

The Corporate Governance Reform of State-owned Commercial  
Banks in China

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**Abstract**

The aim of this doctoral thesis is to identify the inadequacies and weaknesses of the current corporate governance system and structure in Chinese state-owned commercial banks by performing a comprehensive analysis of both the internal and external governance mechanisms of banks, and by learning from the advanced experience of banking in developed economies as well as international economic and banking institutions. The research commences with a conceptual approach to banks, in terms of banking and the corporate governance. It then examines the fundamental theories related to the banking and the corporate governance. The research shows that China has undergone an array of profound economic and banking reform programmes over that past three decades. Since 1995, a new governance system has been established in China's state-owned commercial banks through institutional reforms, which have emphasized addressing the ownership, asset quality and governance issues of the banks. Subsequently, the research demonstrates that the reform efforts have made important changes in the ways that the government conducts its control and influence over the state-owned commercial banks, shifting a system from direct control and influence of business and management to control by indirect forms. The research attempts to explore the potential problems in China's banking laws, present the corporate governance reforms of Chinese state-owned commercial banks and create an appropriate framework of corporate governance for China's state-owned commercial banks from internal and external aspects.

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## **Abbreviations**

ABC	Agricultural Bank of China
AMCs	Asset Management Companies
BOC	Bank of China
CCBs	City Commercial Banks
CCB	China Construction Bank
CBRC	China Banking Regulatory Commission
CIRC	China Insurance Regulatory Commission
CSRC	China Security Regulatory Commission
CCGLC	Code of Corporate Governance for Listed Companies
CCP	Chinese Communist Party
CFWC	Central Financial Work Commission
EU	European Union
EBRD	European Bank for Reconstruction and Development
FSA	Financial Services Authority
GATS	General Agreement on Trade in Services
IMF	International Monetary Fund
ICBC	Industrial and Commercial Bank of China
JSCBs	Joint Stock Commercial Banks
LLR	Lender of Last Resort
MOF	Ministry of Finance
NDRC	National Development and Reform Commission

NPLs	Non-Performing Loans
OECD	Organisation for Economic Co-cooperation and Development
PRC	People's Republic of China
PBOC	People's Bank of China
PSB	Postal Savings Bank
PCA	Prompt Corrective Action
RCCs	Rural Credit Co-operatives
RMB	Renminbi (Chinese Currency)
SOCBs	State-Owned Commercial Banks
SOEs	State-Owned Enterprises
US	United States
USD	United States Dollar
WTO	World Trade Organisation

## **List of Legislation**

*Accounting Rules for Financial and Insurance Enterprises 1988*

*Company Law 1993,1999,2004 & 2005*

*Notice on Asset Liabilities Management of Commercial Banks 1994*

*General Rules on Loans 1995*

*Commercial Banking Law 1995 & 2003*

*Law of People's Bank of China 1995 & 2003*

*Interim Provisions on Off-site Surveillance 1995*

*Monitoring and Supervisory Indexes of Asset-Liability Ratio Management for Commercial Banks 1996*

*Temporary Regulations on Qualifications for Posts of Senior Management in Financial Institutions 1996*

*Guiding Principles for Strengthening Internal Control in Financial Institutions 1997*

*Guidelines for Enhancing Internal Controls of Financial Institutions 1997*

*Provisions on Enhancing Internal Accounting Controls and Management in Banks 1997*

*Forms of Off-site Surveillance Reports for Commercial Banks 1997*

*Regulations Concerning the Punishment of Irregular Financial Activities 1999*

*Measures on Administration of Qualifications for Posts of Senior Management in Financial Institutions 2000*

*Interim Regulations on the Board of Supervisors of Important State-owned Financial Institutions 2000*

*Code of Corporate Governance for Listed Companies 2001*

*Guidance on Provisioning for Loan Losses 2002*

*Law of the PRC on Governing Banking Regulation and Supervision 2003 & 2006*

*Measures on the Administration of Insider and Shareholder Connected Transactions of Commercial Banks 2004*

*Measures on Administration of Capital Adequacy of Commercial Banks 2004*

*Internal Guidelines on Supervisory Ratings of Commercial Banks 2005*

*Measures on Administrative Licensing of Chinese-funded Commercial Banks 2006*

*Guidance on the Disclosure of Capital Adequacy Ratio of Commercial Banks 2009*

*Guidance on Corporate Governance of Commercial Banks 2011*

# CHAPTER ONE

## INTRODUCTION

### 1.1 Introduction

Globalization and the increased demand for better corporate governance are two major trends affecting banking; and the two trends are inexorably intertwined. The term globalization, as used here, refers to the cross-border operations and ownership of businesses in general and banks in particular. The growth of globalization raises issues about the corporate governance of banks.<sup>1</sup>

In the ten years since China's entry into the WTO in 2001, China's banking sector, regarded as a key component of the national economy, has gradually become integrated into the international banking system and witnessed ongoing dramatic reforms. One of the most momentous targets is the establishment of sound corporate governance through the restructuring of the state-owned commercial banks (SOCBs).

This chapter initially presents the merits and demerits of globalization and liberalisation in the financial sector; the responses of related international organizations, the EU and the UK to the recent financial crisis; and China's commitments in banking services after entry into WTO. It then introduces the current Chinese banking system and elaborates on why corporate governance reform of SOCBs was chosen as the theme of this study. Furthermore, the research aim, methodology and summary of chapters are also given in this chapter.

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<sup>1</sup> Benton E. Gup, 'Corporate Governance in Banks: Does the Board Structure Matter?' in Benton E. Gup (ed) *Corporate Governance in Banking: A Global Perspective* (Edward Elgar 2007).

## 1.2 Background

### 1.2.1 Globalisation and liberalisation in the financial sector

Over the past several decades, the international financial system has dramatically changed from its original isolated and fixed structure established under the Bretton Woods system to an increasingly global, integrated and volatile financial system.<sup>2</sup> A number of underlying trends in this change include: (a) the liberalization of cross-border capital flows, growing foreign participation in domestic markets, the introduction of new instruments and the removal of domestic prices; (b) financial markets at international and national levels have undergone a process in which financial flows have moved from traditional banks to capital markets; (c) technological innovation has stimulated the speed of information dissemination around the world; (d) the world has witnessed the spread of privatisation following the reduction in the role of centralised planned economic decision-making since the early 1980s; (e) financial institutions, financial markets, and payment and settlement systems as the three pillars of financial markets have become increasingly international; (f) financial innovations have developed so as to deal with the challenges from the changing financial markets and their participants.<sup>3</sup>

These trends have fundamentally altered the financial landscape around the world. However, the effects of financial globalization and liberalisation have been a matter of

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<sup>2</sup> The Bretton Woods system was a system of exchange rates pegged to gold or major hard currencies supported by a stabilisation fund and administered by the International Monetary Fund (IMF). The IMF was established in 1945 as part of the Bretton Woods Agreement and has a current membership of over 150 countries. In August 1971, the US government suspended the convertibility of the US dollar into gold. The pegged exchange rate system collapsed in March 1973 when currency values were 'set afloat' to be determined by free market conditions. See Charles W. Hultman, *Environment of International Banking* (Prentice Hall College Div 1989) 45-48.

<sup>3</sup> Douglas Arner, Mamiko Yokoi-Arai and Zhongfei Zhou, 'Conclusion: Lessons for the 21<sup>st</sup> Century', in Douglas Arner, Mamiko Yokoi-Arai, and Zhongfei Zhou (eds), *Financial Crisis in the 1990s* (The British Institution of International and Comparative Law [BIICL] 2001) 669.

some debate. On the one hand, these processes strengthen financial development and in turn contribute to higher long-term economic growth. For instance, financial globalisation and liberalisation have driven many national laws to introduce the principles of the most-favoured-nation treatment, reciprocity, and mutual recognition under international treaties in order to lessen or remove discriminatory or non-discriminatory barriers regarding entry and operation in home country markets. It is argued that these processes are probably beneficial to the development of the banking sector, the enlargement of the geographic scope of an operation and the range of financial products which this is likely to create, leading to a boom in the financial market.

On the other hand, financial globalisation and liberalisation induces excessive risk-taking behaviour, increases macroeconomic volatility and leads to more frequent crises. These are evidenced by the occurrence of a series of financial crises in the late 1990s from ‘Thailand to the rest of Southeast Asia, to East Asia, Eastern Europe and South America’, and by the recent financial crisis, which ‘originated in the United States in 2007 and spread to the European Union and then to the rest of the World’.<sup>4</sup> There has been increasing interest in the causes of these crises. In addition, the relevant resolution and possible future prevention of such crises have been areas of concern. As banking systems and markets have dramatically developed, there has been an increasing focus and debate on the quality of the corporate governance of banks, and the approach to regulation and supervision in that ‘the correlation between different types of risk, both within an individual bank and throughout the banking system, has therefore increased and become

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<sup>4</sup> Hennie Van Greuning and Sonja Brajovic Bratanovic, *Analyzing and Managing Banking Risk: a Framework for Assessing Corporate Governance and Financial Risk* (3<sup>rd</sup> edn, World Bank 2009) 2.

more complex.’<sup>5</sup> For individual banks, the changing banking environment and increased market volatility have stimulated the need for effective corporate governance structures that guide banks to operate in a safe and sound manner.<sup>6</sup>

### **1.2.2 The link between the recent financial crisis and corporate governance**

A number of failures in corporate governance:

[H]ave been blamed for exacerbating the 2007-09 global financial crisis, including reckless board practices, insufficient risk management, excessive executive remuneration and reckless bonus policies that encouraged short-termism and rewarded high levels of risk-taking, sometimes to the detriment of the firm.<sup>7</sup>

The poor corporate governance of banks is widely recognised to have been a significant contributory cause to the crisis.<sup>8</sup> During the second year of the financial crisis, the OECD started to reassess the issue of the corporate governance of banks. It published the fact-finding study, *Corporate Governance Lessons from the Financial Crisis*, in February 2009, which focuses on four areas of corporate governance: remuneration, risk management, board practices and the exercise of shareholder rights.<sup>9</sup> Based on those

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<sup>5</sup> *ibid.*

<sup>6</sup> Van Greuning and Brajovic Bratanovic (n 4) 3, 41.

<sup>7</sup> Anu Arora, ‘The Corporate Governance Failings in Financial Institutions and Directors’ Legal Liability’ (2011) *Company Lawyer* 3.

<sup>8</sup> *ibid.* See other factors leading to the recent crisis in Rosa M. Lastra and Geoffery Wood, ‘Reponses to the Financial Crisis’ (2011) *Journal of International Banking Law and Regulation* 307. The changed perception of the interrelationship between the crisis and banks’ corporate governance is reflected in recent studies. See David Ladipo and Stilpon Nestor, *Bank Boards and the Financial Crisis: A Corporate Governance Study of the 25 Largest European Banks* (London: Nestor Advisors Ltd, May 2009); Renee B. Adams, ‘Governance and the Finance Crisis’ (ECGI Finance Working Paper No.248/2009, April 2009) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1398583](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1398583)> accessed 20 March 2010.

<sup>9</sup> Grant Kirkpatrick, ‘The Corporate Governance Lessons from the Financial Crisis’ (2009) *Financial Market Trends* <<http://www.oecd.org/dataoecd/32/1/42229620.pdf>> accessed 12 July 2009.

findings, the OECD further published a full report on the key findings and main messages inside and outside of the banking industry, concluding that there is no immediate call for a revision of the OECD Principles but there is need to implement effectively those standards and norms agreed.<sup>10</sup> Subsequently, in October 2010 the Basel Committee on Banking Supervision released its latest set of principles for enhancing sound corporate governance practices in banking organisations, with the aim of addressing fundamental deficiencies in bank corporate governance during the financial crisis.<sup>11</sup> They focus on the manner in which the business and affairs of banks are governed by their boards of directors and senior management.<sup>12</sup> In addition, the Principles emphasise ‘the importance of supervisors regularly evaluating the bank’s corporate governance policies and practices as well as its implementation of the Committee’s principles.’<sup>13</sup> The G20 at its London Summit on April 2, 2009 also indirectly acknowledged the significance of the issue as well.<sup>14</sup> At the EU level, Mr Jacques de Larosière, the chairman of the High-Level Group on Financial Supervision in the EU, stated clearly in his report that corporate governance in banks ‘is one of the most important failures in the present crisis.’<sup>15</sup> Later, the EU Commission issued a Green Paper concerning corporate governance in financial institutions and remuneration policies, announcing that ‘strengthening corporate

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<sup>10</sup> OECD, ‘Corporate Governance and the Financial Crisis: Key Findings and Main Messages’ (June 2009) <<http://www.oecd.org/dataoecd/3/10/43056196.pdf>> accessed 10 March 2010. See also OECD, ‘Corporate Governance and the Financial Crisis: Conclusions and Emerging Good Practices to Enhance Implementation of the Principles’ (17 February 2010) <<http://www.oecd.org/dataoecd/53/62/44679170.pdf>> accessed 10 March 2010.

<sup>11</sup> Basel Committee on Banking Supervision, ‘Principles for Enhancing Corporate Governance—Final Document’ (October 2010) <<http://www.bis.org/publ/bcbs176.htm>> 20 December 2010.

<sup>12</sup> *ibid.*

<sup>13</sup> *ibid.*

<sup>14</sup> G20 Working Group 1, ‘Enhancing Sound Regulation and Strengthening Transparency—Financial Report’ (25 March 2009) <[http://www.g20.org/Documents/g20\\_wg1\\_010409.pdf](http://www.g20.org/Documents/g20_wg1_010409.pdf)> accessed July 2009.

<sup>15</sup> Jacques de Larosière, ‘Report of the High-Level Group on Financial Supervision in the EU’ (25 February 2009) 29 <[http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf)> accessed 8 February 2010.

governance is at the heart of the Commission's programme of financial market reform and crisis prevention.'<sup>16</sup> Meanwhile, it released the Commission staff-working document, *Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices*, suggesting that:

Corporate governance weaknesses in financial institutions were not *per se* the main causes of the financial crisis. However, timely and effective checks and balances in governance systems might have helped mitigate the worst aspects of the crisis.<sup>17</sup>

Sir David Walker, who the UK government charged with an independent review of corporate governance in the UK banking industry, asserted that 'the need is now to bring corporate governance issues to centre stage' since there were many causes of the crisis, including serious deficiencies in prudential oversight and financial regulation, major governance failures within banks and excessive risk taking.<sup>18</sup> Even the Financial Services Authority (FSA) states that

Poor governance [as]... only one of many factors contributing to the crisis...has widely been acknowledged to have been an important one.<sup>19</sup>

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<sup>16</sup> European Commission, 'Corporate Governance in Financial Institutions and Remuneration Policies' (2 June 2010) <[http://ec.europa.eu/internal\\_market/company/docs/modern/com2010\\_284\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf)> accessed October 2010.

<sup>17</sup> European Commission, 'Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices' (2 June 2010) <[http://ec.europa.eu/internal\\_market/company/docs/modern/sec2010\\_669\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/sec2010_669_en.pdf)> accessed 10 November 2010.

<sup>18</sup> David Walker, 'A Review of Corporate Governance in UK Banks and other Financial Industry entities—Final Recommendations' (26 November 2009) <[www.hm-treasury.gov.uk/walker\\_review\\_information.htm](http://www.hm-treasury.gov.uk/walker_review_information.htm)> accessed 15 March 2010.

<sup>19</sup> FSA, 'Effective Corporate Governance' (Consultation Paper 10/3, January 2010) <<http://www.fsa.gov.uk/pubs/cp/cp103.pdf>> accessed 15 June 2010.

### **1.2.3 China's GATS/WTO commitments in banking services**

Due to China's entry into the WTO, which has driven the Chinese financial market to gradually integrate itself into the international financial market, the recent financial crisis has affected the Chinese banking sector to some extent. The aforementioned section describes the international response to the finance crisis; it is widely recognised that it is imperative to further strengthen corporate governance in the banking industry. The following part turns to China's WTO commitments in the banking services.

After 15 years of negotiation, China joined the WTO on December 11, 2001. Generally, the agreements require China to open access to markets previously closed to foreign investors.<sup>20</sup> Specifically, China's entry into the WTO entailed that its domestic markets were to become fully open to foreign banks within five years of accession. The most dramatic effects of China's accession to the WTO on the banking sector were the permission given to foreign banks to provide Chinese currency (RMB) transactions and services for Chinese enterprises in December 2003, to provide retail banking services to all Chinese clients including individuals in December 2006, and the removal of geographic restrictions on the operations of foreign banks.<sup>21</sup>

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<sup>20</sup> Wei J. Lee, 'China and the WTO: Moving towards Liberalization in China's Banking Sector' (Spring 2003) *DePaul Business & Commercial Law Journal* 488. The agreements refer to China's WTO accession documents which are related to the financial services trade, including the Protocol on Accession of the People's Republic of China (China's Protocol of Accession), Schedule of Specific Commitments on Services, and the Working Party Report. The three legal documents are interrelated and interconnected.

<sup>21</sup> Christopher H. Stephens, 'Policy Collisions – China's Banking Reforms Require Dramatic Changes Affecting Many Policies and Sectors' (January 2003) *120 Banking Law Journal* 35, 37; See details in Ching Cheong and Ching Hung-Yee, *Handbook on China's WTO Accession and Its Impacts* (World Scientific 2003) 265.

### 1.2.3.1 WTO Commitments and rules to China's banking services sector

China's commitments in respect of the banking sector included two main categories, namely horizontal and specific commitments. Under the horizontal commitments, financial institutions including foreign capital enterprises (also referred to as wholly foreign-owned enterprises) and joint venture enterprises are permitted to establish a commercial presence in China.<sup>22</sup> Branches of foreign enterprises may be established, subject to specific restrictions.<sup>23</sup> The horizontal commitments apply to all services including banking services.<sup>24</sup> Under the specific commitments, banking services consist of the acceptance of deposits, all types of lending, financial leasing, as well as all payment and money transmission services, guarantees and commitments, and foreign exchange.<sup>25</sup> Geographic restrictions for foreign currency business were removed upon accession, and restrictions on local currency business were to 'be removed within five

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<sup>22</sup> Horizontal Commitments, 'Part II—Schedule of Specific Commitments on Services List of Article II MFN Exemptions' (WTO 10 November 2001) Report of the Working Party on the Accession of China <[http://www.wto.org/english/thewto\\_e/acc\\_e/protocols\\_acc\\_membership\\_e.htm](http://www.wto.org/english/thewto_e/acc_e/protocols_acc_membership_e.htm)> accessed 10 November 2006.

The General Agreement on Trade in Services (GATS) defines 'commercial presence' as 'any type of business or professional establishment, including through (i) the constitution, acquisition, or maintenance of a juridical person or (ii) the creation or maintenance of a branch or a representative office, within the territory of a Member for the purpose of supplying a service.' See GATS Article XXXVIII (d) (emphasis added). 'Juridical person' is defined as 'any legal entity duly constituted or otherwise organized under applicable law, whether for profit or otherwise, and whether privately owned or governmentally owned, including any corporation, trust, partnership, joint venture, sole proprietorship, or association.' See GATS Article XXXVIII (i) (emphasis added). A GATS 'commercial presence' commitment in banking services requires the relevant Member to allow the establishment of banks of other WTO Members in their market by constituting a new bank or acquiring existing state-owned, state-invested, or privately owned banks that wish to sell all or part of their business, subject only to the limitations that the Member has scheduled on market access and/or national treatment.' Daniel C. Crosby, 'Banking on China's WTO Commitments: "same bed, different dreams" in China's Financial Services Sector' (2008) *Journal of International Economic Law* 82.

<sup>23</sup> Horizontal Commitments (n 22) 2.

<sup>24</sup> *ibid.*

<sup>25</sup> Specific Commitments, 'Part II—Schedule of Specific Commitments on Services List of Article II MFN Exemptions' (WTO 10 November 2001) Report of the Working Party on the Accession of China <[http://www.wto.org/english/thewto\\_e/acc\\_e/protocols\\_acc\\_membership\\_e.htm](http://www.wto.org/english/thewto_e/acc_e/protocols_acc_membership_e.htm)> accessed 10 November 2006.

years after accession.<sup>26</sup> Foreign financial institutions are permitted to provide services in China without restriction as to clients for foreign currency business upon accession, and to provide services to Chinese enterprises upon accession and to all Chinese clients for local currency business by December 2006.<sup>27</sup> In addition, China's commitments to banking services confirmed that 'within five years after accession, any existing non-prudential measures restricting ownership, operation, and juridical form of foreign financial institutions, including on internal branching and licenses, shall be eliminated.'<sup>28</sup> Thus, as of December 2006 China may not restrict:

*[I]nter alia*, the constitution of new banks, the acquisition of existing state-owned or privately owned banks, the form of joint ventures, or the level of foreign investment in Chinese banks, and may not limit the operations, client base or geographic market for foreign institutions.<sup>29</sup>

China's commitments to banking services further provided that foreign financial institutions must be authorised to supply banking services as subsidiaries, branches, or foreign joint banks, or Chinese foreign joint finance companies in China, which should follow the minimum asset and operational conditions. A foreign financial institution is permitted to establish a subsidiary of a foreign bank or a foreign finance company in China if: firstly, it has total assets of more than US \$10 billion at the end of the year prior to filing the application; secondly, if a branch of a foreign bank in China if it has total assets of more than US \$20 billion at the end of the year prior to filing the application; thirdly, if a Chinese-foreign joint bank or a Chinese-foreign joint finance company in

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<sup>26</sup> *ibid.*

<sup>27</sup> *ibid.*

<sup>28</sup> *ibid.*

<sup>29</sup> Crosby (n 22) 83.

