank managers do not act always in the best interests of the state. Thus, the agency problem and related political control problems arose during the reform period. The dilemma of Chinese banking sector over the past two decades is that either the bank managers complain of a lack of autonomy or the state, as an owner, loses control and suffers from lack of bank management accountability. In order to solve the agency problem and political control in the Chinese banks, the Chinese banking sector reform should perhaps address the most fundament issue: the state ownership that caused the agency problem. Thus, the ownership reform (privatization of the banking sector) perhaps is the key to establishing effective corporate governance in the Chinese banking sector.

Table 2: Shareholders of China Construction Bank Corporation (by June, 2005)

Shareholder	Ownership	Capital Contributions (RMB '000)	Proportion (percent)
China SAFE Investments Limited	Wholly Government-Owned	165,538,000	85.228
China Jianyin Investment Limited	Wholly Government-Owned	20,692,250	10.653
State Grid Corporation of China	Wholly Government-Owned	3,000,000	1.545
Shanghai Baosteel Group	Wholly Government-Owned	3,000,000	1.545
China Yangtze Power Co., Ltd.	Joint-stock company	2,000,000	1.030
Total		194,230,250	100
Bank of America	Foreign	US$ 2.5 billion	9

Source: Compiled by the author from China Construction Bank Corporation Annual Report (2004), and the report from *People's Daily* (June 17, 2005, p. A3).

Note 1: According to an agreement signed by Bank of America and China Construction Bank Corporation, Bank of America purchased US$ 2.5 billion buying stakes from the largest shareholder of CCB, China SAFE Investments Ltd., and will purchase US$ 500 million of shares later 2005 in CCB's IPO. It also had an option to buy additional shares in the future to increase its ownership in CCB to 19.9 percent.

Note 2: China Yangtze Power Co., Ltd. is a joint-stock company, however, it is owned by Three Gorges Project Corporation with 5 other entities: Huaneng Power International, Inc.; China National Nuclear Corporation; China National Petroleum Corporation; China Gezhouba Water Resources and Hydropower Engineering Group Co., Ltd.; Changjiang Water Resource Commission's Changjiang Institute of Survey, Planning, Design and Research, all of which are state-owned enterprises.

State-Owned or Concentrated Shareholders and Insider Control

The other major governance issue facing the Chinese banking sector is insider control regarding state ownership and state-concentrated shareholders. As Table 1 indicates, the majority of Chinese banks are either wholly owned by the state or at least have state concentrated ownership. In other words, the state is either the sole owner of Chinese banks or the sole largest shareholder of the Chinese banks. Because of large investment and information asymmetry, the Chinese state has more incentives and ability to acquire information and monitor managers than small shareholders. Thus, state ownership or concentrated ownership can monitor managers, reducing the managerial agency costs in the short run (e.g., Qian, 1995; Orman, 2001; Levine, 2003). During the reform period, the Chinese government removed many high-ranking bank managers for abusing their power for their personal interest or benefit (Guo, 2003). However, as discussed above, in the long run, the agency problems occasionally occurred due to ineffectively monitoring by political bureaucrats in the Chinese banking sector.

Additionally, this full state or concentrated ownership may contribute to the other governance problem, insider control. Due to the Chinese government's large bank investments, its benefits can be maximized through its control rights over management at the expense of small shareholders' interest. This potentially may lead to hindering the financial market development in China. As the government continues to hold a controlling share, it will clearly be able to continue to influence bank management decisions through directorial and supervisory board participation. For example, the largest shareholder of China Construction Bank (CCB) is the SAFE Investments Ltd, which represents Chinese government organizations - the State Administration of Foreign Exchange (SAFE), the Ministry of Finance (MOF) and the People's Bank of China (PBC). As it is shown in Table 2, it holds a controlling share of the CCB (76 percent) even after the Bank of America purchased a nine percent share of the Bank. Under this new governance structure, the Chinese government will be able to play a dominant role through the SAFE Investment Ltd. This new arrangement at the CCB, with the state holding a controlling share, will be challenged in solving not only the agency problems, but also conflicts of interest between the Chinese state (largest shareholder) and small shareholders.