China has total assets of more than US \$10 billion at the end of the year prior to filing the application.<sup>30</sup> Foreign financial institutions willing to engage in local currency business must have operated a business for three years in China and have been profitable for two consecutive years prior to the application.<sup>31</sup>

One of the significant principles of free trade is the ability to trade without discrimination.<sup>32</sup> Accordingly, pursuant to the national treatment rule, the domestic market should treat banking services provided by foreign and domestic banking institutions equally.<sup>33</sup> A WTO member has to ‘comply with this principle only if it has made a specific commitment to permit foreign access to its banking market’.<sup>34</sup> Under China’s Protocol of Accession, in the banking services sector where China has scheduled specific commitments, it must apply the principle of national treatment to foreign services and services providers when the foreign access to its banking market comes into force.<sup>35</sup> The GATS provides that ‘each member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than it accords to its own like services and service suppliers.’<sup>36</sup>

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<sup>30</sup> Specific Commitments (n 25) 36.

<sup>31</sup> *ibid.*

<sup>32</sup> See the WTO website, <[http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/fact2\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm)> accessed 15 December 2006.

<sup>33</sup> Berry Fong-Chung Hsu, Douglas Arner, Qun Wan and Wei Wang, ‘Banking Liberalization and Restructuring in Post-WTO China’ (October 2005) Banking and Finance LRev30.

<sup>34</sup> *ibid.*

<sup>35</sup> Protocol of Accession of the People’s Republic of China (WTO, 23 November 2001) Schedule 9.

<sup>36</sup> GATS, Article XVII (1).

### **1.2.3.2 Commitments to eliminate and limit state involvement**

The Report of the Working Party on the Accession of China to the WTO clarifies China's obligations with regard to the operation of state-owned and state-invested enterprises, including banks in China.<sup>37</sup> The representative stated that 'the state-owned banks had been commercialized and lending to state-owned enterprises took place exclusively under market conditions'.<sup>38</sup> In addition, the representative further confirmed that 'the Government of China would not influence, directly or indirectly, commercial decisions on the part of state-owned or state-invested enterprises...'<sup>39</sup> and pointed out that 'state-owned enterprises, including banks, should be run on a commercial basis and be responsible for their own profits and losses'.<sup>40</sup> Therefore, these commitments to GATS rules and market access commitments should limit government interference in banks' commercial operations and eliminate state influence on commercial negotiations between foreign and Chinese financial institutions concerning investment in Chinese banks.<sup>41</sup>

### **1.2.3.3 Commitments to regulatory transparency**

During the negotiations relating to China's entry into the WTO, some members noted difficulty in finding and obtaining copies of Chinese regulations and other measures undertaken by various ministries as well as those taken by provincial and other local authorities; this problem was caused by a lack of transparency regarding the laws, regulations and other measures that applied to matters covered in the WTO agreements.<sup>42</sup>

The representative of China promised that none of the information required by the WTO

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<sup>37</sup> Report of the Working Party on the Accession of China (WT/ACC/CHN/49 1 October 2001) para 43.

<sup>38</sup> *ibid.*

<sup>39</sup> Report of the Working Party on the Accession of China, para 47.

<sup>40</sup> Report of the Working Party on the Accession of China, para 172.

<sup>41</sup> Crosby (n 22) 86.

<sup>42</sup> Report of the Working Party on the Accession of China, para 324.

Agreement or related to China's Protocol of Accession would be withheld as confidential information, except in very special cases.<sup>43</sup> Moreover, China confirmed that only those laws, regulations and other measures 'that are published and readily available to other WTO Members, individuals and enterprises, shall be enforced.'<sup>44</sup> Thus, China has to publish all laws, regulations and other measures affecting trade in the financial services.

### **1.3 The current Chinese banking system**

Over the past three decades, China's banking sector has evolved from a mono-bank system, in which the People's Bank of China (PBOC) served the dual roles of central bank and sole commercial bank, into an increasingly sophisticated and open system with multiple institutions performing diverse financial functions.<sup>45</sup>

As of the end of December 2010, the banking sector in China comprises: policy banks, state-owned commercial banks (SOCBs), joint stock commercial banks (JSCBs), city commercial banks (CCBs), rural commercial banks, rural credit co-operatives, one postal savings bank, foreign banks and non-bank financial institutions.<sup>46</sup>

#### **1.3.1 State-owned commercial banks**

There are four state-owned commercial banks in China. These are the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), the China Construction

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<sup>43</sup> Report of the Working Party on the Accession of China, para 333.

<sup>44</sup> China's Protocol of Accession (n 34) Part I: 2(C). 1.

<sup>45</sup> Lawrence Sæz, *Banking Reform in India and China* (Palgrave MacMillan TM 2004) 17-21. See also Jack Teo and B.S. Suresh, 'WTO: waiting time's over-China opens its domestic banking market to foreign banks after recent changes to its banking law and regulations make them WTO compliant' (2007) *Journal of International Banking Law and Regulation* 334. From 1949 until China's first steps towards economic liberalisation in 1978, the Communist government closed down and prohibited all commercial banks, while the state assumed responsibility for collecting money from workers and directing funds to state-owned enterprises through the People's Bank of China. See Crosby (n 22)78.

<sup>46</sup> CBRC Annual Report 2010, part 1 26.

Bank (CCB), and the Agricultural Bank of China (ABC).<sup>47</sup> The promulgation of the State Council Notification Regarding the Re-establishment of the Agricultural Bank of China led to the re-establishment of the ABC on 23 February 1979.<sup>48</sup> The BOC was separated from the PBOC on March the same year. This was followed by the establishment of the ICBC in April 1984 and the CCB in November 1985 respectively. The promulgation of the Commercial Banking Law of 1995 allowed commercial banks, including the four SOCBs, to operate in accordance with the rules of a market economy.<sup>49</sup>

The SOCBs have extremely large nationwide branch networks and huge numbers of employees around the nation. The SOCBs in the past were characterised by a lack of capital adequacy, asset quality, sound corporate governance and financial innovation. However, a new round of reforms in the SOCBs started in late 2003 that have transformed aspects including bank recapitalization and restructuring, and overseas listing.<sup>50</sup> SOCBs have made great strides in improving corporate governance and transparency.

Although their influence over the banking sector has continuously decreased in recent years, the SOCBs still had a 49.2 percent share among all banking institutions in China at the end of 2010.<sup>51</sup> Foreign strategic investors are allowed to invest in the SOCBs, but SOCBs continue to be controlled by the state. As of the end of December 2010, all of four SOCBs have been listed on the Hong Kong Stock Exchange.

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<sup>47</sup> The number of the SOCBs has increased in 2007. The SOCBs consist of the ICBC, the ABC, the BOC, the CCB and the Bank of Communications.

<sup>48</sup> Chien-Hsun Chen and Hui-Tzu Shih, *Banking and Insurance in the New China* (Edward Elgar 2004) 3.

<sup>49</sup> *ibid.*

<sup>50</sup> Jing Leng, 'China's Banking Reform in the context of Globalization and Transition' (2006) European Business LRev 1281.

<sup>51</sup> CBRC Annual Report 2010. They refer to the big four and the Bank of Communications (BOCOM).

### 1.3.2 Policy banks

Three policy banks were created in 1994, the Agricultural Development Bank of China, the China Development Bank and the Export Import Bank of China, to undertake the policy lending responsibilities previously assumed by the state-owned commercial banks.<sup>52</sup> These policy banks must assume their own financial risks, protect their asset values and must not compete with commercial financial institutions.<sup>53</sup> Funding for these banks is mainly raised through state budgetary allocations and government deposits as well as guaranteed bond issues.<sup>54</sup> In effect, these banks are state credit-granting agencies because each of them has been assigned specific mandates for carrying out state policies.<sup>55</sup> The China Development Bank has already separated its policy lending function from that of commercial lending. Other policy lending banks are likely to follow suit. The policy banks accounted for 8 percent of banking assets at the end of 2010.<sup>56</sup>

### 1.3.3 Joint stock commercial banks (JSCBs)

There are 13 joint-stock banks with sizable national business scope that have been operating in corporate form for several years.<sup>57</sup> The equity of these banks is partly owned

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<sup>52</sup> The function of the China Development Bank is to provide long-term financing support for key projects promoted by government economic plans, for example, the Three Gorges Dam, and gas transfer. The function of the China Export Import Bank is to provide export credit. And the main mission of the Agricultural Development Bank is to provide current funds for the procurement of grain, cotton and oil. Ding Tao, 'China's Financial Sector: Basic Form and Reform' (5 June 2005) <[http://www.forest-trends.org/~foresttr/documents/files/doc\\_1128.pdf](http://www.forest-trends.org/~foresttr/documents/files/doc_1128.pdf)> accessed 6 July 2007.

<sup>53</sup> Decision of the State Council on Reform of the Financial System 1993, s 2.

<sup>54</sup> *ibid.*

<sup>55</sup> *ibid.*

<sup>56</sup> CBRC,

<<http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=200711025B785FAE76192B31FFD3D3385278A400>> accessed 10 May 2011.

<sup>57</sup> The JSCBs include CITIC Bank, Everbright Bank of China, Huaxia Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Banking Co., Evergrowing Bank, China Zhenshang Bank and China Bohai Bank.

by the state and partly owned by state-owned enterprises, private enterprises and minority investors.<sup>58</sup> However, they have a clear commitment to shareholder value. 7 of the 13 are listed in the domestic stock markets in China.<sup>59</sup> Therefore, they need to meet additional information disclosure requirements.

Although JSCBs have been increasingly expanding their share of lending in the past few years, they still ‘have lower NPLs ratios, better capitalisation and more adequate provisions against NPLs than the SOCBs.’<sup>60</sup> They accounted for 15.6 percent of banking assets at the end of 2010.<sup>61</sup>

#### **1.3.4 City commercial banks (CCBs)**

There are 147 city commercial banks, which are owned by municipal governments.<sup>62</sup> These banks account for 8.2 percent of the total banking sector.<sup>63</sup> CCBs originated in the consolidation of urban credit co-operatives under the guidance of local authorities.<sup>64</sup> They are organised as joint stock companies that have multiple shareholders with representation on the board.<sup>65</sup> Local governments and enterprises, which hold important shares in the CCBs and often receive low-interest loans from banks, tightly control them.<sup>66</sup>

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<sup>58</sup> OECD, *Governance in China* (OECD 2005) 382. However, China Minsheng Bank is the only one that is entirely owned by non-state enterprises.

See <<http://www.cmbc.com.cn/en/about/jianjie.shtml>> accessed 10 September 2010.

<sup>59</sup> China Merchant Bank, Huaxia Bank, Minsheng Bank, Shanghai Pudong Development Bank, Shenzhen Development Bank, Industrial Bank and CITIC Bank.

<sup>60</sup> OECD (n 58).

<sup>61</sup> CBRC (n 56).

<sup>62</sup> *ibid.*

<sup>63</sup> *ibid.*

<sup>64</sup> OECD (n 58) 385.

<sup>65</sup> *ibid.*

<sup>66</sup> *ibid.*

Some city commercial banks have adopted reform measures including recapitalisation, internal reform, introduction of strategic investors and IPOs.<sup>67</sup> Due to their strong ties with local networks and knowledge, city commercial banks' main clients are small and medium enterprises and their deposits are also likely to come from local governments and companies.<sup>68</sup> Some of these banks are seeking to expand their business scope beyond their local licence so that it is possible to take future mergers with other city commercial banks or with larger banks with a national licence.<sup>69</sup> Moreover, several city commercial banks are planning to list on the domestic stock markets.<sup>70</sup>

### **1.3.5 Rural credit co-operatives (RCCs)**

The reform of the large and very fragmented rural credit co-operatives sector has been steadily carried out since 2004. The central authorities have been attempting to consolidate the RCC sector. Some of these co-operatives have emerged to become rural commercial banks and rural co-operative banks under a new shareholding structure.<sup>71</sup> By the end of December 2010, the RCC sector comprised 85 rural commercial banks, 223 rural cooperative banks and 2,646 rural credit cooperatives.<sup>72</sup> They have a market share of only 11.2 per cent among the banking institutions in China.<sup>73</sup> The RCC sector provides funding to the rural sector in general. For example, rural commercial banks and rural cooperative banks provide funding to commercial projects in rural areas, whereas rural credit co-operatives mainly provide financing for agricultural households.<sup>74</sup> The financial

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<sup>67</sup> For instance, Bank of Beijing listed on the Shanghai Stock Market in 2007.

<sup>68</sup> Syetarn Hansakul, 'China's banking sector: Ripe for the next stage' (Deutsche Bank Research 2006).

<sup>69</sup> *ibid.*

<sup>70</sup> *ibid.*

<sup>71</sup> Hansakul (n 68) 6.

<sup>72</sup> CBRC (n 46).

<sup>73</sup> *ibid.*

<sup>74</sup> Teo and Suresh (n 45).

standing of RCCs is still weak with problems of corporate governance and a heavy non-performing loans (NPL) burden.

### **1.3.6 Postal Savings Bank (PSB)**

China's banking regulator formally approved the launch of the postal savings bank at the end of 2006; subsequently the Postal Savings Bank of China was inaugurated in March 2007.<sup>75</sup> The PSB is wholly owned by the China Post Group and is subject to supervision by the CBRC.

Due to its numerous branches in urban and vast rural areas, it focuses on developing retail and intermediary businesses and offers basic financial services for all residents.<sup>76</sup> Additionally, it is likely to 'create supplementary links with other commercial banks to support the construction of a "new socialist countryside" and the balanced development of urban and rural economics'.<sup>77</sup>

However, the PSB has several problems, including weak internal control, a poor risk management system and a lack of talent. These problems were passed on by the previous management of the postal system. Therefore, the PSB needs to further strengthen its internal control mechanism, risk management system and scientific accounting system.<sup>78</sup>

### **1.3.7 Foreign banks**

Following China's ascension to the WTO on December 10, 2001, it gradually opened its domestic banking services market to foreign counterparties without geographic, product

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<sup>75</sup> Xinhua, 'China's Postal Savings Bank Opens for Business' (Xinhua News Agency 2007).

<sup>76</sup> Yu Lu, 'New postal savings bank gets approval' (China Daily 3 January 2007).

<sup>77</sup> *ibid.*

<sup>78</sup> *ibid.*

or client restrictions. Currently, there are 90 foreign bank branches and 40 locally incorporated foreign banking institutions, although they have a market share of only 1.8 percent among all banking institutions in China.<sup>79</sup>

### **1.3.8 Non-bank financial institutions**

As of December 2010, there are now 63 trust companies, 107 finance companies of corporate groups, 17 financial leasing companies, 4 money brokerage firms, 13 auto financing companies, 4 consumer finance companies and 9 lending companies in China.<sup>80</sup> They have a market share of only 2.2 percent among all Chinese banking institutions.<sup>81</sup>

## **1.4 Why focus on corporate governance and state-owned commercial banks (SOCBs) in China?**

The timing of a study into the corporate governance of SOCBs is opportune. To analyse the shortcomings and deficiencies of corporate governance in banks after the financial crisis is highly appropriate because it provides a reference point for further corporate governance reform in Chinese SOCBs. Corporate governance is not only a legal discipline which is situated at the heart of company law or corporate law, but is also a very important concept which is related to the economic life of banks and other financial institutions.<sup>82</sup> Therefore, analysing corporate governance in Chinese SOCBs after the financial crisis contributes significantly to this study.

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<sup>79</sup> CBRC (n 46).

<sup>80</sup> *ibid.*

<sup>81</sup> *ibid.*

<sup>82</sup> Corporate governance is also very important to companies and firms in the non-financial sector. But this thesis focuses on governance issues in banks.

Until fairly recently, corporate governance has been relatively ignored as a topic of inquiry. However, there has been an increasing amount of interest in banks' corporate governance, particularly in the wake of a series of corporate governance failures in banks, such as the collapse of the Bank of Credit and Commerce International, the debacle of the Barings Banks, the scandal in the Daiwa's New York branch, and also the bankruptcy of Lehman Brothers in autumn 2008 that triggered the scale of the recent financial crisis.<sup>83</sup> All the aforementioned events have made corporate governance a major topical issue. From a banking industry perspective, a corporate governance system can be defined as 'a set of mechanisms in setting the incentives for a banking organization to act prudently and for control of the risks that a bank takes.'<sup>84</sup> The recent events mentioned above have emphasised that good corporate governance should be regarded as one of the foremost elements in the financial sector and the economy at large.<sup>85</sup> In addition, the recent crisis is acting as a new stimulus to set up legal, regulatory and internal systems for corporate governance in banking organisations. Therefore, corporate governance has become a topic that has attracted much global attention.

Many bodies at national, regional and international level have realised the significance of banks' corporate governance and set up standards and norms regarding important aspects of corporate governance in banks. More specifically, at international level, the Basel Committee on Banking Supervision published the first edition of *Enhancing Corporate Governance for Banking Organisations* in September 1999 after the Asia crisis in 1997,

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<sup>83</sup> Caleb M Fundanga, 'Corporate Governance and Its Impact on Financial Institutions' (BIS Central Bankers' Speeches 27 April 2011) < <http://www.bis.org/review/r110504c.pdf> > accessed 15 May 2011. See also Zhongfei Zhou and Jingwei Li, 'In Search of Approaches to Improving Corporate Governance in China's State-owned Commercial Banks' (2002) *International Lawyer* 215.

<sup>84</sup> Zhou and Li (83).

<sup>85</sup> *ibid.*

and a revised version of its guideline in 2006 based on the *OECD Principles of Corporate Governance* of 2004, and the latest set of principles for enhancing sound corporate governance practices at banking organisations in October 2010 after the recent financial crisis.<sup>86</sup> At national level, the Swiss and Italian banking supervisors even issued rules respecting banks' corporate governance structures and features in detail.<sup>87</sup>

The global credit crunch that began in the second half of 2007 has led to enormous losses in the Western financial market. However, the influence of the global financial crisis on Chinese banks has been less than their Western counterparts.<sup>88</sup> The outbreak of the sub-prime crisis in the USA exerted a profound impact on the world economy and the financial industry in 2007.<sup>89</sup> Although there were increased volatilities in the financial market, the performance of SOCBs was outstanding in 2008. The Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), and the China Construction Bank (CCB) surpasses their Western counterparts to become the world's largest banks in market capitalisation by early 2009.<sup>90</sup>

This research selects SOCBs in China as research objects for the following reasons: first of all, the author comes from China and has a strong incentive to produce contributions to further reforms in Chinese SOCBs. In addition, China has increasingly played an important role in the world economy and trade system. Moreover, the Chinese government has made major efforts to reform the banking sector, particular the four

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<sup>86</sup> Basel Committee on Banking Supervision, 'Principles for Enhancing Corporate Governance for Banking Organisation' (Basel: BIS 1999, 2006 and 2010).

<sup>87</sup> Peter O. Mülbert, 'Corporate Governance of Banks after the Financial Crisis—Theory, Evidence, Reforms' (2010) European Corporate Governance Institute Law Working Paper No. 130/2009, 6<  
[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1448118](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1448118) > accessed 3 January 2011.

<sup>88</sup> Dan Luo, Shujie Yao, Jian Chan and Jianling Wang, 'World Financial Crisis and Efficiency of Chinese Commercial Banks' (2011) 34 *The World Economy* 805.

<sup>89</sup> CBRC Annual Report 2008.

<sup>90</sup> Luo, Yao, Chan and Wang (n 88).

SOCBs, which refer to the ICBC, BOC, CCB, and the Agricultural Bank of China (together the ‘Big Four’). These banks, the ‘Big Four’, are the most significant players in the Chinese banking system. Although there has been marginal decline, the dominance of the Big Four over China’s financial market is well entrenched and will remain so for the foreseeable future. They also play a crucial role in allocating financial resources in China.<sup>91</sup> As of the end of 2009, according to the China Banking Regulatory Commission (CBRC), they represented a 50.9 percent share of the total assets of the banking institutions in the country and accounted for 51 percent of total liabilities.<sup>92</sup> In addition, the Big Four operate a vast nation-wide branch network that has over 80,000 branches with strong brand recognition.<sup>93</sup> Given the dominance of banking assets in the financial system as a whole, this means that the Big Four SOCBs account for approximately half of the financial assets of the entire nation. Therefore, China does not merely operate what is a bank-centric financial system but one that is actually dominated by the Big Four. Due to the significance of the Big Four, the ways in which reforms of the banks are resolved could have systemic consequences. Therefore, it is justified to suggest that reform in the Chinese banking system, especially the SOCBs carries great weight for the country’s further sustainable economic development as a whole and poses far-reaching consequences for the success of the state-owned enterprises (SOEs) reform.<sup>94</sup>

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<sup>91</sup> This can be evidenced by the PBOC’s data on *Sources & Uses of Credit Funds of 4 largest State-owned National-operating Commercial Banks (RMB)* (2010) <<http://www.pbc.gov.cn/publish/html/2010s03c.htm>> accessed 15 December 2010.

<sup>92</sup> CBRC Annual Report 2009.

<sup>93</sup> CBRE Research, ‘Coming Taking-off of Overseas Banks’ (CBRE Research, October 2010) 3.

<sup>94</sup> C.A.E Goodhart and Xiaosong Zeng believe that the fundamental problems with China’s banking system are the interdependence between banks and state-owned enterprises. See C.A.E Goodhart and Xiaosong Zeng, ‘China’s Banking Reform: Problems and Potential Solution’ (2005) LSE Financial Markets Group Special Paper No.163 <<http://www2.lse.ac.uk/fmg/documents/specialPapers/2005/sp163.pdf>> accessed 10 January 2009. And that banking system is the main financier of SOEs, thus bank reform will have a direct impact on SOEs. See Alicia Garc ía-Herrero, Sergio Gavilá and Daniel Santabábara, ‘China’s Banking

## 1.5 Research aim

Since entering the WTO in 2001, China has made great progress in undertaking financial services trade, gradually permitting financial market access to foreign banks, and making dramatic reforms in the banking sector. By the end of 2006, the Chinese banking market was fully opened to foreign banks according to China's WTO commitments in regards to banking services.<sup>95</sup> Therefore, it was imperative for SOCBs to increase competition and management in order to face the challenges from foreign counterparts. One of the paramount targets is setting up sound corporate governance via recapitalizing and restructuring the SOCBs.

The dramatic developments discussed above triggered this research question as to whether the corporate governance reform in the SOCBs implemented since the late 1970s has transformed them into independent commercial entities that operate in accordance with the best international practices of modern banking. The proposed answer is no. The study provides a comprehensive analysis of both internal and external governance mechanisms of the banks. It highlights four major issues, which are the general development process, recapitalization and restructuring, regulation and supervision, and internal governance systems. Building on China's accession to the WTO, the four issues are addressed in two chapters, namely chapter three entitled 'the corporate governance reform of SOCBs pre-WTO accession' and chapter four named 'the corporate governance reform of SOCBs post-WTO accession'. The intention of this study is not

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Reform: An Assessment of its Evolution and Possible Impact' (Bank of Spain 2005)  
<<http://www.bde.es/webbde/Secciones/Publicaciones/PublicacionesSeriadas/DocumentosOcasionales/05/Fic/do0502e.pdf>> accessed 10 December 2006.

<sup>95</sup> See s 1.2.3.

only to focus on overall discussions and analyses of issues of corporate governance in the SOCBs and how the Chinese government deals them, but also to identify best practices.

## **1.6 Methodology**

The methodology of this thesis is mainly analytical, which primarily lies in a comprehensive review of existing literature, legislation, cases and official documents. The methodology of this thesis is also theoretical, at least to the extent, in which it draws on the theoretical doctrines of corporate governance and the nature of banking. Furthermore, there is an inter-disciplinary law aspect in banking, ownership and corporate governance. For instance, chapter two resolves the theoretical issues of corporate governance, which will provide the prerequisite preparation for the following chapters, by using economic, legal and managerial approaches. In addition, some parts of the thesis will analyse the historic development or traditional cultural influence of relevant institutions and mechanisms and thus, some issues with Chinese characteristics will be deeply understood.

## **1.7 Summary of chapters**

The thesis is comprised of six chapters. Chapter two reviews the literature on the rationale for corporate governance, banks and banking regulation to provide the prerequisite preparation for the following chapters. It is divided into two sections. The first section provides a brief overview of corporate governance theories in the West, aimed at offering background description of the concept as it has emerged in developed countries. It continues to analyse the diversity of practices of corporate governance around the world due to different institutional environments. The second section

discusses the special features of banks and addresses why banking institutions are different from other non-banking institutions in terms of corporate governance. In addition, it reviews the prevailing practices of bank governance including internal and external mechanisms. Finally, it discusses the rationale for banking regulation.

Chapter three examines two different facets of the corporate governance reforms in China's SOCBs pre-WTO accession. Initially, the evolution of the Chinese banking system spanning from the late 1970s until the end of 2001 is briefly described as well as the main reasons for its poor performance. The chapter then examines the rehabilitation programme for the SOCBs during this period. The section analyses the unique set of problems in SOCBs; it discusses the process of financial restructuring and proceeds to evaluate the ways in which the problems of asset quality and capital adequacy have been tackled. Subsequently, the chapter focuses on an important aspect of banking reform, which is related to banking regulation and supervision. The section explores the policy developments affecting the corporate governance framework for SOCBs. It analyses the characteristics of the banking regulation in China and discusses the reform of the institutional structure of banking regulation and supervision during this period.

Chapter four continues to examine two different facets of the corporate governance reforms in China's SOCBs post-WTO accession. First, the chapter provides an overview on the development of corporate governance in SOCBs from 2002 to the end of 2010. Moreover, it examines how the Chinese government has rehabilitated the SOCBs including changes in ownership and internal governance. Finally, the chapter concentrates on improvements concerning banking regulation and supervision in China during this period.

Chapter 5 examines three major aspects of the corporate governance reform in Chinese SOCBs, namely ownership, party committee and the institutional structure of banking regulation in China, and discusses their merits and demerits in detail. Furthermore, it takes a stance as to what can be done to ameliorate problems associated with these aspects.

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

## CHAPTER TWO

### THEORITICAL BACKGROUND OF THE REFORM

#### 2.1 Introduction

The previous chapter presented a general overview of the whole study, as well as corporate governance and SOCBs. The emphasis of this chapter is on the theoretical and functional issues of corporate governance, the special features of banks, the rationale for banking regulation and banks' governance mechanisms in practice.

Banks play an integral role in any economy. As the principal financial intermediary, banks provide 'financing for commercial enterprises, access to payment systems and a variety of retail financial services for the economy at large.'<sup>1</sup> Banks facilitate industrial expansion, the corporate governance of companies, and capital allocation. 'When banks efficiently mobilize and allocate funds, this lowers the cost of capital to firms, boosts capital formation, and stimulates productivity growth.'<sup>2</sup>

Given the importance of banks, it is paramount to ensure that their functions are subject to a sound corporate governance regime.<sup>3</sup> The corporate governance of banks affects their 'valuation, their cost of capital, their performance and their risk-taking behaviour.'<sup>4</sup> Research findings suggest that banks have a strong impact on economic development. Banking crises bring about direct costs to taxpayers and to economic growth. It is now

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<sup>1</sup> Kern Alexander, 'Corporate Governance and Banks' in Joseph J Norton, Jonathan Rickford and Jan Kleineman (eds), *Corporate Governance Post-Enron: Comparative and International Perspectives* (BIILC 2006).

<sup>2</sup> Ross Levine, 'The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence' (2004) World Bank Policy Research Working Paper No.3404  
<[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=625281](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625281)> accessed 10 May 2009.

<sup>3</sup> *ibid.*

<sup>4</sup> Andrea Polo, 'Corporate Governance of Banks: the Current State of the Debate' (2007)  
<<http://ssrn.com/abstract=958796>> accessed 18 November 2008.

acknowledged that corporate governance in the banking and financial sector differs from that in the non-financial sectors because of the systemic risks that banking activity poses for the economy and society at large.<sup>5</sup> Corporate governance reforms that suit the non-financial sector may not be appropriate for banks.<sup>6</sup>

This chapter is comprised of two sections. The first section presents a general overview of existing literature concerning the main aspects of corporate governance including the most prevalent theories and practices. The distinct theoretical approaches and various practices around the world determine that it is almost impossible to have a common definition of corporate governance. Cross-country historical evidence illustrates that the evolution of corporate governance in each system occurs under particular social circumstances. In fact, those factors such as economic reality, culture, politics, and legal tradition play critical roles in shaping corporate governance systems. Therefore, corporate governance issues in a transition economy differ from those in an advanced economy. Different corporate governance problems need different governance solutions. The following section turns to the specific corporate governance issues of banks. The second section provides an overview of the rationale for banking regulation and then reviews the corporate governance practice of banks, which is based on three dimensions: ownership, regulation and internal control mechanisms.

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<sup>5</sup> John Eatwell and Lance Taylor, *Global Finance at Risk* (Polity Press, 2000) 21-7.

<sup>6</sup> Renee Adams and Hamid Mehran, 'Is Corporate Governance Different for Bank Holding Companies?' (2003) 9 *Economic Policy Review* 123.

## 2.2 Theoretical and functional issues of corporate governance

Corporate governance has become a central issue over the past decades thanks to its significance for growth and development of companies as well as countries in general.<sup>7</sup> The vital importance of corporate governance for accountability and performance is now fully recognised in developed market economies and even in developing economies.<sup>8</sup> To understand the corporate governance problems of banks, it would be useful to begin by defining corporate governance.

### 2.2.1 Corporate governance: a conceptual perspective

There is no generally accepted definition of corporate governance. According to the arguments of Claessens, definitions with regard to corporate governance can be divided into two categories. The first set of definitions concerns a set of behavioural patterns namely the actual behaviour of corporations comprising performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders.<sup>9</sup> Key considerations must to be taken into account include, 'how boards of directors operate, the role of executive compensation in determining firm performance, the relationship between labour policies and firm performance, and the role of multiple shareholders.'<sup>10</sup> The second set of definitions focuses on the rules under which companies operate within the legal system, the judicial system, financial markets and labour markets.<sup>11</sup> The purpose

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<sup>7</sup> Stijn Claessens, 'Corporate Governance and Development' (October 2003)

<[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=642721](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=642721)> accessed 10 September 2010.

<sup>8</sup> Thomas Clarke, *International Corporate Governance: A Comparative Approach* (Routledge 2007) 1.

<sup>9</sup> Claessens (n 7) 4.

<sup>10</sup> *ibid.*

<sup>11</sup> Claessens (n 7) 4.

of the definition is to ‘investigates how differences in the normative framework affect the behavioural patterns of firms, investors and others.’<sup>12</sup>

In its narrow sense, corporate governance is often confined to the structure and functioning of the board, or the rights of shareholders in corporate decision-making. For example, corporate governance in the UK Corporate Governance Code is defined as ‘what the board of a company does and how it sets the values of the company.’<sup>13</sup> According to Shleifer and Vishny, ‘Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.’<sup>14</sup>

In a broader sense, corporate governance is defined as ‘the system by which companies are directed and controlled.’<sup>15</sup> This is close to the definition used by the OECD:

The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation such as the board, managers, shareholders and other stakeholders and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance.<sup>16</sup>

However, Blair uses a much broader definition, describing corporate governance:

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<sup>12</sup> *ibid.*

<sup>13</sup> Financial Reporting Council, *The UK Corporate Governance Code* (FRC 28 May 2010) <[www.frc.org.uk/corporate/reviewCombined.cfm](http://www.frc.org.uk/corporate/reviewCombined.cfm)> accessed 8 July 2010.

<sup>14</sup> Andrei Shleifer and Robert Vishny, ‘A Survey of Corporate Governance’ (1997) 52 *Journal of Finance* 737.

<sup>15</sup> Cadbury Committee, *Report of the Cadbury Committee on the Financial Aspects of Corporate Governance* (Gee Publisher 1992) Introduction.

<sup>16</sup> OECD, *Principles of Corporate Governance* (OECD 2004) 11.

The whole set of legal, cultural and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated.<sup>17</sup>

To Blair's definition, corporate governance mainly involves 'four-level legal, cultural and institutional arrangements, including regulatory governance, market governance, stakeholder governance and internal governance.'<sup>18</sup> Thus, in a broad sense, corporate governance systems refer to 'the whole set of regulatory, market, stakeholder and internal governance.'<sup>19</sup> Regulatory governance is defined as 'the public order and control over corporations by state statutes, governmental and professional bodies' regulations and government policies.'<sup>20</sup> Market governance is 'the use of various market mechanisms (such as supply and demand, price signal, free competition, market entrance and exit, market contract and market bid) to control and discipline corporate behaviour and action.'<sup>21</sup> Stakeholder governance is 'the direct and indirect control or influence over corporate business, decision-making and corporate behaviour by key stakeholder groups who have direct or indirect interests in the corporation.'<sup>22</sup> Typical stakeholders may include 'investors, banks, suppliers, customers, employees, government and local communities.'<sup>23</sup> Internal corporate governance is 'the institutional arrangement of checks

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<sup>17</sup> Margaret Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (Brookings Institution Press 1995) 19.

<sup>18</sup> William Sun, Jim Stewart and David Pollard, 'Introduction: Rethinking Corporate Governance Lessons From the Global Financial Crisis' in William Sun, Jim Stewart and David Pollard (eds), *Corporate Governance and the Global Financial Crisis* (Cambridge University Press 2011) 8.

<sup>19</sup> *ibid.*

<sup>20</sup> *ibid.*

<sup>21</sup> *ibid.*

<sup>22</sup> *ibid.*

<sup>23</sup> *ibid.*

and balances among the shareholder general meeting, the board of directors and management within the corporation, prescribed by corporate laws.’<sup>24</sup>

Corporate governance is important for financial market stability, investment, economic growth and social well-being, which mainly embodies two dimensions. The initial dimension shows that it provides the incentives and performance measures necessary to achieve business success, while another demonstrates that it provides the accountability and transparency needed to ensure the equitable distribution of the resulting wealth.<sup>25</sup>

According to Jensen and Meckling, good corporate governance can improve corporate performance by minimising the total cost of aligning managers’ and shareholders’ incentives, and reducing the effect of unavoidable self-interested managerial behaviour. It not only has to provide proper incentives for the board and management, so as to pursue the interests of the company and its shareholders, but also facilitate effective monitoring in order to take advantage of their resources more effectively.<sup>26</sup> On the other hand, poor corporate governance can enable the ruin of the interests of managers or shareholders, leading to poor performance and even the bankruptcy of a company.

Corporate governance systems have evolved in response to corporate failures or systemic crises over centuries. With an array of well-known company failures, such as the collapse of the Bank of Credit and Commerce International and Barings bank, Enron and WorldCom, corporate governance as a means to improve corporate performance has inevitably attracted public attention once more. Policy makers are now more aware of the

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<sup>24</sup> *ibid.*

<sup>25</sup> Clarke (n 8) 2.

<sup>26</sup> Michael Jensen and William Meckling, ‘Theory of the Firm: Managerial Behaviours, Agency Cost and Ownership Structure’ (1976) 3 *Journal of Financial Economics* 305.

contribution good corporate governance makes to financial market stability, investments and economic growth. It is important for companies to understand how good corporate governance contributes to their competitiveness.<sup>27</sup> For developing and transition economies, a healthy and competitive corporate sector is ‘fundamental for sustained and shared growth-sustained in that it withstands economic shocks, shared in that it delivers benefits to all of society.’<sup>28</sup> Sound corporate governance is important ‘not only to attract long-term patient foreign capital, but more especially to broaden and deepen local capital markets by attracting local investors-individual and institutional.’<sup>29</sup> There is also an increasing realisation among countries that good governance of corporations is ‘a source of competitive advantages and critical to economic and social progress.’<sup>30</sup> The Cadbury committee insisted that:

[T]he country’s [Britain’s] economy depends on the drive and efficiency of its companies. Thus, the effectiveness with which boards discharge their responsibilities determines Britain’s competitive position. They must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance.<sup>31</sup>

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<sup>27</sup> OECD (n 16) 3.

<sup>28</sup> Maqdi Iskander and Naderah Chamlou, *Corporate Governance: a Framework for Implementation* (World Bank 2000) 2.

<sup>29</sup> *ibid.*

<sup>30</sup> *ibid.*

<sup>31</sup> Adrian Cadbury, *The Final Report of the Committee on the Financial Aspects of Corporate Governance: the Code of Best Practice* (London: Gee and Co. Ltd 1992) 2.

In addition, it has been consistently realised that higher standards of corporate governance are not only necessary to ensure accountability, but also to positively improve corporate performance.<sup>32</sup>

### **2.2.2 Corporate governance: a theoretical perspective**

The development of corporate governance is associated with the evolution of theories about the company. Issues that are relevant to the rationale for existence and control of a company have remained subjects of interest and of some debate.<sup>33</sup> Adam Smith wrote in the eighteenth century that:

Directors...being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partner frequently watch over their own...Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.<sup>34</sup>

Later in the twentieth century, Berle and Means coined the phrase 'the separation of ownership and control' that remains the most widely used expression in the numerous literatures on corporate governance.<sup>35</sup> Since then, the separation of ownership and control has become the focus of subsequent research on corporate governance and many theories regarding corporate control are set in this context. The following three distinct schools of

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<sup>32</sup> Clarke (n 8) 22.

<sup>33</sup> Thomas Clarke (ed), *Theories of Corporate Governance: The philosophical foundations of corporate governance* (Routledge 2004) 4.

<sup>34</sup> Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (W. Strahan and T. Cadell 1776) 700.

<sup>35</sup> Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (Transaction Publishers 1932).

thought, which have had the most impact on the development of corporate governance, are analysed and discussed in detail.

### **2.2.2.1 Agency theory**

Agency theory emerged from seminal papers by Alchian and Demsetz and Jensen and Meckling that explained the company as a nexus of contracts among individual factors of production.<sup>36</sup> From the perspective of classical economics, the company previously was deemed as a single-product entity with a commitment to the maximization of profits, and the operation of the firm had been considered of less interest compared to the operation of markets.<sup>37</sup> Agency theory examined and analysed the workings of the firm by explaining it as a constantly re-negotiated contract, contrived by many individuals each with the aim of maximising their own utility.<sup>38</sup>

Agency theory has various manifestations. Alchian and Demsetz focused on ‘team production’ and the problem of free riding and monitoring within this.<sup>39</sup> Jensen and Meckling by contrast contended that organisations should be regarded as no more than a set of implicit and explicit contracts with associated rights.<sup>40</sup> As they argue agency theory rests upon the contractual view of the firms, the essence of the agency problem is the separation of management and finance.<sup>41</sup> In practice, as managers raise funds from investors and put them to productive use, the financiers and managers will sign a contract

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<sup>36</sup> Clarke (n 33) 4. See Armen A Alchian and Harold Demsetz, ‘Production, Information Costs and Economic Organisation’ (1972) 62 American Economic Review 777. And also Jensen and Meckling (n 26).

<sup>37</sup> Clarke (n 33) 4.

<sup>38</sup> Simon Lounsbury, ‘Theorizing Corporate Governance: New Organizational Alternatives’ (June 2002) Cambridge ESRC Centre for Business Research Paper No.237 <<http://www.cbr.cam.ac.uk/pdf/WP237.pdf>> accessed 15 March 2007.

<sup>39</sup> Alchian and Demsetz (n 36).

<sup>40</sup> Jensen and Meckling (n 26).

<sup>41</sup> *ibid.*

in general that specifies exactly what the managers will do with the funds and how the profits will be allocated between managers and investors.<sup>42</sup> However, the largest problem is that future contingencies are difficult to foresee, and consequently, complete contracts are unfeasible.<sup>43</sup>

Agency view suggests that the pre-eminent position of shareholders is not based on the idea that they are the owners but instead the residual risk takers of the firm.<sup>44</sup> Fama focuses on the irrelevance of ownership:

Ownership of capital should not be confused with ownership of the firm.

Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs. In this “nexus of contracts” perspective, ownership of the firm is an irrelevant concept.<sup>45</sup>

Fama looked to the potential of the managerial labour market to constrain and channel individual executive opportunism.<sup>46</sup> Donaldson characterises these various models of the nature of organisational relationships, which are constructed around a few simple assumptions, as a ‘theory of interest, motivation and compliance.’<sup>47</sup> Given the combination of assumed autonomy and self-interested motivation of actors, it is assumed

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<sup>42</sup> Clarke (n 33) 5.

<sup>43</sup> *ibid.*

<sup>44</sup> Alchian and Demsetz (n 36).

<sup>45</sup> Eugene F. Fama, ‘Agency Problem and the Theory of the Firm’ (1980) 88 *Journal of Political Economy* 288, 290.