To sum up, from the corporate governance perspective, it can be concluded that the Chinese banking sector is challenged by agency problems and insider control issues, and that both of these concern Chinese state ownership or state-concentrated ownership. Thus, in order to improve the bank governance structure in China, the first step the government should consider taking is to change the Chinese state ownership. In other words, relinquishing state ownership of banks to the private sectors will likely be an option worthy of consideration.

POLICY DISCUSSIONS

Reshaping the Ownership Structure in the Chinese Banking Sector

As discussed above, the full or concentrated state ownership of the banking sector is perhaps one of the major causes of poor governance structure in the Chinese banking sector. With the deepening of the economic reform and further opening of the Chinese economy, the ownership reform has become one of the most important elements in the establishment of effective corporate governance in the Chinese SOEs and the banking sector.

So far, diversification of ownership seems to be an effective way of improving the governance structure of the Chinese state-owned or state-dominated banks. With more private investors (e.g., domestic and foreign strategic investors) getting involved in purchasing shares Chinese domestic bank shares, the better the governance structure will likely become (Gillan & Starke, 2003). This is because those investors' involvement will not only help improve the governance structure of the Chinese banks by introducing their advanced management expertise and advanced management philosophy, but also by creating a competitive market for the Chinese domestic banks. In order to survive in a more competitive banking market, the Chinese bank managers will be required to serve the best interests of their shareholders. Otherwise, they might be threatened to be fired. In this sense, diversification of the ownership structure, to some extent, will likely have a positive effect on the agency problem (e.g., abuse of managerial power, corruption, etc). With the government relinquishing its ownership or controlling shares of the Chinese domestic banks, the competitive market will likely become influential in pressuring the Chinese domestic bank managers to best serve their shareholders' interests, thus, the profitability and efficiency of the Chinese banks will likely increase as a result.

Recent reforms in the Chinese banking sector appear to be on the right track. *The Guidelines on Corporate Governance Reforms and Supervision of Bank of China and China Construction Bank*, issued by the CRBC in March, 2004 (CRBC website, 2005), clearly encourages state banks to introduce domestic and foreign strategic investors in an effort to diversify their ownership structure in the future. The CBRC even raised the maximum equity share held by a single foreign investor in a Chinese financial institution from 15 to 20 percent. As Table 3 shows, foreign banks are increasingly becoming shareholders in the Chinese domestic banks, with some becoming the second largest shareholders in certain Chinese domestic banks (e.g., HSBC in the Bank of Communications, 19.9 percent; New Bridge Capital Group in Shenzhen Development Bank, 17.89 percent; Standard Chartered in Bohai Bank, 19.9 percent). The HSBC, as the second largest shareholder of the Bank of Communications, now sits in both the directorial board and executive management of the Bank of Communications.

It appears unlikely that the Chinese government will relinquish its controlling share in the Chinese domestic banks in the near or intermediate term. In the long run, with the market institutional buildup,

Table 3: Foreign Ownership in China's Local Banks

Chinese Domestic Banks	*Foreign Financial Institutions*	*Month /Year*	*Million US $*	*Share*
Industrial and Commercial Bank of China	Goldman Sachs Group Inc.	01/2006	258	7.00
	American Express Co.	01/2006	28.0	1.00
	Allianz AG	01/2006	92.0	2.00
Bank of China	Asian Development Bank	03/2006	NA	0.23
	USB AG	03/2006	NA	1.55
	Asian Financial Holdings Pte. Ltd.	03/2006	NA	4.80
	RBS China Investments SARL	03/2006	NA	9.61
China Construction Bank	Bank of America	06/2005	250	9.00
	Temasek	09/2005	150	5.10
Jinan City Commercial Bank	Commonwealth Bank of Australia	11/2004	120	11.00
Bohai Bank	Standard Chartered	11/2004	175	19.90
Shenzhen Development Bank	New Bridge Capital Group	10/2004	150	17.89
Bank of Communications	HSBC	08/2004	175	19.90
Fujian Asian Bank	HSBC	12/2003	20	27.00
Fujian Industrial Bank	Hang Seng Bank (HSBC Group)	12/2003	207.95	15.89
	Singapore Government Investment Corp.	12/2003	NA	5.00
	International Finance Corp.	12/2003	NA	4.00
China Minsheng Banking Corp.	International Finance Corp.	11/2003	23.5	1.22
Nanchong Commercial Bank	German Development Finance Group DEG	01/2003	NA	NA
Pudong Development Bank	Citibank	11/2003	72	4.62
Xi'an City Commercial Bank	International Finance Corp.	09/2002	NA	12.4
	Canada's Nova Scotia Bank	09/2002	NA	11.5
Nanjing City Commercial Bank	International Finance Corp.	11/2001	27	15.00
Bank of Shanghai	HSBC	12/2001	62.6	8.00
	International Finance Group	1999/2001	NA	7.00
	Shanghai Commercial Bank	12/2001	NA	3.00
Dalian City Commercial Bank	SHK Financial Group	NA	NA	10.00
China Everbright Bank	China Everbright Holding Co. Ltd (HK)	1997	NA	20.07
	Asian Development Bank	1996	NA	3.03