<sup>46</sup> *ibid* 295.

<sup>47</sup> Lex Donaldson, ‘The Ethereal Hand: Organizational Economics and Management Theory’ (1990) 15 *The Academy of Management Review* 369.

that the relationship between shareholders (principles) and managers (agents) will be problematic.<sup>48</sup>

Jensen and Meckling paid attention to the issue of the principal-agent in the public corporation.<sup>49</sup> They postulate that shareholders are the principals and managers are their agents in a firm. They suggest that the problem of agency is:

[...] A contract under which in or more persons (the principals) engage another (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. 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 [...]<sup>50</sup>

This statement obviously demonstrates that a firm is simply a nexus of a set of contracting relationships among individuals, creating agency costs because of divergences of interest between principles and agents.<sup>51</sup> The remedies to this conception of the agency problem within corporate governance involve the acceptance of certain ‘agency costs’ included either in creating incentives or sanctions that shareholders have to prevent the directors from diverging from the shareholders’ interests; this can be done

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<sup>48</sup> Michael Jensen, ‘Self-interest, Altruism, Incentives and Agency theory’ (1994) *Journal of Applied Corporate Finance* 44.

<sup>49</sup> Jensen and Meckling (n 26).

<sup>50</sup> *ibid.* In microeconomics, the utility maximization problem is the problem that consumers face: “how should we spend our money in order to maximize my utility?”.

<sup>51</sup> As applied to corporate governance it is the shareholder who is cast as the ‘principal’ and the problem is how the principle can ensure that his ‘agents’—company directors—serve the shareholders interests rather than their own. Either in the form of ‘shirking’ which in the governance context can be seen in terms of a lack of attention to maximising shareholder returns, or in terms of ‘self-interested opportunism’— accruing wealth to themselves rather than shareholders— the principals is vulnerable to the self-interest of their agents.

by monitoring costs, thus mitigating the directors' aberrant actions and constraining their opportunism, or by devising appropriate incentives for directors.<sup>52</sup>

Daily et al. explains the prevalence of agency theory in the governance literature:

First, it is an extremely simple theory, in which large corporations are reduced to two participants—managers and shareholders—and the interests of each are assumed to be both clear and consistent. Second, the notion of humans as self-interested and generally unwilling to sacrifice personal interests for the interests of others is both age old and widespread...Economists struggled with this problem for centuries until Jensen and Meckling provided their convincing rationale for how the public corporation could survive and prosper despite the self-interested proclivities of managers. In nearly all modern governance research governance mechanisms are conceptualised as deterrents to managerial self-interest.<sup>53</sup>

In order to bring the interests of managers in line with those of shareholders, there are four main internal and external governance mechanisms.<sup>54</sup> The first mechanism is governance structure. The company should have an effectively structured board as an essential monitoring device, which acts by conducting performance evaluations of the management and communicating shareholders' interests to managers. Secondly, agency theory draws attention to the production of effective compensation contracts that

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<sup>52</sup> Jensen and Meckling (n 26). According to the theory of Jensen and Meckling, agency costs including the monitoring costs by the principle, the economic bonding expenditures by the agent and the residual loss are an unavoidable result of the agency relationship.

<sup>53</sup> C.M. Daily, D.R. Dalton and A.C. Cannella, 'Corporate Governance: Decades of Dialogue and Data' (2003) 28 *Academy of Management Review* 371, 372.

<sup>54</sup> Clarke (n 33) 7.

encourage a shareholder orientation. The key solution to the agency problem is to adopt appropriate incentive systems to reward managers. Thirdly, concentrated ownership holdings can lead to active monitoring of executives. The market approach is the fourth solution to corporate governance problems when internal mechanisms for controlling managerial opportunism or failure have not worked.<sup>55</sup> Particularly, agency theory focuses on the facilitation of the efficiency of the market.<sup>56</sup>

Agency theory has dominated thinking on corporate governance for the last decades of the twentieth century. It has brought important insights into the workings of companies. Nevertheless, agency theory has its limits even though it specifically contributes to the treatment of information and implications.<sup>57</sup> There are many critiques over the theory's underlying assumptions and propositions, specifically that its proponents 'tend to see the firm principally in contractual terms; are guided by the assumption of utility-maximizing self-interested human behaviour; [and] tend to posit the protection of investor's capital as the corporate governance problem.'<sup>58</sup> Doucouliagos argued that labelling all motivation as self-serving does not explain the complexity of human action.<sup>59</sup> Also, Frank suggested that the model of man who is individualistic and self-serving does not suit the demands of a social existence.<sup>60</sup> Additionally, agency theory is an extremely simple theory that

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<sup>55</sup> Daily, Dalton and Cannella (n 53). See also J.P. Walsh and J.K. Seward, 'On the efficiency of Internal and External Corporate Control Mechanisms' (1990) 15 *Academy of Management Review* 421.

<sup>56</sup> Corporate governance failure can be best addressed by removing restrictions on factor markets. See Fama (n 45). Any external interventions and additional obligations imposed on corporations may distort free market mechanisms and should be avoided. See Oliver Hart, Andrei Shleifer and Robert W. Vishny, 'The Proper Scope of Government: Theory and an Application to Prisons' (1997) 112 *Quarterly Journal of Economics* 1127.

<sup>57</sup> E.M. Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14 *Academy of Management Review* 57.

<sup>58</sup> Learnount (n 38) 1.

<sup>59</sup> Chris Doucouliagos, 'A Note on the Evolution of Homo Economicus' (1994) 3 *Journal of Economic Issues* 877.

<sup>60</sup> R.H. Frank, *Microeconomics and behaviour* (McGraw-Hill 1994).

reduces large corporations into two participants, namely managers and shareholders.<sup>61</sup> It is clear that companies cannot operate without the effect of stakeholders, so there is a need to take the interests of varied stakeholder groups into consideration.

#### **2.2.2.2 Stewardship theory**

Stewardship theory is an alternative view of agency theory, in which managers are assumed to act in their own self-interests at the expense of shareholders.<sup>62</sup> It proposes that managers left on their own will indeed act as responsible stewards of the assets they control.<sup>63</sup> According to stewardship theory, a manager whose behaviour is pro-organizational and collectivistic has higher utility than individualistic, self-serving behaviour.<sup>64</sup> Thus, even where the interests of the steward and the principal are not aligned, the manager places higher value on cooperation than defection in that the manager perceives greater utility in cooperative behaviour and behaves accordingly, his or her behaviour can be considered rational.<sup>65</sup>

Stewardship theory argues that ‘the performance of a steward is affected by whether the structural situation in which he or she is located facilitates effective action’.<sup>66</sup> Under this view, it is suggested that a steward should be empowered by appropriate governance structures and mechanisms to maximize the benefits of a steward. According to Donaldson and Davis, for CEOs who are stewards, their pro-organizational actions are

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<sup>61</sup> Daily, Dalton and Cannella (n 53).

<sup>62</sup> Jay B. Barney and William S. Hesterly, *Strategic Management and Competitive Advantages* (Pearson Prentice Hall 2008) 273.

<sup>63</sup> Lex Donaldson and James H. Davis, ‘Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns’ (1991) 16 *Australian Journal of Management* 49. See also Lex Donaldson, James H. Davis and F. David Schoorman, ‘Davis, Schoorman, and Donaldson Reply: the Distinctiveness of Agency Theory and Stewardship Theory’ (1997) 22 *The Academy of Management Review* 611.

<sup>64</sup> Donaldson, Davis and Schoorman (n 63).

<sup>65</sup> *ibid.*

<sup>66</sup> *ibid.*

best facilitated when the corporate governance structures give them high authority and discretion.<sup>67</sup> Structurally, this situation is attained more readily if the CEO chairs the board of directors. The CEO-chair, who is unambiguously responsible for the fate of the corporation, will have the power to determine strategy without fear of being countermanded by an outside chair of the board.<sup>68</sup> Therefore, stewardship theorists emphasize ‘structures that facilitate and empower rather than those that monitor and control.’<sup>69</sup>

Empirical researchers have shown mixed findings for the claims of stewardship theory. Some researchers have found that stewardship’s executive-chaired boards have significantly higher corporate performance.<sup>70</sup> While others have argued that there is no significant difference in firm performance between executive-chaired and outsider-chaired boards.<sup>71</sup> However, it is important to note that stewardship theory is relatively new and needs to be validated by further research.

### **2.2.2.3 Stakeholder theory**

By contrast with agency theory, stakeholder theory has had much less influence on thinking and policy regarding corporate governance in recent times, and yet it has a

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<sup>67</sup> *ibid.*

<sup>68</sup> In this respect stewardship theory directly challenges agency theory, where the monitoring role of an independent board and a powerful chairman, who can represent the interests of shareholders against the self-interest of executive managers, is conceived as always having a positive effective on performance.

<sup>69</sup> Donaldson, Davis and Schoorman (n 63).

<sup>70</sup> Lex Donaldson and James H. Davis, ‘CEO governance and shareholder returns: Agency theory or stewardship theory’ (Annual meeting of the Academy of Management, Washington, DC, 1989). Sydney Finkelstein and Richard A. D’Aveni, ‘CEO duality as a double-edged sword: How boards of directors balance entrenchment avoidance and unity of command’ (1994) 37 *The Academy of Management Journal* 1079.

<sup>71</sup> Rajeswararao S. Chaganti, Vijay Mahajan and Subhash Sharma, ‘Corporate Board Size, Composition and Corporate Failures in Retailing Industry’ (1985) 22 *Journal of Management Studies* 400.

historical lineage considerably longer and more substantial.<sup>72</sup> Pursuant to Robert Philips, stakeholder theory is a theory of organizational management and business ethics that addresses morals and values in managing an organization.<sup>73</sup> Freeman laid the basis for developing stakeholder theory in his book *Strategic Management: a Stakeholder Approach*.<sup>74</sup> According to stakeholder theory, society's attitude plays a decisive role relating to the survival and prosperity of a company, thus companies must seriously fulfil their social responsibilities and behave in a way that is beneficial to the public as a whole.<sup>75</sup> Clarkson has offered the following definition of stakeholder theory, in which the firm is a system of stakeholders operating within the large system of the host society that provides the necessary legal and market infrastructure for the firm's activities.<sup>76</sup> The objective of the company is 'to create wealth or value for its stakeholders by changing their stakes into goods and services.'<sup>77</sup>

The shareholders are the owners of the company under the traditional view of the company, namely the shareholder view. The objective of the company has been traditionally defined as maximising the interests of shareholders in the Anglo-American corporate system. However, stakeholder theory defines organisations as multilateral agreements between the enterprise and its multiple stakeholders.<sup>78</sup> Therefore, the management should take a long-term view of the corporate commercial needs rather than

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<sup>72</sup> Clarke (n 33) 10.

<sup>73</sup> Robert Philips, *Stakeholder Theory and Organizational Ethics* (Berrett-Koehler 2003).

<sup>74</sup> R. Edward Freeman, *Strategic Management: a Stakeholder Approach* (Boston: Pitman 1984). It identifies and models the groups which are stakeholders of a corporation, and describes and recommends methods by which management can give due regard to the interests of those groups.

<sup>75</sup> Yuwa Wei, *Comparative Corporate Governance: A Chinese Perspective* (Kluwer Law International 2003) 45.

<sup>76</sup> Max B E Clarkson, 'A Risk Based Model of Stakeholder Theory' (Centre for Corporate Social Performance and Ethics, University of Toronto 1994).

<sup>77</sup> *ibid.*

<sup>78</sup> R. Edward Freeman and M. William Evan, 'Corporate Governance: A Stakeholder Interpretation' (1990) 19 *Journal of Behavioural Economics* 337.

pursue a short-term strategy to maximise shareholder value. A stakeholder is defined as ‘any group or individual who can affect or is affected by the achievement of an organisation’s objective.’<sup>79</sup> There are many parties involved in the operation of a company according to stakeholder theory, which can be divided into primary stakeholders and secondary stakeholders. The primary stakeholders are these who are directly and immediately impacted by a company’s activities, including investors, employees, suppliers, customers, managers, government bodies, political groups, trade associations, trade unions and communities. The secondary stakeholders are those who are indirectly or less obviously influenced by a company’s success or failure such as regulators, competitors and media.

The relationship between the company and its internal stakeholders is framed by formal and informal rules developed through the history of the relationship. This institutional setting constrains and creates the strategic possibilities for the company. While management may receive finance from shareholders, they depend on employees to fulfil strategic intentions. External stakeholders are equally important, and also are constrained by formal and informal rules that businesses must respect.<sup>80</sup>

Pursuant to Donaldson and Preston, stakeholder theory can be categorised into three types, that are normative, instrumental and descriptive/empirical.<sup>81</sup> The descriptive/empirical type theory is used to ‘describe, and sometimes to explain, specific

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<sup>79</sup> Freeman (n 76) 46

<sup>80</sup> Clarke (n 33) 10, 11.

<sup>81</sup> Thomas Donaldson and Lee E. Preston, ‘The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications’ (1995) 20 *The Academy of Management Review* 65.

corporate characteristics and behaviours.’<sup>82</sup> Instrumental type theory is used to ‘identify the connections, or lack of connections, between stakeholder management and the achievement of traditional corporate objectives.’<sup>83</sup> And the normative type theory is applied to ‘interpret the function of the corporation, including the identification of moral or philosophical guidelines for the operation and management of corporations.’<sup>84</sup> Donaldson and Preston argue that the central core of stakeholder theory is normative, and that it focuses on the intrinsic value of the interests of stakeholders. Managerial relationships with stakeholders are based on normative, moral commitments, rather than on a desire to use those stakeholders solely to maximise profits.<sup>85</sup> Mitchell, Agle and Wood derive a typology of stakeholders based on the attributes of power, legitimacy and urgency.<sup>86</sup> By examining the combination of these attributes in a binary manner, eight types of stakeholders are derived along with their implications for the organisation. Friedman and Miles explore the implications of contentious relationships between stakeholders and organizations by introducing compatible/incompatible interests and necessary/contingent connections as additional attributes with which to examine the configuration of these relationships.<sup>87</sup>

Significantly, the stakeholder theory has its own inadequacies just as other theories of corporate governance do. For instance, it fails to provide adequate guidance to the managerial decision-making process. Friedman and Miles argue that stakeholder theory

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<sup>82</sup> *ibid* 70.

<sup>83</sup> Donaldson and Preston (n 81) 71.

<sup>84</sup> *ibid*.

<sup>85</sup> Donaldson and Preston (n 81) 74.

<sup>86</sup> Ronald K. Mitchell, Bradley R. Agle and Donna J. Wood, ‘Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts’ (1997) 22 *The Academy of Management Review* 853.

<sup>87</sup> Andrew L. Friedman and Samantha Miles, ‘Developing Stakeholder Theory’ (2002) 39 *Journal of Management Studies* 1.

presumes a clear-cut, stable and homogeneous boundary among stakeholder groups, between stakeholder legitimacy and illegitimacy, and in managerial perceptions of stakeholder-corporation relationships.<sup>88</sup> But in practice, the theory does not provide a suitably accurate formula because of the diverse and conflicting interests of stakeholders.

Although the mainstream theories of corporate governance, which have different ideas and assumptions regarding the theory of the company, have made great contributions to the understanding of corporate governance, it cannot be denied that each theory has its own limits and insufficiencies.

### **2.2.3 Factors affecting the development of a corporate governance system**

The behaviour of corporations has been a subject of vital concern for many centuries, as corporations have been and are deemed key institutions in the generation and allocation of a society's resources.<sup>89</sup> Therefore, they have been treated with different, complicated systems of corporate governance to regulate their behaviour.<sup>90</sup> In fact, the development of a corporate governance system is not isolated from other social forces of the particular society. A nation with special economic, political, cultural and legal traditions has its own characteristics that form a part of the corporate governance system. It is apparent that factors like economic reality, politics, culture and legal traditions have certainly been important in moulding different corporate governance systems around the world. Thus, it is significant to identify and examine those factors that play a consequential role in

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<sup>88</sup> *ibid.*

<sup>89</sup> Jeswald W Salacuse, 'The Culture Roots of Corporate Governance' in Joseph J Norton, Jonathan Rickford and Jan Kleineman (eds), *Corporate Governance Post-Enron Comparative and International Perspectives* (BIICL 2006).

<sup>90</sup> *ibid.*

shaping a corporate governance system so as to seek a proper and practicable model of corporate governance.<sup>91</sup>

### **2.2.3.1 The economic factor**

The economy plays a major role in pushing forward corporate development, which is usually regarded as the driving force behind the development of corporate governance. Thus, it is necessary to review corporate history in order to illustrate the fact that the economy plays a vital part in melding the developmental direction of corporate governance. Along with motivating technological development and innovation, the economy promotes companies to manufacture on an ever-increasing scale and thus, the industrial sector takes on a major and indispensable part in accumulating national wealth. Because of this, the industrial sector demands a large amount of capital to enlarge its scale and operation. Consequently, the traditional owner-management relationship is broken when many investors are invited to invest in companies. The tendency of corporate governance in a company is to separate ownership and control, which results in the conflict between supervision and management.

The economy determines that there are different characteristics in various corporate systems because distinct economic conditions in each country lead to the adoption of different approaches and strategies for the development of corporate governance. It is a fact that as the first industrialized country, the UK adopted a gradual and free trade approach for the establishment of its own corporate economies. However, Germany and Japan, as later industrialized countries, faced more competition. Initially, the establishment and development of companies in the UK was as a means of increasing

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<sup>91</sup> Wei (n 75) 176. This section is based on the research by Yuwa Wei.

investors' wealth while Germany and Japan supported and financed the development of their companies in order to advance their national economies.

Large companies in countries that have strong economies and industrial strength, such as the USA and the UK, often meet the problem of the separation of ownership and management. Whereas for those countries that have weak economic conditions and fragile industrial foundations, their problem is not separation of ownership and management, but a lack of capital, cash flow and further expansion. So it can be concluded that a country's economic condition determines its corporate structure system and also that each country prioritises the development of its corporate economy based on its own economically determined characteristics.<sup>92</sup>

### **2.2.3.2 The political factor**

The theory of political economy illustrates that a country's approach to the organization of its financial institutions deeply relies upon its political systems and attitudes. Furthermore, this determines the corporate ownership structure in a nation's large companies.<sup>93</sup> Research carried out by Mark Roe has been cited to explain the different ownership structures in large companies through the analysis of the roles of financial intermediaries in the USA, Germany and Japan. He attributed the dispersed ownership structure in large US companies to fragmented financial institutions dictated by American politicians.<sup>94</sup> According to the characteristics of the American political system, namely federalism, it is a fact that every state has excluded branches of banks from other states so as to protect its local banks, so that a real nationwide banking system does not exist in the

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<sup>92</sup> *ibid* 177.

<sup>93</sup> *ibid*.

<sup>94</sup> Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press 1996).

United States.<sup>95</sup> Consequently, it is very difficult for large US companies to obtain a large amount of capital from banks and thus, they only acquire their capital from scattered investors in the securities and stock market. Therefore, dispersed ownership leads the power of control to be with managers instead of investors.<sup>96</sup>

Compared with the US tradition, financial institutions in Germany and Japan have played a critical role in financing companies. German law allows banks to become involved in providing a series of services and capital for industrial companies. Thus, it is obvious that in contrast to the US banks, the banks in Germany have been given a high degree of independence. Banks supply a significant amount of large German companies' capital which means that they do not need to raise funds from other investors. It is noteworthy that the shareholdings of German companies are relatively concentrated.<sup>97</sup> Therefore, banks are able to impact on boards via voting power. The major concern of corporate governance in Germany is not the agency problem.

The ownership structure in large Japanese companies is the same as that of German companies, which means financial institutions hold concentrated blocks of voting rights and enjoy managerial power.<sup>98</sup> In Japan, a group of companies and financial institutions are usually joined together by cross-shareholdings called a "keiretsu". The banks as the major financiers are the cores of such "keiretsu". Obviously, they hold the largest bulk of shareholdings in Japanese companies. Thus concentration becomes the major characteristic in the ownership structure of Japanese companies.

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<sup>95</sup> *ibid.*

<sup>96</sup> *ibid.*

<sup>97</sup> Wei (n 75), 178.

<sup>98</sup> *ibid.*

The cases of corporate structure in US, Germany and Japan illustrate that although those countries have similar economies, they do not generate similar corporate ownership structures. Pursuant to the political contexts, financial institutions in those countries have played different roles in supporting their companies, leading to a diversification of large company ownership structures.

### **2.2.3.3 The cultural factor**

Breuer and Salzmann argue that:

Culture induces actions compatible with its values through its impact on organisational policies and on the values of individual decision-makers. Cultural values constitute a convention of common tastes for certain interpersonal relations and institutions, and, as a result, may influence the choice of particular corporate governance structures.<sup>99</sup>

Roland indicates that the content of corporate governance structures should be in accordance with and partly reflect the prevailing cultural orientations in a society from the long-term perspective.<sup>100</sup>

Breuer and Salzmann further point out:

Countries with a strong emphasis on the cultural dimensions of Embeddedness and Harmony should tend to have a bank-based corporate governance system. Embeddedness coincides with values like “social order”, “respect for tradition”, and “honoring of parents/elders”, which relates to the existence of privileged insiders. The dimension of Harmony relies on values

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<sup>99</sup> Wolfgang Breuer and Astrid Juliane Salzmann, ‘National Culture and Corporate Governance’ (January 7, 2011) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1260746](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1260746)> accessed 20 March 2011.

<sup>100</sup> G  rard Roland, ‘Understanding Institutional Change: Fast-Moving and Slow-Moving Institutions’ <<http://elsa.berkeley.edu/~groland/pubs/gr3.pdf>> accessed 18 May 2010.

like “a world in peace” and “unity with nature”, which reflects the pronounced stability orientation of the system. A strong emphasis on the cultural dimensions of Hierarchy and Autonomy militates in favor of the market-based corporate governance system. Hierarchy emphasizes values like “social power” and “authority”, and corresponds to external governance via market mechanisms. Autonomy draws on values like “freedom” and “creativity”, which is reflected in the flexibility of the market based system. Countries with a low emphasis on the mentioned cultural dimensions should demonstrate reverse characteristics.<sup>101</sup>

The study by Breuer and Salzmänn shows that national culture is an essential determinant in the design of corporate governance systems.<sup>102</sup> Wei compares two different paths of corporate governance by Japanese and overseas Chinese in communities in the Pacific region. These groups were chosen because they are deeply impacted by Confucianism which is made up of two basic moral principles including loyalty to the emperor and filial piety.<sup>103</sup> In the following paragraphs, the details will be discussed.

Taking corporate development in Japan as an example, when referring to Japanese corporate governance, some obvious features are mentioned such as ‘groupism’, ‘familism’, lifetime employment, and the ideology that the motivation of a company is to

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<sup>101</sup> Breuer and Salzmänn (n 99) 5-6.

<sup>102</sup> Breuer and Salzmänn (n 99).

<sup>103</sup> Wei (n 77) 179.

serve the nation, not maximum private gain.<sup>104</sup> These characteristics have deep roots in Japanese culture.<sup>105</sup>

Due to traditional Japan that has been completely established under Confucian doctrines, as Japan's entry into the time of industrialization, it was interesting to note that the purpose of their business activities was not making profit but was promoting the stability and lasting of the community or company when traditional moral tenets were transformed into business activities.<sup>106</sup>

Therefore, it can be understood that in a modern Japanese company, the interest between managers and employees is not conflict; instead they have a collaborative of interest that the goal of the business is to pursue the continuity of the company. The first target of the board is not to maximise the interests of shareholders, as in the Anglo-American corporate governance system, but to maintain the continuity and pursue the long-term interests of the company. Pursuant to the study by the two scholars, the board is an insider board appointed from the management ranks.<sup>107</sup>

Another typical cultural example that has a deep influence on corporate governance is shown in the business companies of overseas Chinese communities in the Pacific region. The governance model of overseas Chinese companies is quite different from that of Japanese companies. A significant example of this difference is that Japanese companies are group-oriented and Chinese companies are family-oriented. Overseas Chinese

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<sup>104</sup> Rodney Clark, *The Japanese Company* (Yale University Press 1981) 25, 29. Also Keiichiro Nakagawa, *Social Order and Entrepreneurship* (University of Tokyo 1977) 202, 203 and 207-09.

<sup>105</sup> *ibid.*

<sup>106</sup> Rodney Clark, *The Japanese Company* (Yale University Press 1981) 25, 29. Also Keiichiro Nakagawa, *Social Order and Entrepreneurship* (University of Tokyo 1977) 202, 203 and 207-09.

<sup>107</sup> Hideki Kanda, 'Trends in Japanese Corporate Governance' in Klaus J. Hopt and Eddy Wymeersch (eds), *Comparative Corporate Governance: Essays and Materials* (deGruyter 1997) 187. See also in Nakagawa (n 104) 212.

companies are the property of their families and the company's goal is to pursue maximum interests for families. Although there are many problems in family-oriented companies, particularly in managing effectiveness and integrating employers and employees, it is surprising to note that overseas Chinese firms have created an economic miracle, especially in the south eastern countries. Thus, it is necessary to explain that there is a vast difference between the mainstream corporate models and theories, and the corporate governance models in overseas Chinese companies.<sup>108</sup>

It can be interpreted that this is partly a result of Confucianism, which is deeply rooted in Chinese culture. Confucian family values in the Chinese cultural tradition have partly driven the overseas Chinese communities to find their own way to deal with corporate issues and activities, which have assisted them to achieve economic success.

Despite the recent trend to focus on cultural influences in corporate behaviour, it is possible to overestimate the power of culture to meld corporate governance systems since economic development is the fundamental determinant of the pattern of corporate governance systems and corporate economics. Kester has emphasised the view that:

Culture was an essential element in the crucible of industrial change and contributes critically to the creation of an alloy that could bend and adapt itself admirably to a changing political-economic environment. But it was the conflicting interests of diverse stakeholders that were the hammer and anvil used to shape the final corporate form. In this regard, the modern Japanese corporation shares a heritage with corporations of other industrialized nations.

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<sup>108</sup> S. Tam, 'Contrasting Ideal Types of Chinese and Japanese Firms' in Stewart R. Clegg and S. Gordon Redding (eds) *Capitalism in Contrasting Cultures* (Walter De Gruyter Incorporated 1989)168-9.

It is, in the end, still an economic institution whose behaviour is susceptible to explanation and prediction by models rooted in classical microeconomic axioms of purposeful, self-interested action by individuals. So too is its evolution.<sup>109</sup>

In the phenomenon of the culture of corporate governance in Japanese companies, it is worth pointing out that the Japanese government has played an important role in promoting industrialization, business morality, advancing national interest and other corporate behaviour.<sup>110</sup>

It is acknowledged that unique political and social environments have advanced to form the especial Chinese business behaviour abroad, while Chinese culture has deeply impacted the corporate governance system and corporate activities in overseas Chinese companies. Initially, Chinese entrepreneurs abroad were not supported by their local governments politically or financially, so they followed a path of self-training and self-development.<sup>111</sup> Family companies and family capitalism brought advantages to Chinese business people abroad, such as providing the most reliable business environment and a sense of responsibility to contribute in tasks, jobs and other obligations.<sup>112</sup> Conversely, it cannot be ignored that there are many disadvantages in family companies, such as their limited scale and lack of human resources. However, such shortcomings were greatly neutralised by informal business networks and other innovations. This shows that

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<sup>109</sup> W.C. Kester, *Japanese Takeover: The Global Contest for Corporate Control* (Harvard Business School Press 1991) 52.

<sup>110</sup> Clark (n 104).

<sup>111</sup> Wei (n 77) 181.

<sup>112</sup> *ibid.*

overseas Chinese entrepreneurs have an ability to melt into particular political, economic, and geographic and market environments to gain economic benefits.<sup>113</sup>

In addition, one should note that cultural elements should be taken into account along with the political and economic atmosphere to decide why different patterns of corporate governance are adopted, because similar economic and political conditions seem to have generated similar business behaviour.

#### **2.2.3.4 The legal factor**

Legal traditions also impact on corporate governance systems. Generally, there are two main distinct legal systems, specifically the common law system and the civil law system. Modern common law originated in England and has been generally adopted by those countries with a history as British colonies or commonwealths such as the United States, Canada, and Australia, while the civil law system refers to those other jurisdictions which have adopted the European continental system of law, with its origins in Roman law that exists in most European continental countries, Japan, Latin America, former socialist countries and most former colonies of continental European countries.<sup>114</sup>

The difference between the two systems is that the common law tradition recognises that flexibility is the critical legal value, thus common law tends to be case-centred and judge-centred. This means that the judge is allowed a certain scope to apply a discretionary and

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<sup>113</sup> Tam (n 108) 172-3.

<sup>114</sup> 'Common Law', *World Encyclopedia* (Philip's, 2008)

<<http://www.oxfordreference.com/views/ENTRY.html?entry=t142.e2661>> accessed on 20 March 2010;

'Civil Law', *World Encyclopedia* (Philip's, 2008)

<<http://www.oxfordreference.com/views/ENTRY.html?entry=t142.e2481>> accessed on 20 March 2010. In China, it is a mixture of civil law and socialist law. In the late years of the Qing Dynasty, the German Civil Code was introduced and formed the basis of the law of the PRC, which remains in force.

pragmatic approach based on principles, such as fairness and equity, to solve particular problems or disputes. In the Anglo-American legal system, the company law shows the principle of freedom of contract between legal persons with judicial intervention in order to pursue justice and equity. The principles and ideology of common law are retained even though the tendency of company laws in countries under the common law system is moving towards a statutory direction.<sup>115</sup>

As a distinct and typical representative in the civil law system, Germany has developed a self-contained model of company law. Different types of companies such as public companies, closely-held companies and group companies are ruled by separate bodies of law. Unlike Anglo-American internal governance, Germany introduces the two-tier board in a company so as to separate the power of internal governance. There is less space for judicial interpretation in German corporate law. Thus, German company law is strict and prescriptive. Compared with characteristics of Anglo-American corporate laws, it is obvious to note that German corporate law lacks flexibility. However, German corporate law's scientific and comprehensive approach makes it a distinctive and influential system that greatly impacts many other jurisdictions.

#### **2.2.4 Corporate governance in practice**

It is generally accepted that there are two basic models of corporate governance, which are always divided into an outsider system, namely the Anglo-Saxon model, which is characterized as a market-based corporate governance system that is prevalent in the USA, UK and other English-speaking countries such as Canada and Australia, and an

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<sup>115</sup> John Henry Merryman, *The Civil Law Tradition: An Introduction to the Legal Systems of Western European Latin America* (Stanford University Press 1985) 49.

inside system, namely the German-Japanese model, which is characterized as a bank-based corporate governance system that is practised in many Continental European countries and Asian countries.<sup>116</sup>

The Anglo-American outsider system of corporate governance is the longest established of the two systems, and has affected much of the rest of the world because the US and the UK have strong capital markets and their investment institutions have increasingly become active on an international level. They are characterised by dispersed shareholding, shareholder sovereignty and alignment of shareholders' and managers' interests.<sup>117</sup> The Anglo-Saxon model is at the heart of agency theory and associated corporate governance principles. The central characteristics of the market-based outsider model of corporate governance are:

The importance of the enhancement of monitoring is stressed; diffuse equity ownership with institutions having very large shareholdings; shareholder interests are considered the primacy focus of company law; the protection of minority shareholder is well-established by law and regulations; there is a stringent requirement for continuous disclosure to inform the market.<sup>118</sup>

The German-Japanese insider system of corporate governance with concentrated ownership, bank finance and the representation of majority interests on the board of directors predominates in Europe, the Asia Pacific and other regions of the world.<sup>119</sup> The insider system, which is characterised by 'cross-shareholdings, cross-representation of

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<sup>116</sup> Ruth V. Aguilera and Gregory Jackson, 'The Cross-National Diversity of Corporate Governance: Dimensions and Determinants' (2003) 28 *Academy of Management Review* 447.

<sup>117</sup> Clarke (n 8).

<sup>118</sup> *ibid* 129.

<sup>119</sup> Clarke (n 8) 9.

directors, large investor involvement in corporate decision-making, and the concentration of share ownership', is built on a close relationship with a wide range of stakeholders and the creation of value for all stakeholders is viewed as the corporate objective and mission.<sup>120</sup>

The Chinese corporate governance system is quite different from two dichotomous models of Anglo-American and Continental European corporate governance. Upon the founding of the People's Republic of China in 1949, the new Chinese communist government commenced to reform the old corporate system established during the Nationalist period and has been determined to build a socialist economic system:

China embarked on a socialist transformation of the whole economy by setting up a socialist public ownership system led by the state-run economy.<sup>121</sup>

The State ownership system had the characteristic of a high degree of centralization and dominated most of the industrial sectors in China, which were the cornerstone in the Chinese socialist economy. Thereafter, the state-owned enterprises played an extremely significant role in the national economy.

Since 1978, China has gradually carried out its clear goal of the establishment of a socialist market economy. Unlike other former communist countries in Europe, China has adopted the gradual reform strategy that 'has combined the introduction of market forces, gradual reduction of mandatory planning, decentralization and autonomy in economic

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<sup>120</sup> Jian Chen, *Corporate Governance in China* (Routledge Curzon 2005) 1.

<sup>121</sup> Lay Hong Tan, 'Corporate Law Reform in the People's Republic of China' (1999) Nanyang Technological University Business Law Series No.TLH01/02  
< [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=325441](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=325441) > accessed 20 June 2008.

management and opening the economy to international trade and foreign investment.’<sup>122</sup> After thirty years of reform, China has achieved a remarkable level of economic and social progress. Since the end of the 1990s, the Chinese government has implemented the fundamental reforms of the state-owned enterprises in order to begin the establishment of a modern corporate system in Chinese state-owned enterprises. Since then, the Chinese government has adopted different strategies for different sized state-owned enterprises. For instance, small state-owned enterprises were privatized, sold or dragged into insolvency. The Chinese government has transformed large and medium-sized state-owned enterprises associated with national economic security from wholly state-owned enterprises into modern shareholding companies controlled by the state.<sup>123</sup>

In summary, there are significant differences between the three broad systems of corporate governance. The actual practices adopted in addressing the issues are accordingly distinct because of different issues of corporate governance across the countries. Therefore, different corporate governance systems have incentives and control mechanisms for trade-offs.

## **2.3 The governance of banks: special features**

In contrast to non-financial companies, banks substantially differ in some important respects.<sup>124</sup> First of all, banks are highly leveraged institutions. Pursuant to Mülbert, banks are compensated for accepting a maturity mismatch by a premium charged to creditors. For instance, a bank’s creditors have to pay a higher interest rate than the bank pays for its refinancing. Therefore, a bank’s profit increases directly in proportion with

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<sup>122</sup> Harry G. Broadman, *Meeting the Challenge of Chinese Enterprises Reform* (The World Bank 1995) 2.

<sup>123</sup> See more details in Chen (n 120) and Wei (n 75).

<sup>124</sup> This part is based on the works of Levine (n 2), Polo (n 4) and Mülbert (n 125).

the volume of lending to creditors. The upper bound for an increase in lending is derived from the marginal cost of a bank's refinancing, given that an increase of the bank's leverage will increase its probability of default, and depositors as well as other debt holders will demand a higher risk premium as compensation for the higher risk of insolvency, and from minimum capital requirements provided for by prudential regulation.<sup>125</sup>

Second, banks are generally more opaque than non-financial companies, which lead to particularly severe information asymmetry and the agency problem.<sup>126</sup> The core of corporate governance problems refers to informational asymmetries between the providers of capital and the controllers of capital. It is a universal phenomenon that some degree of information asymmetry between inside and outside investors exists in all companies. However, market-based mechanisms are able to solve these problems in most companies, while financial companies are those who are subject to heavy government regulation whose rationale is based on the notion that bank assets are extremely difficult for outsiders to value, leading to the consequence that market mechanisms are unable to completely control bank managers and shareholders.<sup>127</sup> This type of opacity is reflected in the difficulty of evaluating the quality of bank loans because many loans do not trade in active secondary markets where the quality of many assets of nonfinancial firms such

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<sup>125</sup> Peter O. Mülbert, 'Corporate Governance of Banks after the Financial Crisis—Theory, Evidence, Reforms' (2010) ECGI (European Corporate Governance Institute) Law Working Paper No. 130/2009, < [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1448118](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1448118) > accessed 3 January 2011.

<sup>126</sup> Gerard Caprio and Ross Levine, 'Corporate Governance in Finance: Concepts and International Observations' in Robert E. Litan, Michael Pomerleano and V. Sundararajan (eds.), *Financial Sector Governance: the Roles of the Public and Private Sectors* (Brookings Institution 2002). See also Levine (n 2).

<sup>127</sup> Polo (n 4).

as plant and equipment is much more easily receivable by third parties.<sup>128</sup> Some other assets, such as securities including asset-backed securities, collateralized debt obligations and credit-default swaps that banks invest in, are also not readily observable. The financial turmoil that took place in the autumn 2008 was caused by these difficulties to a large extent.<sup>129</sup> After the collapse of Lehman Brothers, banks prevalently distrusted the quality of other banks' assets, thus the interbank market for short-term lending virtually crashed.<sup>130</sup> There are two important studies that address the issue of whether banks are relatively more opaque than other firms. These produce contradictory results that indicate that rating agencies disagree more with respect to the quality of bonds issued by banks than with the quality of bonds issued by other firms.<sup>131</sup> Pillar 3 of Basel II Accord sets out qualitative and quantitative disclosures of capital structure and capital adequacy, as well as risk exposure and assessment, so as to respond to the problem of banks being arguably more opaque than generic firms by promoting market disciplines.<sup>132</sup>

Third, due to the unique features of banks, for instance, their systemic importance, their vulnerability to runs, excessive risk taking and other moral hazard behaviour caused by

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<sup>128</sup> Peter O. Mülbert (n 125) 11. As a response to the financial crisis, the Basel Committee on 16 December 2010 issued the Basel III rules text, which presents the details of global regulatory standards on bank capital adequacy and liquidity agreed by the Governors and Heads of Supervision, and endorsed by the G20 Leaders at their November 2010 Seoul summit. The rules text presents the details of the Basel III Framework, which covers both micro prudential and macro prudential elements. The Framework sets out higher and better-quality capital, better risk coverage, the introduction of a leverage ratio as a backstop to the risk-based requirement, measures to promote the build up of capital that can be drawn down in periods of stress, and the introduction of two global liquidity standards. See < <http://www.bis.org/bcbs/basel3.htm> > accessed 5 March 2011.

<sup>129</sup> *ibid.*

<sup>130</sup> *ibid.*

<sup>131</sup> Donald P. Morgan, 'Rating Banks: Risk and Uncertainty in an Opaque Industry' (2002) 92 *American Economic Review* 874. See also Giuliano Iannotta, 'Testing for Opacity in the European Banking Industry: Evidence from Bond Credit Ratings' (2004) SDA Bocconi Working Paper No. 122/04 < [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=570483](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=570483) > accessed 6 March 2008.

<sup>132</sup> Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework' (Basel: Bank for International Settlements, November 2005) < <http://www.bis.org/publ/bcbs128.htm> > accessed 10 May 2008.

deposit insurance or safety nets, most countries set out special regulations and supervision for banks, which are more comprehensive than for other sectors of the economy.<sup>133</sup> The main purpose of bank regulation in the contemporary setting is to restrain the adverse externalities arising from bank failures.<sup>134</sup>

## 2.4 Rationale for banking regulation

Banking is one of the most heavily regulated sectors across the world in spite of the competition present in the sector, which is regarded as the traditional means to achieve development and efficiency of a sector.<sup>135</sup> Generally, the public suggests that banks are vital to economic stability.<sup>136</sup> Some scholars deem that the development and efficiency of the banking system are significant contributors to overall economic growth.<sup>137</sup> Therefore, the public and communities unanimously realise that it is necessary for extraordinary

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<sup>133</sup> Regulation is defined as a set of laws and regulations applicable to banking. Supervision refers to the oversight by authorities of banks' activities and the enforcement of banking regulations. 'Schemes of deposit insurance and the role of central banks as lenders of last resort are the main instruments governments have built to prevent bank runs, contagion and other strains of systemic risk'. However, these instruments might result in a 'moral hazard, as it reduces the incentives of depositors to monitor banks and it increases banks' incentive to take more risks'. See Polo (n 4) 6.

<sup>134</sup> Darius Palia and Robert Porter, 'Contemporary Issues in Regulatory Risk Management of Commercial Banks' (2003) 12 *Financial Markets, Institutions and Instruments* 223. 'Basically, banking regulation limits the amount of risk a bank may take, in particular, under Pillar 1 of the Revised Framework of the Basel Committee on Banking Supervision (Basel II) by stipulating risk-adjusted minimum capital requirements, i.e., by linking the required regulatory capital for a bank's assets (loans, securities, and other assets) in a rather sophisticated approach to the adjusted risk-weight of the different assets, limits a bank's exposure to a single creditor or group of creditors and addresses the risk from disruptions in the access to sufficient liquidity by setting standards for liquidity management.' Peter O. Mülbert (n 121) 13.

<sup>135</sup> Randall S. Kroszner, 'Rethinking Bank Regulation: A Review of the Historical Evidence' (1998) *Journal of Applied Corporate Governance* 48.

<sup>136</sup> Thomas Huertas, 'The Rationale for and Limits of Bank Supervision' (Financial Service Agency London Financial Regulation Seminar 2009) <[http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0119\\_th.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0119_th.shtml)> accessed 12 November 2010.