Source: *US-China Business Review* (2003, 2004), *Tokyo Mitsubishi Review* (2004), *the Wall Street Journal* (2003, 2005), and various reports from *People's Daily* and *China Daily*; Various banks' annual reports and news press.

it seems natural for the Chinese government to eventually disengage from involvement in economic activities such as the banking business.

Market Discipline on the Governance Behavior

Publicly listing is also an effective way to force the banks to improve their governance structure. By publicly offering shares, the Chinese domestic banks may be able to expand their capital base and enhance their equity structure and transparency for public oversight. After public offerings, the Chinese domestic banks will be required to attain standards of information disclosure as listed companies, and be monitored by shareholders, regulatory authorities, the general public and other related parties. They will also be forced to listen to the shareholders' voices, concerning the interests of shareholders.

Market competition is a driving force towards efficiency (Lin & Tan, 1999). However, it cannot by itself solve all corporate governance problems of the Chinese domestic banks. Even in well-developed Western markets (e.g., the United States), corporate scandals like Enron, Global Crossing, Worldcom and Xerox suggest that the world may be without a perfect market. Markets may fail, requiring repair at the time of such failures. Thus, the nurturance of a well-functioning market in China requires the effective establishment of the corresponding systems and institutions of laws and rules. For that to occur, the Chinese government would and must play a crucial role even if that required it to cease playing its ownership and/or control role in the Chinese banking market.

The Role of Government: Regulator and Rule Setter

As argued above, the state ownership is the major cause for the poor Chinese bank governance. In order to build effective governance structure in the Chinese banking sector, it will eventually be natural for the Chinese government to disengage itself from the banking business.

Compared with non-financial firms, banks are generally more opaque (Levine, 2003), thus information asymmetries are larger with banks (Furfine, 2001; Levine, 2003; Arun & Turner, 2004). Information asymmetries increase the difficulty for shareholders to effectively monitor bank managers. Thus, the opaqueness of the banking industry requires regulation. To encourage the effective monitoring of bank management by non-state investors, the Chinese government can play an important role as a regulator and a rule setter in the banking market. As a rule setter and regulator, the Chinese government needs to make available a legal and regulatory framework demanding the adoption of international accounting standards by bank managers as well as requiring the revelation of appropriate information that allows for efficient monitoring of bank management by private investors. In this way, the Chinese government still continues to play its important role in the banking industry.

CONCLUSIONS

Based on theoretical discussions of the governance issues of Chinese banks, this paper argues that state ownership or state concentrated ownership of Chinese banks is a fundamental factor contributing to ineffective governance in the Chinese banking sector. In order to reduce political and agency costs, and solve the insider control problem facing the Chinese state banks, privatization may eventually be necessary for establishing effective Chinese banking governance with the market supporting institutions, such as the rule of law being well established. Towards this end, the current reform approach (i.e., adopting the standard corporate governance structure, inviting foreign banks to hold bank shares, listing in the international stock markets, and strengthening the banking regulation and supervision) seems to be essentially headed in the right direction. However, to assist private sectors to more efficiently monitor bank managers, the government should consider the gradual cessation of its involvement in banking activities, and instead engage in a rule-setter and regulatory role. In other words, it is recommended in this paper that, as opposed to being both an owner and a player in the banking sector, the government play the role of a fair competition market nurturer, establishing and enforcing legal, bankruptcy, and regulatory systems in the banking sector.

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