<sup>137</sup> Jith Jayaratne and Philip Strahan, 'The Finance-Growth Nexus: Evidence from Bank Branch Deregulation' (1996) 111 *Quarterly Journal of Economics* 639. See also Ross Levine, 'Stock Markets, Banks and Economic Growth' (1998) 88 *American Economic Review* 537.

government intervention and support in order for banks to continue to operate effectively as amply demonstrated in the current financial crisis.<sup>138</sup>

The public and communities effectively bring a credit risk to banks. Regulation is able to be deemed as correspondence to the covenants that a commercial lender would fulfil, if it were to serve as a liquidity backstop to the bank and/or guarantor of a bank's deposits.<sup>139</sup> These covenants or regulations are with regard to the condition that banks must maintain in a healthy condition with minimum amounts of capital and liquidity. In addition, they should restrain large exposures, limit lending to connected affiliates and account accurately for assets and liabilities.<sup>140</sup> Also, these covenants or regulations pertain to the requirement that banks must conduct themselves properly.<sup>141</sup> 'Their managers and owners have to be "fit and proper" and they have to act with integrity.'<sup>142</sup> Banks need to operate with due care, skill and diligence in order to avoid the following: market abuse or manipulation, mismanagement in conflicts of interest, inappropriate use of client assets, and misleading customers.<sup>143</sup> Thus, they need to have appropriate systems and controls.

There are diverse reasons for regulating the banking sector, and different authors have divergent opinions on the validity of these reasons. The next section will provide an analysis of the key underlying reasons for the range of regulations that face the banking sector.

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<sup>138</sup> Huertas (n 136).

<sup>139</sup> Mathias Dewatripont and Jean Tirole, *The Prudential Regulation of Banks* (MIT Press 1994) 31-2, 87-92.

<sup>140</sup> Huertas (n 136).

<sup>141</sup> *ibid.*

<sup>142</sup> *ibid.*

<sup>143</sup> *ibid.*

It is very common for information asymmetries to exist in the banking sector. Banks are financial intermediaries where, simultaneously, the general public places their deposits with banks and then banks make use of the funds to lend money to borrowers.<sup>144</sup> However, banking customers need confirmation that banks perform their task in the interest of the clients. As clients depend on intermediaries to evaluate the quality of the borrowers, and it is difficult for individual savers to do so, perhaps customers are likely to wonder whether their bank is actually carrying out its role in an optimal manner. Depositors are able to withdraw their deposits on short notice, which is seen as a critical sanctioning mechanism in this area.<sup>145</sup> According to this basis, Benston has concluded that banks will ensure high quality services and avoid engaging in overly risky activities. It is not necessary to have further regulation if there is sufficient competition in the financial market and alternatives for investors to invest their funds as they meet problematic activity.<sup>146</sup> However, it is likely to be very difficult for clients to assess the quality of the service they obtain in advance, and it is likely to take customers a very long time to assess the quality of their bank's service. Even depositors may only discover problematic bank activity after it has been continuing for several years. Moreover, the key nature of bank services, such as risk management and monitoring, requires borrowers to have knowledge of complex and advanced skills. Thus, depositors need to take advantage of intermediaries. Banking services can therefore be called 'credence goods',

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<sup>144</sup> Ralf Bebenroth, Diemo Dietrich and Uwe Vollmer, 'Bank Regulation and Supervision in Bank-dominated Financial Systems: A Comparison between Japan and Germany' (2008) *European Journal of Law and Economics* 177.

<sup>145</sup> Xavier Freixas and Jean-Charles Rochet, *Microeconomics of Banking* (Cambridge MIT Press 1997) 17.

<sup>146</sup> George J. Benston, *Regulating Financial Markets: A Critique and some Proposals* (London Institute of Economic Affairs 1998) 38.

for instance, the quality can only be assessed at serious cost after a long period of time.<sup>147</sup>

Thus, it is essential to have confidence in a bank's activities.

While it is difficult for depositors to evaluate the quality of the services provided by their bank, it is likely that banks engage in risky activity but depositors do not have adequate measures to take action against them. It is obvious that a principle-agent problem is created by delegation. It is difficult for the principle (namely, the depositor) to control the agent (namely, the bank). In fact, savers have limited incentives to monitor their bank since other depositors will rely exactly on any supervisory effort made by the individual saver.<sup>148</sup> It could be concluded from the reasons above that perhaps banks do decide to engage in behaviour that is not in the interests of depositors.

Banking activities have continuously evolved from traditional deposit-taking and lending activities to cover the entire sphere of financial services over the past three decades.<sup>149</sup> Subsequently, it is inevitable that banks are indeed confronted with greater and more complicated risks in order to enhance profits.<sup>150</sup> As a result, banking crises have developed many times over the past decades. Banks are subject to a wide series of risks in the course of their operations.<sup>151</sup> According to Van Greuning and Brajovic Bratanovic,

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<sup>147</sup> David Llewellyn, 'The Economic Rationale for Financial Regulation' (1999) FSA Occasional Paper Series No.1 < [www.fsa.gov.uk/pubs/occpapers/OP01.pdf](http://www.fsa.gov.uk/pubs/occpapers/OP01.pdf) > accessed 20 November 2010.

<sup>148</sup> Dewatripont and Tirole (n 139). Also, Dirk Heremans, 'Regulation of Banking and Financial Markets' in Boudewijn Bouckaert and Gerrit De Geest (eds), *Encyclopaedia of Law and Economics* (Cheltenham, Edward Elgar 2000) 956.

<sup>149</sup> Joseph J. Norton, 'The New International financial Architecture and Global Banking Institutions' in Say Goo, Douglas Arner and Zhongfei Zhou (eds), *International Financial Sector Reform: Standard Setting and Infrastructure Development* (Kluwer Law International 2002) 13.

<sup>150</sup> *ibid* 14.

<sup>151</sup> Hennie Van Greuning and Sonja Brajovic Bratanovic, *Analyzing and Managing Banking Risk: a Framework for Assessing Corporate Governance and Financial Risk* (3<sup>rd</sup> edn, World Bank 2009) 2. Specifically speaking, the risks that banks need to confront are, amongst others, (a) the risk that a borrow will not be able to repay his loan according to the agreed terms (credit risk), (b) the risk that a bank has concentrated too much of its activities on a limited group of borrowers and that if some of this group fail, the activities would not have been sufficiently diversified to set off the losses (concentration risk), (c) the

banking risks can be divided into four categories namely financial, operational, business and event risks.<sup>152</sup> Financial risks are made up of two types of risk that are pure risks including liquidity, credit and solvency risks, and speculative risks which include interest rate, currency and market price risks. Both types of risks are able to lead to a loss if they are not properly managed. Operational risks refer to a bank's overall business strategy; internal and operational systems including organization, computer-related and other technologies; in compliance with bank policies and procedures; and measures against mismanagement and fraud.<sup>153</sup> Business risks are related to a bank's business environment, which involves macroeconomic and policy concerns, legal and regulatory factors, the infrastructure of the financial sector and its payment system, and the overall systemic risk for operations.<sup>154</sup> Event risks are associated with all kinds of exogenous risks including politics, contagion, and banking crises.

The incorporation of new financial instruments to transfer risk has further increased information asymmetries. Along with competition from non-bank financial intermediaries and the financial market, banks have been pushed towards risky behaviour that damages the interests of consumers and shareholders. As the financial markets have increasingly become sophisticated, it is difficult for banks to raise sufficient money to fund their lending activity. Therefore, savers are not likely to be interested in deposits because banks are unable to provide high returns to depositors. Consequently, banks are

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risk that a bank will not be able to sell an asset on the market and thus make it liquid (market liquidity risk) or not be able to fund a position (funding liquidity risk), (d) the risk that general market fluctuations will affect the bank's assets (market risk), (e) the risk that problems relating to the internal functioning of the bank (like fraud, negligence or technological errors) create wider financial problems (operational risk), (f) the risk that certain actions by (employees of ) the bank affect the good reputation of the bank (reputation risk).

<sup>152</sup> *ibid.*

<sup>153</sup> *ibid.*

<sup>154</sup> *ibid.*

likely to make decisions that depend on other channels of funding and engage in activities beyond those of traditional banking.<sup>155</sup>

When banks previously engaged in securitization, as an innovative tool to supplement deposit funding, they could convert non-marketable assets into marketable assets represented by securities.<sup>156</sup> As financial markets became more efficient, banks were no longer required to depend solely on expensive deposit financing for their lending activities.<sup>157</sup> In addition, financial markets are likely to reduce the risks incurred by the banks through these instruments in that the credit risk associated with the loan is transferred from the bank to the investor if investors buy a loan. It is possible to sell the credit risk by means of credit derivatives, which are financial contracts whose value is derived from the underlying asset (the loan).<sup>158</sup> Banks insured themselves against credit risk by these financial instruments. However, the entities that now buy this risk may try to fund their operations by borrowing on the market. For example, banks have set up

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<sup>155</sup> Pim Lescrauwaet, 'Links between Institutional Investors and Banks' (2006) Background Paper for the Working Group Institutional Investors, Global Savings and Asset Allocation of the Committee on the Global Financial System <<http://www.bis.org/publ/wgpapers/cgfs27lesrauwaet.pdf>> assessed 12 October 2010.

<sup>156</sup> The marketable assets are secured on the non-marketable assets (namely the receivables, like interest payments for a loan). See Philip R Wood, *Project Finance, Securitisations, Subordinated Debt* (The Law and Practice of International Finance Series Volume 5, Sweet & Maxwell 2007) 112.

<sup>157</sup> Kern Alexander, John Eatwell, Avinash Persaud and Robert Reoch, 'Financial Supervision and Crisis Management in the EU' (2007) Study for the Policy Department on Economic and Scientific Policy of the European Parliament IP/A/ECON/IC/2007-069, 8 <<http://www.europarl.europa.eu/activities/committees/studies/download.do?language=en&file=26588>> accessed 10 February 2010.

<sup>158</sup> The best-known example of a credit derivative is a 'Credit Default Swap'. This is a contract in which the buyer of the Credit Default Swap pays a periodic fee to the protection seller. In the case of the underlying asset (e.g. the loan), the buyer can merely speculate on the default of the underlying asset. This is an important difference with an insurance contract. See Robert F Schwartz, 'Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and A Theory of Demarcation' (2007) 12 *Fordham Journal of Corporate and Financial Law* 174-76.

Structured Investment Vehicles that buy long-term loans and fund them by short-term debt.<sup>159</sup>

Banks can move loans off their balance sheets and transfer risk to different entities by means of financial techniques so that the incentives for banks to engage in adequate monitoring of borrowers are reduced, and they will not effectively be prevented from making bad lending decisions.<sup>160</sup> However, investors rely on ratings by credit rating agencies to buy packages.<sup>161</sup> These rating agencies evaluate the quality of the diversification in the packages and take other economic and systemic factors into consideration. Therefore, the credit rating agencies are delegated to monitor the quality of the risk packages. Although independent ratings by these agencies theoretically assure that the process of diversifying and relocating risk does indeed result in a reduction of risk, some authors argue that the wide availability of the methodology of credit rating

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<sup>159</sup> These vehicles can make profit because the interest to pay for short-term debt is generally lower than the return obtained from long-term loans. Other entities may buy credit risk and fund it by selling bonds to investors. To this end, pools of risk are bundled into a 'collateralised debt obligation'. The collateralised debt obligation allows the banks to sell a pool of assets to a Special Purpose Vehicle. This vehicle then divides the pool into different parts (called tranches), corresponding to different levels of risk. These tranches are sold to investors with a different risk appetite. The so-called junior-tranche will first experience possible losses in the underlying assets. Next, possible losses will be allocated to mezzanine-tranches and finally to the senior tranche. See Geoff Fuller and Franz Ranero, 'Collateralised Debt Obligations', (2005) 9 *Butterworths Journal of International Banking and Financial Law* 343-51. Martin Hellwig, 'Systemic Risk in the Financial Sector: An Analysis of the Subprime-Mortgage Financial Crisis' (2008) Reprints of the Max Planck Institute for Research on Collective Goods, Bonn 2008/43 <[http://www.coll.mpg.de/pdf\\_dat/2008\\_43online.pdf](http://www.coll.mpg.de/pdf_dat/2008_43online.pdf)> accessed 12 February 2010.

<sup>160</sup> The credit risk held by banks could be reduced to an important extent by engaging in securitisation. A diversified risk portfolio would be traded by means of collateralised debt obligations. Given the large amount of risk that is pooled together, the chance that one of the underlying assets defaults becomes lower and thus aggregate risk is reduced. The securitisation of loans by means of collateral debt obligations thus leads to increased efficiency: more credit is available to borrowers and risk is managed more efficiently. However, it is hard for investors to assess the quality of the investment packages that are offered.

<sup>161</sup> If a loan defaults, the consequences will be made by the investors in the securities that are backed by the loan and not by the bank that has originated the loan. This is exacerbated because loans are pooled into collateralised debt obligations. Indeed, while an investor may be hesitant to invest in securities that have bad underlying assets (e.g. bad loans), the determination of whether the underlying assets are effectively of low quality becomes very difficult if different credit risks are pooled together. The necessary market disciplines to avoid banks engaging in overly risk lending becomes thus flawed. Further, when several underlying assets are affected at the same time, the influence on the package cannot be underestimated. See Hellwig (n 159) 14-35.

agencies reduces the independence between the packaging of risk by banks and the rating of the package by rating agencies.<sup>162</sup>

To be specific, the individual depositors of a failing bank will bear the cost of such failure that could be led by bad lending decisions because of the lack of incentives upon banks to perform optimal monitoring and the mentioned information asymmetries.<sup>163</sup> The depositors in banks are ultimately affected even though credit risk is transferred because loans get securitised.<sup>164</sup> The first reason for regulating banking services is the private costs of bank failures. However, the importance of banking activity to public policy is that individual bank failures create social costs that reach beyond private costs.

When a bank fails, the influence is not only restrained to the customers of the bank or its managers and shareholders, but will also affect other banks and financial institutions. The effects of bank failures are eventually felt in the real economy. This is because of the high level of interconnection between banks and the important role carried out by banks in the real economy.

Despite the lack of a precise definition, regulators and the academic literature often use the notion of systemic risk which is separate from the other risks facing individual banks credit risk, market risk, and political risk and so on to discuss the crises in the banking system.<sup>165</sup> Problems of contagion are always referred to as domino effects.<sup>166</sup> When a

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<sup>162</sup> Alexander, Eatwell, Persaud and Reoch (n 157) 18. Banks could make use of the available methodology to build the packages so that they would obtain a favourable rating. It has also been suggested that credit rating agencies have underestimated the credit risk of collateralised debt obligations and that conflicts of interest play with regard to credit rating agencies.

<sup>163</sup> Llewellyn (n 147) 38.

<sup>164</sup> The global financial crisis has shown that depositors may still become affected as the insurers of the debt are overstretched and eventually fail.

<sup>165</sup> Kaufman and Scott define “systemic risk” in imprecise terms: ‘Systemic risk refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components,

bank fails and depositors of the bank withdraw their deposits, depositors with other banks may also have worries on the soundness of the activities of their banks. As a result, the savers may also start to withdraw their deposits from their bank, even when the latter bank may be perfectly solvent. Therefore, problems are likely to spread to other banks. Information asymmetries cause this type of reaction. The main reason that the systemic risk is deemed as particularly relevant to the banking sector is probably to be found in the huge spill over costs from systemic banking crises to the real economy, in addition to the historical experiences of financial crises.<sup>167</sup> Systemic risk partly derives from interbank linkages,<sup>168</sup> and partly from the linkages between banks through the payment system.<sup>169</sup> Moreover, systemic risk is created when the public considers that other banks are in the same position as the suspect or failed bank causes systemic risk.<sup>170</sup>

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and is evidenced by correlation among most or all the parts.' See George G. Kaufman and Kenneth E. Scott, 'What is Systemic Risk, and Do Bank regulators Retard or Contribute to It?' (2003) 7 *The Independent Review* 371.

<sup>166</sup> Contagion may refer to a situation where problems within one financial institution affect the rest of the financial system. In addition, problems in one bank may spill over to the real economy. It is worth noting that contagion may spread across borders.

<sup>167</sup> Martin Summer, 'Banking Regulation and Systemic Risk' (2003) 14 *Open Economies Review* 43

<sup>168</sup> Ross Cranston, *Principles of Banking Law* (2nd edn, Oxford University Press 2002) 66-67. 'If banks have large interbank deposits with a failed bank, for example, they may in turn suffer illiquidity, or in extreme cases, insolvency. Because the exposures which banks have to other banks can be enormous, techniques such as loss-sharing are impractical. However, exposure on the interbank market is less extensive than it was: banks use the interbank market for basic funding needs, but derivatives for hedging and position-taking. The credit exposure is less than with deposits, since the loss on derivatives is confined to the replacement value.'

<sup>169</sup> Hal S. Scott, 'Deregulation and Access to the Payment System' (1986) 23 *Harvard Journal on Legislation* 331. 'If a bank fails and is unable to settle the payment obligations it has accumulated to other banks during the day, those other banks are in jeopardy of defaulting on the payment obligations they have in turn contracted. Fear of contagion through the payment system has been a major factor in the move to real-time gross settlement, where each payment obligation is settled immediately.' See Cranston (n 168) 66-67.

<sup>170</sup> 'There is a run on these other banks as the public moves to banks perceived to be the very strongest, or there is a flight to cash. These banks may be perfectly healthy, but will face a liquidity crisis if there is a rush to withdraw deposits. There is an asymmetry in the maturity of a bank's deposits on the one hand and their assets on the other. In normal times this does not matter, because banks will have sufficient liquidity to deal with withdrawals. In times of crisis, banks will have to call on the lender-of-last-resort facilities of the central bank.' See Cranston (n 168) 67.

There are significantly different rationales for regulation and forms that the regulation should take between banking and non-banking financial services, particularly as long-term contracts are involved.<sup>171</sup> For instance, systemic issues are much more significant in the regulation of banks, while client protection issues are relatively more important for non-bank financial services.<sup>172</sup> The traditional rationale for bank regulation and supervision is on the basis of four main considerations including:

[T]he pivotal position of banks in the financial system, especially in clearing and payments systems; the potential systemic dangers resulting from banks runs; the nature of bank contracts; adverse selection and moral hazard associated with the lender-of-last-resort role and other safety net arrangements that apply to banks.<sup>173</sup>

Governments have introduced safety nets consisting of central bank credit of last resort and deposit insurance schemes so as to prevent systemic risk. Although the introduction of a deposit insurance scheme is always regarded as an effective instrument to prevent a bank run and to provide a safety net, deposit insurance has some drawbacks.<sup>174</sup> ‘For instance, banks will invest in unduly risky assets and reduce reserves while incentives for depositors to monitor and to exert market discipline are reduced.’<sup>175</sup> Some scholars have uncovered other flaws and discussed distinct ways to optimize insurance schemes.<sup>176</sup> Pursuant to Chan et al., deposit insurance schemes are unable to be implemented on the

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<sup>171</sup> Charles Goodhart, Philipp Hartmann, David Llewellyn, Liliana Rojas-Suárez and Steven Weisbrod, *Financial Regulation: Why, how and where now?* (Routledge 1998) 10.

<sup>172</sup> *ibid.*

<sup>173</sup> *ibid.*

<sup>174</sup> Bebenroth, Dietrich and Vollmer (n 144) 182.

<sup>175</sup> *ibid.*

<sup>176</sup> *ibid.*

basis of risk-sensitive and actuarial calculations and strive for incentives to excess risk taking, while other insurance schemes result in inefficient cross-subsidisation within the banking sector.<sup>177</sup> Consequently, strong banks will opt out of the scheme. Moreover, Bhattacharya argues that deposit insurance may accompany deadweight losses from other sectors.<sup>178</sup> A distinct method is to promote market discipline through restraining coverage or incorporating coinsurance in a way that interest rates on deposits rely on a bank's profitability, liquidity and risk.<sup>179</sup> The approach to mitigate adverse incentives caused by full deposit insurance coverage is to further limit a bank manager's scope of activities.<sup>180</sup> Capital adequacy ratios may lead to an increased probability of a bank defaulting and thus cause bank instability.<sup>181</sup>

In contrast to deposit insurance, where the main purpose is to prevent single bank runs and to protect depositors, the priority of a lender of last resort (LLR) is to prevent bank-financed firms from being prematurely liquidated. Under most circumstances, LLR refers

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<sup>177</sup> Yuk-Shee Chan, Stuart I. Greenbaum and Anjan V. Thakor, 'Is Fairly Priced Deposit Insurance Possible?' (1992) 47 *The Journal of Finance* 227.

<sup>178</sup> Sudipto Bhattacharya, Arnoud Boot and Anjan V. Thakor, 'The Economics of Bank Regulation' (1998) 30 *Journal of Money, Credit and Banking* 745.

<sup>179</sup> Bebenroth, Dietrich and Vollmer (n 1404) 182. For instance, with limited coverage or an insurance ceiling, some depositors such as large ones, institutional investors, corporate enterprises, other banks or foreign investors, are able to be excluded from insurance. See Robert B Avery, Terrence M Belton and Michael A Goldberg, 'Market Discipline in Regulating Bank Risk: New Evidence from the Capital Markets' (1988) 20 *Journal of Money, Credit and Banking* 597. Also, Sangkyun Park, 'Market Discipline by Depositors: Evidence from Reduced Form Equations' (1995) 35 *The Quarterly Review of Economics and Finance* 497.

<sup>180</sup> Bebenroth, Dietrich and Vollmer (n 144) 182. According to Gennotte and Pyle, incentives to capitalize on deposit insurance benefits can be alleviated when bank managers face a restriction on the maximum volume of deposits, i.e., when there is minimum capital adequacy as put forward by the first Basel accord. See Gerard Gennotte and David Pyle, 'Capital Controls and Bank Risk' (1991) 15 *Journal of Banking and Finance* 805.

<sup>181</sup> 'It has been argued that a flat rate capital requirement may induce banks to choose even higher risks. To remedy this adverse incentive effect, Kim and Santomero have proposed to adopt risk-sensitive capital standards. However, even then a bank may choose too high a probability of default when liability is limited, which may be prevented with an additional minimum equity base. Alternatively, adverse investment incentives can also be mitigated if only depositors benefit from deposit insurance rather than the banker. This idea can be translated into policy by assigning the control rights over bank assets to the regulator or insurer in a state-contingent fashion, i.e., when insurance claims are filed.' See Bebenroth, Dietrich and Vollmer (n 144) 183.

to ‘discretionary provision of emergency liquidity to a single financial institution or the financial markets by the central bank usually only against first-class collateral.’<sup>182</sup> Central banks sometimes take the provision of risk capital as being part of their LLR function due to systemic consequences possibly caused by the failure of an insolvent financial institution. However, a moral hazard is likely to emerge with some commercial banks and therefore, central banks tend to express doubts as to whether or not they are likely to perform as LLR and not disclose the circumstances and conditions that financial support will be granted.<sup>183</sup>

All in all, although externalities are able to justify bank regulations and supervision, the balance between efficiency and stability of the banking system can be changed by all measures taken by authorities.<sup>184</sup> Therefore, there still remains an open discussion in regards to the issue of a first best in banking regulation and supervision.<sup>185</sup> Thus, it is not strange that distinct countries may have adopted different regulatory and supervisory frameworks.<sup>186</sup> In addition, the current regulatory and supervisory frameworks evolved from a political discourse during a financial crisis, instead of the outcome of a theoretically founded debate.<sup>187</sup>

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<sup>182</sup> Bebenroth, Dietrich and Vollmer (n 144) 183.

<sup>183</sup> Xavier Freixas, Curzio Giannini, Glenn Hoggarth and Farouk Soussa, ‘Lender of Last Resort: What Have We Learned Since Bagehot?’ (2000) 18 *Journal of Financial Services Research* 63.

<sup>184</sup> Bebenroth, Dietrich and Vollmer (n 144) 184.

<sup>185</sup> *ibid.*

<sup>186</sup> *ibid.*

<sup>187</sup> *ibid.*

## **2.5 Corporate governance of banks: a theoretical perspective**

### **2.5.1 Ownership structure and governance**

The ownership structure of companies plays a primary role in determining the extent of agency problems, which has significant implications for corporate governance. However, because of the different stages of economic and cultural development around the globe, distinct ownership structures for banks emerge in different countries. For instance, in some countries, banks are owned by diffuse minority shareholders. In other countries, banks are controlled by a financial conglomerate or holding companies. Banks in some countries face heavy government intervention and control. Therefore, banks can be classified into three different ownership structures based on the shareholding intensity of banks around the world, which include dispersed ownership, concentrated ownership and government ownership.<sup>188</sup> Compared with other industries, ownership restrictions in the banking sector prevail across countries, which are motivated by various factors including the concern for conflict of interests and stability of the financial sector.<sup>189</sup> Thus, limitation on ownership plays an important role in distributing the power of a bank's shareholders.

#### **2.5.1.1 Dispersed ownership**

US banking is characterised as dispersed ownership; it is mainly made up of a large number of individual shareholders and institution investors because it is associated with sufficient protection based on the following: ownership by law, relatively perfect market system, and the developed securities market in the United States. In 1933, as a response

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<sup>188</sup> James R. Barth, Gerard Caprio Jr., and Ross Levine, 'Bank Regulation and Supervision: What Works Best?' (2001) < <http://www.bis.org/bcbs/events/b2ealev.pdf> > accessed 6 March 2009.

<sup>189</sup> *ibid.*

to the general belief that the banking and economic problems across the nation had been caused by overzealous commercial bank involvement in stock market investment, the Glass-Steagall Act was enacted to establish a regulatory firewall between commercial and investment bank activities, both of which were curbed and controlled. In 1956, the Banking Holding Company Act was promulgated, which regulated the actions of bank holding companies, for the purpose of restricting the activities of a bank holding company to prevent unsafe or unsound practices and to prevent the undue concentration of banking sources in the hands of a few companies.<sup>190</sup> The Gramm-Leach-Bliley Act, which was enacted in late 1999, allowed commercial banks, investment banks, securities firms and insurance companies to consolidate; following this Act, the restrictions on ownership and affiliation were partly lifted.

Bath et al. presented a relative ranking of countries by permissible banking activities and ownership restrictions, noting that countries generally place greater restrictions on the ability of banks to own non-financial firms, than on the ability of non-financial firms to own banks.<sup>191</sup> The EU nations rank among the least restrictive nations, while the US is ranked as one of the most restrictive countries even though the data was compiled after the enactment of the Gramm-Leach-Bliley Act.<sup>192</sup>

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<sup>190</sup> For a detailed discussion of American commercial banks and regulatory change, see Wolfgang H. Reinicke, *Banking, Politics and Global Finance* (Edward Elgar 1995).

<sup>191</sup> James R. Barth, Gerard Caprio Jr., and Daniel E. Nolle, 'Comparative International Characteristics of Banking' (January 2004) Economic and Policy Analysis Working Paper 1/2004  
<<http://www.business.auburn.edu/~barthjr/papers/BCN%20Working%20Paper%20Final.pdf>> accessed 10 January 2008.

<sup>192</sup> *ibid.*

### 2.5.1.2 Concentrated ownership

Concentrated ownership is common in continental Europe and keiretsu is a dominant business form in Japan. It is a common phenomenon for European-style universal banks and non-financial firms to own each other's shares.<sup>193</sup> There are close and long-term relationships between the bank and its commercial and industrial customers. The Japanese keiretsu are conglomerates that are based upon mutual shareholding and connected directors. Banks play a significant and central role in providing long-term and short-term capital for a firm and for being a shareholder. Although there are huge changes in the Japanese banking system, especially in the decrease of the keiretsu system, it has been showed that the ownership structure in Japanese banks is still relatively concentrated.<sup>194</sup>

Dispersed and concentrated ownership systems result in distinct corporate governance problems. For instance, in banks with a diffuse ownership structure, due to ownership limitations, managers are given much greater power while small shareholders do not have the ability or have little incentive to monitor their banks due to the free-rider problem. Even if they have an interest, it is possible for them to lack expertise and suffer from information asymmetries. Consequently, numerous small shareholders in practice may not be able to implement their rights and voting, given by laws and regulations, to affect decision-making in banks. In addition, it is difficult for boards of directors to play any supervisory and monitoring roles because managers attempt to control them.

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<sup>193</sup> James R. Barth, Gerard Caprio Jr., and Ross Levine, 'Banking Systems around the Globe: Do Regulation and Ownership Affect Performance and Stability?' (1999) World Bank Policy Research Working Paper No. 2325 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=630697](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=630697)> accessed 10 April 2008.

<sup>194</sup> Takeo Hoshi and Anil Kashyap, *Corporate Financing and Governance in Japan: the Road to the Future* (MIT Press 2001). See also Christopher W. Anderson and Terry II Campbell, 'Corporate Governance of Japanese Banks' (2004) 10 *Journal of Corporate Finance* 327.

For concentrated ownership of banks, the problems of insider control could be overcome. Generally, shareholders under a more significant voting share may be able to elect their representatives to the board of directors and effectively monitor the functions of the manager. According to Demsetz and Lehn, theories of ownership structure also predict that heightened uncertainty of a firm's operating environment leads to an increase in ownership concentration in order to motivate or facilitate more intense monitoring of managerial decisions.<sup>195</sup>

However, concentrated ownership also has disadvantages. It is interesting to note that banks with concentrated ownership, especially in Germany and Japan, carry out dual roles as creditor and shareholder because of their close and special relationship with other industrial companies; consequently, this leads to a significant conflict of interest. As the creditor, it has an economic incentive for banks to vote against those risk-taking companies which they have lent to. On the other hand, banks as shareholders decrease risk-taking to an unfavourable status and therefore transfer money from shareholders to the banks themselves. In addition, larger owners (blockers) may play a valuable role by reducing the familiar agency problems between shareholders and managers. However, recent research has emphasised that large block holding give rise to a second agency problem between block holders and minority investors.<sup>196</sup>

Therefore, the effect of block holder ownership on a firm's value could be positive or negative. A positive effect may come about because large shareholders have greater

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<sup>195</sup> Harold Demsetz and Kenneth Lehn, 'The Structure of Corporate Ownership: Causes and Consequences' (1985) 93 *Journal of Political Economy* 1155.

<sup>196</sup> Andrei Shleifer and Robert W. Vishny, 'A Survey of Corporate Governance' (1997) 52 *Journal of Finance* 737. See also Marco Becht, Patrick Bolton and Ailsa Röell, 'Corporate Governance and Control' (2002) Finance Working Paper No. 02/2002 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=343461](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=343461)> accessed 18 May 2009.

power and stronger incentives to ensure shareholder value maximization.<sup>197</sup> A negative effect may occur if block holder ownership above a certain level leads to entrenchment of owner-managers that expropriate the wealth of minority shareholders.<sup>198</sup> As a result, the emergence of the block holder also has potential costs, as there is equilibrium between the effectiveness of their monitoring of the bank and the possibility that they exploit other stakeholders or expropriate minority shareholders through connected lending.

### **2.5.1.3 Government ownership**

Government ownership of banks, which is a highly concentrated ownership by the government, has a long history in both developing and developed countries. Statistics suggest that although the tendency of privatization in the banking industry around the world has increased over the past twenty years, state-owned institutions still control 40 percent of the bank assets across the world.<sup>199</sup> To some extent, government ownership is viewed as a hybrid of dispersed and concentrated ownership. On one hand, state-owned banks have highly concentrated ownership if the government is regarded as a single entity. On the other hand, unlike private block holders, government ownership is sponsored by the state's money that ultimately belongs to the state as a whole and not to the individuals within the government; this affects the actions of the bank. In this regard, the ultimate ownership of state-owned banks seems to be quite dispersed.

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<sup>197</sup> Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305. Richard J. Zeckhauser and John Pound, 'Are Large Shareholders Effective Monitors? An Investigation of Share Ownership and Corporate Performance' R. Glenn Hubbard (ed.) *Asymmetric Information, Corporate Finance and Investment* (University of Chicago Press 1990) 149-80. Mike Burkart, Denis Gromb and Fausto Panunzi, 'Large Shareholders, Monitoring and the Value of the Firm' (1997) 112 *The Quarterly Journal of Economics* 693-729.

<sup>198</sup> Eugene F. Fama and Michael C. Jensen, 'Agency Problems and Residual Claims' (1983) 26 *The Journal of Law and Economics* 327-49.

<sup>199</sup> Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Government Ownership of Banks' (2002) 57 *The Journal of Finance* 265.

However, there are quite a number of problems with regard to corporate governance in state-owned banks. First of all, governments make use of taxpayers' money and state-owned institutions to support and finance those borrowers with little creditworthiness. Moreover, managers who come from the civil servant system are not likely to have incentives to perform and operate under the soft budget constraints and other political and social pressures or bureaucratic interests. Private shareholders lose the monitoring incentives in state-owned banks. Lastly, government ownership leads to a key phenomenon in the banking sector, for example, lack of competition forces, limitation of effectiveness of inside and outside supervision, and non-transparent bank operations.<sup>200</sup>

It is necessary to examine the rationale for government ownership of banks in order to gain insights into implications that government ownership of banks has for corporate governance. There are three different views concerning the existence and role of state-owned banks including the development, political and agency view.<sup>201</sup> In the following section, these three principle views will be explored.

The development view, which is based on the economic theory of institutions, suggests that private banks play a significant role in financial development and economic growth. Economic institutions need sufficient capital to develop, so it is necessary for the government to provide loans and financial support through financial intermediaries such

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<sup>200</sup> Gerard Caprio Jr. and Ross Levine, 'Corporate Governance of Banks: Concepts and International Observations', (2002) Paper presented at the Global Corporate Governance Forum Research Network Meeting.

<sup>201</sup> See Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Belknap Press of Harvard University Press 1962). A.V. Banerjee, 'A Theory of Misgovernance' (1997) 112 Quarterly Journal of Economics 1289. Oliver Hart, Andrei Shleifer and Robert W. Vishny, 'The Proper Scope of Government: Theory and an Application to Prisons' (1997) 112 Quarterly Journal of Economics 1127. Andrei Shleifer and Robert W. Vishny, 'Politicians and Firms' (1994) 109 Quarterly Journal of Economics 995. Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Government Ownership of Banks' (2002) 57 The Journal of Finance 265.

as state-owned banks. Gerschenkron, who was an early supporter of the development view, stated that state-owned banks contributed to the economic growth of developing countries. Compared with private banks, government ownership of banks may pay more attention to social objectives rather than profit maximization on the ground; private banks may not be able to allocate funds to projects with high social returns or to firms located in specific industries.<sup>202</sup> Therefore, some scholars and experts suggest that the creation and existence of public financial institutions could remedy market failures in financial and credit markets.<sup>203</sup> It can be concluded that pursuant to the development view, state-owned banks are beneficial for economic development and the improvement of general welfare. Furthermore, Park maintains that governments are able to potentially affect private non-bank firms to act in accordance with the country's development objectives.<sup>204</sup>

Although the agency view has the same idea as the development view, that governments pursue the maximization of social welfare, it can result in corruption and misallocation.<sup>205</sup> According to the agency view, the public financial institutions are created to solve market failures. But Tirole suggests that agency costs within government bureaucracy are able to lead to low-powered managerial incentives when state-owned enterprises maximize multiple non-measurable objectives.<sup>206</sup> According to Laffont and Tirole, a concern for quality needs lower incentives under some circumstances and thus,

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<sup>202</sup> Joseph E. Stiglitz, Jaime Jaramillo-Vallejo and Yung Chal Park, 'The Role of the State in Financial Markets' (1993) World Bank Research Observer, Annual Conference on Development Economics Supplement <<http://www.econ.uoa.gr/UA/files/1924580762..pdf>> accessed 8 May 2009.

<sup>203</sup> Joseph E. Stiglitz and Andrew Weiss, 'Credit Rationing in Markets with Imperfect Information' (1981) 71 *American Economic Review* 393. Bruce C Greenwald and Joseph E Stiglitz, 'Externalities in Economies with Imperfect Information and Incomplete Markets' (1986) 101 *Quarterly Journal of Economics* 229.

<sup>204</sup> Yung Chul Park, 'Financial Repression and Liberalization' in Lawrence B. Krause and Kihwan Kim (ed.) *Liberalization in the Process of Economic Development* (University of California Press 1991) 332

<sup>205</sup> A.V. Banerjee, 'A Theory of Misgovernance' (1997) 112 *Quarterly Journal of Economics* 1289

<sup>206</sup> Jean Tirole, 'The Internal Organization of Government' (1994) 46 *Oxford Economic Papers* 1.

it could be argued that lower incentives are not always bad.<sup>207</sup> Nevertheless, according to the agency view, it can be concluded that the ultimate efficiency of state-owned enterprises relies on a balance between internal and allocated efficiency only if the incentive problems are associated with the control of state-owned enterprises.<sup>208</sup> It can be assumed that public managers exercise less effort than private managers do, even though state-owned banks provide resources to socially profitable activities. Therefore, it can be further anticipated by the agency view that although ‘state-owned banks serve social objectives and allocate resources where private markets fail, public managers of state-owned banks exert low effort or divert resources for personal benefits, such as career concerns, with an eye towards future job prospects in the private sector.’<sup>209</sup>

Both the development and the agency views unanimously contend that the government plays an important economic role in markets cannot function or perform well. On the contrary, pursuant to a hypothesis of the political view, politicians tend to prioritise their own personal, political and economic objectives rather than maximizing social welfare. Based on this assumption, the purpose of the creation and maintenance of state-owned banks by politicians is not to efficiently and economically utilize the funds, but to maximize their own personal objectives, which are to obtain voting support. Consequently, resources that are allocated by political leaders have an adverse influence on economic growth.<sup>210</sup>

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<sup>207</sup> Jean-Jacques Laffont and Jean Tirole, *A Theory of Incentives in Procurement and Regulation* (MIT Press 1993).

<sup>208</sup> Tirole (n 206) .

<sup>209</sup> Wei Sun, ‘China’s Banking Reform: A Corporate Governance Perspective’ (DPhil thesis, University of Leeds 2007) 39.

<sup>210</sup> Porta, Lopez-de-Silanes and Shleifer (n 199).

It is clearly observed that the agency and the political views depend on the different assumptions with regard to government objectives and they have distinct reasons for the misallocation of resources. For the agency view, the misallocation of resources emerges because of the private use of managers; while for the political view, the misallocation of resources takes place because of the political objective of politicians rather than as a consequence of a lack of incentives. As a result, it will lead to the phenomenon that state-owned banks will allocate more resources to areas with political support, and finance friends and supporters of politicians.

### **2.5.2 Internal governance mechanisms**

It is recognized in corporate governance literature that in addition to companies' ownership, there are several aspects of companies' board, remuneration structure and the system of internal controls, which can work as effective corporate governance mechanisms or devices. For example, the board of directors plays an essential role in monitoring management.<sup>211</sup> Also, managerial remuneration can work as a significant mechanism that influences managers to take actions that maximize the value of the company.<sup>212</sup> Apart from remuneration, the system of internal controls, particularly risk management, has attracted most interest in the debate about lessons to be learned from the recent crisis with a view to improving banks' corporate governance. Therefore, the next part will illustrate the internal governance mechanisms from board of directors, compensation, and internal controls, and risk management.

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<sup>211</sup> Eugene F. Fama and Michael Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 301.

<sup>212</sup> Kevin J. Murphy, 'Executive Compensation' in Orley Ashenfelter and David E. Card (ed.) *Handbook of Labour Economics* (North-Holland 1999) 2485. John E. Core, Wayne R. Guay and David F. Larcker, 'Executive Equity Compensation and Incentives: A Survey' (2003) *Economic Policy Review* 27.

### 2.5.2.1 Board of directors

Pursuant to the agency theory, the board of directors is regarded as the principal internal control mechanism to monitor management behaviour by conducting performance evaluation of the management and communicating shareholders' interests to managers. According to the *Policy Brief on Corporate Governance of Banks in Eurasia* by the OECD and the European Bank for Reconstruction and Development (EBRD), boards are increasingly expected to serve as a key fulcrum in corporate governance between shareholders and professional management.<sup>213</sup> Together with guiding corporate strategy, boards are chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing the competing demands of relevant stakeholders. According to the law, boards have two fiduciary duties, namely the duty of care and the duty of loyalty to companies.<sup>214</sup> In terms of banks, the boards should also be aware of their responsibilities to depositors who entrust their everyday savings.<sup>215</sup>

The board of directors is authorised to fulfil and execute decision-making and oversight roles inside a bank. Pursuant to the *Policy Brief on Corporate Governance of Banks in Asia*, the board of a bank should not only guide, approve and oversee the bank's strategic objectives, corporate values and policies, but also create of structures and processes which include setting up both clear lines of responsibility and accountability throughout

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<sup>213</sup> OECD and EBRD, 'Corporate Governance of Banks in Eurasian: A Policy Brief' (2008) <<http://www.oecd.org/dataoecd/12/24/40804232.pdf>> accessed on 20 October 2009.

<sup>214</sup> Jonathan R. Macey and Maureen O'Hara, 'The Corporate Governance of Banks' (2003) Economic Policy Review 91.

<sup>215</sup> OECD and EBRD (n 213).

the bank, and strict internal control systems ensuring effective oversight.<sup>216</sup> The 2004 OECD *Principles of Corporate Governance* points out that:

The board of directors should ensure the strategic guidance of the company, effectively monitor management, and be accountable to the company and the shareholders.<sup>217</sup>

Boards of banking companies not only undertake the same responsibilities as non-financial companies do, but also take additional responsibilities stipulated by regulators.

Many corporate governance failures and lapses took place during the financial crisis that started in mid-2007, including insufficient board oversight of senior management, inadequate risk management and unduly complex or opaque bank organizational structures and activities.<sup>218</sup> Against this background, the Basel Committee on Banking Supervision (the Committee) decided to review and revise its 2006 principles.<sup>219</sup> The key areas in the new guidance are: board practices, senior management, risk management and internal controls, compensation, complex or opaque corporate structures, and disclosure and transparency.<sup>220</sup>

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<sup>216</sup> OECD, 'Policy Brief on Corporate Governance of Banks in Asia' (Asian Roundtable on Corporate Governance 2006) <<http://www.oecd.org/dataoecd/48/55/37180641.pdf>> accessed on 14 September 2010.

<sup>217</sup> OECD, *OECD Principles of Corporate Governance* (OECD 2004) 24.

<sup>218</sup> Basel Committee on Banking Supervision, 'Principles for Enhancing Corporate Governance' (2010) <<http://www.bis.org/publ/bcbs176.pdf>> accessed on 10 March 2011.

<sup>219</sup> The key issues of corporate governance in the 2006 guidance were that: 'the board should be appropriately involved in approving the bank's strategy; clear lines of responsibility should be set and enforced throughout the organisation; compensation policies should be consistent with the bank's long-term objectives; and the risks generated by operations that lack transparency should be adequately managed'. See the Committee (n 218).

<sup>220</sup> See details in the Committee's 2010 Final Document on Principles for Enhancing Corporate Governance <<http://www.bis.org/publ/bcbs176.pdf>> accessed on 10 March 2011.

The Committee recognises that boards of directors in banks are primarily responsible for good corporate governance and the following practices are viewed as critical elements of the corporate governance process according to the Committee's 2010 principles:

- 1) The board should actively carry out its overall responsibility for the bank, including its business and risk strategy, organization, financial soundness and governance. The board should also provide effective oversight of senior management.
- 2) To fulfill this responsibility, the board should exercise sound objective judgment and have and maintain appropriate qualifications and competence, individually and collectively; follow good governance practices for its own work as a board; and be supported by competent, robust and independent risk and control functions, for which the board provides effective oversight.
- 3) Under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board.
- 4) A bank should have an independent risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board.
- 5) Risks should be identified and monitored on an ongoing firm-wide and individual entity basis, and the sophistication of the bank's risk management and internal control infrastructures should keep pace with any

changes to the banks' risk profile (including its growth) and to the external risk landscape.

6) Effective risk management requires honest and timely internal communication within the bank about risk, both across the organization and through reporting to the board and senior management.

7) Banks should fully implement the Financial Stability Board's (FSB) *Principles for Sound Compensation Practices* and accompanying Implementation Standards or the applicable national provisions that are consistent with the FSB Principles and Standards.

8) The board and senior management should know, understand and guide the bank's overall corporate structure and its evolution, ensuring that the structure (and the entities that form the structure) is justified and does not involve undue or inappropriate complexity.

9) Senior management, and the board as appropriate, should understand the purpose of any structures that impede transparency, be aware of the special risks that such structures may pose and seek to mitigate the risks identified.

10) Transparency is one tool to help emphasis and implement the main principles for good corporate governance.<sup>221</sup>

### **2.5.2.2 Compensation**

It is still debatable whether industry-wide remuneration structures creating high-powered incentives for short-term risk taking are an important or even major cause for the

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<sup>221</sup> Basel Committee on Banking Supervision (n 214).

financial crisis.<sup>222</sup> However, regulators, politicians and society at large are united in favouring stringent new rules on remuneration issues at banks, in particular and, albeit to somewhat lesser extent, at large and/or listed companies in general.<sup>223</sup> According to the Committee's 2010 guidance, compensation systems contribute to bank performance and risk-taking, and should therefore be key components of a bank's governance and risk management. In practice, however, risk has not always been taken into account in determining compensation practices, with the result that some long-term risks may have been exacerbated by compensation incentives, such as those to boost short-term profits.<sup>224</sup>

#### **2.5.2.2.1      *Compensation of executives***

Remuneration of senior management and key personnel is regarded as an important corporate governance mechanism because it is a special tool for aligning the interests of banks managers with those of shareholders. There are three primary mechanisms of compensation and incentives for corporate executives including firstly flow compensation (the base salary, bonus and new equity grants), secondly capital gains on

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<sup>222</sup> Peter O. Mülbert (n 125) 30.

<sup>223</sup> *ibid.*

<sup>224</sup> Basel Committee on Banking Supervision (n 218) 23. Regarding this area, the FSB issued the FSB Principles in April 2009 and the accompanying FSB Standards in September 2009 to assist in their implementation. In addition, the Committee issued in January 2010 a document on Compensation Principles and Standards Assessment Methodology. See the Committee, <[www.bis.org/publ/bcbs166.htm](http://www.bis.org/publ/bcbs166.htm)> accessed 18 May 2010. This document aims to guide supervisors in reviewing individual firms' compensation practices and assessing their compliance with the FSB Principles and Standards, and seeks to foster supervisory approaches that are effective in promoting sound compensation practices at banks and help support a level playing field.

their portfolio of stocks and options, and thirdly, the markets' assessment of their human capital that is affected by their performance in their current jobs.<sup>225</sup>

Debates on the growth in the use of stock options in executive compensation have rapidly increased in recent years.<sup>226</sup> Advocates of the use of equity-based compensation argue that equity incentives and stock-based compensation can decrease agency problems. It is possible to raise the wealth of shareholders by motivating top management to adopt more value-enhancing decisions because of the link between the compensation of CEOs and changes in shareholder wealth.<sup>227</sup> According to Houston and James, there has been a significant positive relationship between CEO stock holdings and bank charter value.<sup>228</sup> They suggest that compensation in the banking industry does not promote risk-taking.<sup>229</sup> Following this view and based on empirical evidence of the US banks in 1990s, Becher argued that a high degree of equity-based compensation for directors utilized by banks is linked with higher growth without a similar increase in risk.<sup>230</sup>

But opponents argue that the incentive for compensation is not effective. Incomes and outcomes of other short-term performance can easily be manipulated at the cost of the long term health of banking because of serious asymmetric information. According to

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<sup>225</sup> Rick Antle and Abbie Smith, 'An Empirical Investigation of the Relative Performance Evaluation of Corporate Executives' (1986) 24 *Journal of Accounting Research* 1. Also, Kevin J. Murphy and Michael C. Jensen, 'Performance Pay and Top Management Incentives', 1990 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=94009](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=94009)> accessed 16 March 2010.

<sup>226</sup> Joel F. Houston and Christopher James, 'CEO Compensation and Bank Risk is Compensation in Banking Structured to Promote Risk Taking?' (1995) 36 *Journal of Monetary Economics* 405; See also James R. Booth, Marcia Millon Cornett and Hassan Tehranian, 'Boards of Directors, Ownership and Regulation' (2002) 26 *Journal of Banking and Finance* 1973.

<sup>227</sup> John E. Core, Wayne R. Guay and David F. Larcker, 'Executive Equity Compensation and Incentives: A Survey' (2003) *Economic Policy Review* 27.

<sup>228</sup> Houston and James (226).

<sup>229</sup> *ibid.*

<sup>230</sup> David A. Becher, Terry L. Campbell II and Melissa B. Frye, 'Incentive Compensation for Bank Directors: the Impact of Deregulation' (2005) 78 *Journal of Business* 1753.

McConnell and Servaes, after some level of managerial ownership, managers make insufficient effort, gain private benefits and entrench themselves at the expense of other investors.<sup>231</sup> In addition, some authors suggest that there is a resurgence of entrenchment behaviour at high levels of managerial ownership.<sup>232</sup> Stock options, which are considered as incentive measures, are able to stimulate managers to take excessive risk and to artificially manipulate the company's stock price so as to increase the value of the options.<sup>233</sup>

By contrast to those executives in other industries, there is the tendency that bank executives receive fewer shares and hold fewer stock options even though the debate on the increase in utilizing and using equity-based compensation for bank executives has not stopped.<sup>234</sup> The following reasons will explain such a difference. First of all, banking firms or industry, which can be considered to have characteristics of low-growth firms or industry, depend less on stock-based compensation.<sup>235</sup> Therefore, boards in low-growth industries should rely more on fixed than on stock-based compensation in that boards can much more easily observe, monitor and evaluate the actions of CEOs of firms and industries with low-growth opportunities than they can in firms or industries with high-

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<sup>231</sup> John J. McConnell and Henri Servaes, 'Additional Evidence on Equity Ownership and Corporate Value' (1990) 27 *Journal of Financial Economics* 595.

<sup>232</sup> Randall Morck, Andrei Shleifer and Robert W. Vishny, 'Management Ownership and Market Valuation: An Empirical Analysis' (1988) 20 *Journal of Financial Economics* 293. Also, see Helen Short and Kevin Keasey, 'Managerial Ownership and the Performance of Firms: Evidence from the UK' (1999) 5 *Journal of Corporate Finance* 79. For instance, Gorton and Rosen showed evidence that managerial entrenchment was more important than the moral hazard problem in explaining the dramatic increase in bank failures in the 1980s. See Gary Gorton and Richard Rosen, 'Corporate Control, Portfolio Choice and the Decline of Banking' (1995) 50 *Journal of Finance* 1377.

<sup>233</sup> David Yermack, 'Do Corporations Award CEO Stock Options Effectively?' (1995) 39 *Journal of Financial Economics* 237. Also, see David Aboody and Ron Kasznik, 'CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures' (2000) 29 *Journal of Accounting and Economics* 73.

<sup>234</sup> Houston and James (n 218). And James R. Booth, Marcia Millon Cornett and Hassan Tehranian, 'Boards of Directors, Ownership and Regulation' (2002) 26 *Journal of Banking and Finance* 1973.

<sup>235</sup> Renee B. Adams and Hamid Mehran, 'Is Corporate Governance Different for Bank Holding Companies?' *Economic Policy Review* 4/2003, 9

<[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=795584](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=795584)> accessed 12 April 2009.

growth opportunities.<sup>236</sup> Moreover, according to Demsetz and Lehn, banks are heavily regulated and supervised so that it is possible for regulators to replace some of the monitoring functions of ownership to some extent.<sup>237</sup> Thus, it is likely that there is less need for equity-based compensation for executives in banks.

#### **2.5.2.2.2      *The role of the board in the compensation system***

According to Principle 10 of the Committee's 2010 guidance, the board is responsible for the overall design and operation of the compensation system for the entire bank. As such, those board members who are most actively involved in the design and operation of the compensation system should be independent, non-executive members with substantial knowledge about compensation arrangements and the incentives and risks that can arise from such arrangements. As compensation should be aligned with risk, an understanding of the firm's risk measurement and management, and of how different compensation practices can impact the firm's risk profile, is also crucial. Board compensation committees should also meet the criteria set forth in the Governance section of the FSB Standards, including working closely with the board's risk committee to evaluate incentives arising from compensation and ensuring that an annual compensation review is undertaken.<sup>238</sup> The board should ensure that 'lower risk-adjusted income in a business line will result in reduced compensation'.<sup>239</sup> 'The compensation of the control function

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<sup>236</sup> Clifford W. Smith Jr. and Ross L. Watts, 'The Investment Opportunity Set and Corporate Financing, Dividend, and Compensation Policies' (1992) 32 *Journal of Financial Economics* 263. Also, see Hamid Mehran, 'Executive Incentive Plans, Corporate Control, and Capital Structure' (1992) 27 *Journal of Financial and Quantitative Analysis* 539.

<sup>237</sup> Harold Demsetz and Kenneth Lehn, 'The Structure of Corporate Ownership: Causes and Consequences' (1985) 93 *Journal of Political Economy* 1155.

<sup>238</sup> Basel Committee on Banking Supervision (n 218) 24.

<sup>239</sup> *ibid.*

should be structured in a way that is based principally on the achievement of their objectives and does not compromise their independence’.<sup>240</sup>

#### **2.5.2.2.3      *Compensation of employees***

According to Principle 11 of the Committee’s 2010 guidance, an employee’s compensation should be effectively aligned with prudent risk taking: compensation should be adjusted for all types of risk; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment.<sup>241</sup>

#### **2.5.2.3      Internal controls and risk management**

The system of internal controls is a significant component of bank management for the safety and the soundness of banking institutions. Internal control is a process affected by the board of directors, senior management and all levels of personnel. It is designed to provide reasonable assurance regarding the achievement of objectives in the following categories: efficiency and effectiveness of activities (performance objectives); reliability, completeness and timeliness of financial and management information (information objectives); and compliance with applicable laws and regulations (compliance objectives).<sup>242</sup>

The internal control process is said to have been a mechanism for reducing instances of fraud, misappropriation and errors. However, it has become more extensive, addressing

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<sup>240</sup> *ibid.*

<sup>241</sup> *ibid.*

<sup>242</sup> Basel Committee on Banking Supervision, ‘Framework for Internal Control Systems in Banking Organisation’ (1998) <<http://www.bis.org/publ/bcbasc131.pdf>> accessed 5 January 2009.

all the various risks faced by banking organisations. An effective internal control system for banks since they are in the business of risk-taking requires that:

[T]he material risks that could adversely affect the achievement of the bank's goals are being recognized and continually addressed. This assessment should cover all risks facing the bank and the consolidated banking organization (that is credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk and reputational risk). Internal controls may need to be revised to appropriately address any new or previously uncontrolled risks.<sup>243</sup>

The Committee assesses internal control systems for banks and identifies five categories including management oversight and accountability, and development of a strong control culture within the bank; recognition and assessment of the risk of certain banking activities comprising on or off-balance sheet; key control structures and activities such as segregation of duties, approvals, verifications, reconciliations, and reviews of operating performance; communication of information between levels of management within the bank, especially in the upward communication of problems; audit programs and monitoring activities.<sup>244</sup>

*A Policy Brief on Corporate Governance of Banks in Eurasia* points out:

[E]ffective internal controls will be achieved when there is a bank culture, established by the boards and senior management that emphasizes and demonstrates to all levels of personnel the importance of internal controls. In

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<sup>243</sup> *ibid.*

<sup>244</sup> *ibid* 5-6.

addition to evaluations made by internal auditors (and often by external auditors), banks should continuously monitor and evaluate the effectiveness of their own internal controls. It is the responsibility of senior management to establish and improve banks' internal control systems based on these evaluations. The boards (or supervisory boards) should guide senior management and ensure that they properly established, implement, monitor and evaluate the effectiveness of, and constantly improve, the internal controls. The Basel Committee's Framework for Internal Control Systems in Banking Organization provides valuable suggestions not only for banks on how to establish, implement and improve their internal controls but also for banking supervisors on how to evaluate the effectiveness of banks' internal controls.

One of the key issues that internal controls should address is checks and balances, or the "four eyes principle" (i.e. segregation of duties, cross-checking, dual control assets and double signatures). Task Force members point out that the true value of the four eyes principle may not be widely understood across banks in the Eurasian region. Control activities tend to be regarded as something redundant or in addition to the daily activities of the bank and are often seen as less important. However, the control activities would work most effectively and thus enable quick responses to changing conditions and avoid unnecessary costs when they are viewed by management and other employees as an integral part of the daily operations. The boards and senior management should nurture a bank culture in which

control activities such as the implementation of the four eyes principles are regarded as an integral part of daily operations.<sup>245</sup>

Risk management has played a significant role in the management process for banking institutions' development, stability and prosperity under the new financial environment.<sup>246</sup> Therefore, it is critical for banks to have the capacity to identify, measure, monitor and control various risks so that effective risk management is indissolubly linked with the sound corporate governance.<sup>247</sup>

### **2.5.3 Regulation and supervision**

The mid 2007 financial crisis that was the result of poor corporate governance in most countries' banking institutions has generated calls for reforms in bank regulation and supervision. The most direct and obvious internationally response to the corporate governance problems of banks is an extensive list of best practices promoted by international organizations, such as the Basel Committee on Bank Supervision, International Monetary Fund, and World Bank, that should be adopted by each country for the regulation and supervision of banks. The most obvious national response to the corporate governance problems of banks is government regulation, especially bank supervision, bank capital requirements, bank safety and soundness. The main purpose of

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<sup>245</sup> OECD and EBRD (n 213).

<sup>246</sup> For instance, operational risk of banking institutions is being driven by a number of factors including globalization, increasing competition, new technology, new product, product sophistication, new markets and distribution channels, cultural diversity of staff and clients, and staff turnover.

<sup>247</sup> According to the Committee, risk management generally encompasses the processes of: identifying key risks to the bank; measuring exposures to those risks; monitoring risk exposures and determining the corresponding capital needs on an ongoing basis; taking steps to control or mitigate risk exposures; and reporting to senior management and the board on all the items noted in this paragraph. See Basel Committee on Banking Supervision (n 242).

bank regulation and supervision is to improve bank safety and soundness, thereby promoting growth and stability.

There are two broad and competing theories of bank regulation and supervision. The helping-hand view holds that governments implement rigorous, official oversight of bank activities including official supervision of banks, limits on bank activities, and restrictions on bank entry and a deposit insurance scheme so as to alleviate market failures and thereby enhance bank performance and stability.<sup>248</sup> The grabbing-hand view, in contrast, argues that strong government regulation and supervision of banks will not ease market failures and enhance bank performance and stability.<sup>249</sup> According to this view, government limits on bank entry, restrictions on bank activities, powerful official supervision of banks, and government ownership of banks will be associated with higher levels of corruptions but without compensating improvement in bank performance.<sup>250</sup> Therefore, this view predicts that:

Governments focusing more on empowering private-sector control of banks are more likely to promote bank development than governments taking a more hands-on approach to regulation.<sup>251</sup>

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<sup>248</sup> Barth, Caprio and Levine (n 193) 2.

<sup>249</sup> *ibid.*

<sup>250</sup> *ibid.*

<sup>251</sup> *ibid.* The private empowerment view suggests that bank regulations should focus on enhancing the ability and incentives of private agents to overcome informational barriers and exert corporate governance over banks. Furthermore, this view argues that many empowered bank creditors will be less susceptible to capture by politicians and banks than a single government supervisory agency. Thus, special connections and corruption may play less of a role in countries that foster private monitoring. See SJ Grossman and OD Hart, 'Disclosure Laws and Takeover Bids' (1980) 35 *Journal of Finance* 323. Also, Jonathan R Hay and Andrei Shleifer, 'Private Enforcement of Public Laws: A Theory of Legal Reform' (1998) 88 *American Economic Review* 398.

According to the findings by Barth, Caprio and Levine, evidence tends to support the view that suggests regulations that power the private sector work best to improve the governance of banks.<sup>252</sup> They find that strong private empowerment regulations boost overall bank development and efficiency. Moreover, they find that strong private empowerment reduces the reliance on corrupt ties with bank officials by firms to receive bank credit and strong private empowerment tends to lower the financing obstacles faced by the average firm.<sup>253</sup>

Research carried out by Barth, Caprio and Levine suggests that regulatory and supervisory practices should force accurate information disclosure, empower private-sector corporate control of banks and foster incentives for private agents to exert corporate control that works best to promote bank performance and stability.<sup>254</sup> Although the results of the research argue that official regulation and supervision are critical, their research findings seem to emphasise that:

A strategic approach to bank regulation that stresses private-sector monitoring of banks tends to be associated with greater banking-system success than strategies that place excessive emphasis on direct official government oversight of and restrictions on banks.<sup>255</sup>

In summary, corporate governance of banks consists of three essential elements, namely ownership structure, internal governance mechanisms, and regulation and supervision.

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<sup>252</sup> Barth, Caprio and Levine (n 193).

<sup>253</sup> *ibid.*

<sup>254</sup> Barth, Caprio and Levine (n 193) 41.

<sup>255</sup> *ibid.*

Each element has different characteristics tailored for a bank's unique governance problems.

## **2.6 Conclusions**

This chapter presents theoretical and functional issues of corporate governance, the special features of banks, the rationale for banking regulation and banks' governance mechanisms in practice. It indicates that corporate governance issues in a transition economy such as China are quite different from those of a developed economy, and even corporate governance problems also vary among advanced economies. Different corporate governance problems need different governance solutions. The different forms of corporate governance have been proven to derive from and have been successful under different contingencies, and no single form has yet emerged as being universally superior.

Due to moral hazards, the opaqueness of banking business and information asymmetry, banks need heavier regulation. It is widely recognized that the influence of external forces such as takeovers and product-market competition on banks is weaker than that on other companies. Banking governance relies more on the workings of internal mechanisms such as the oversight of the board of directors with regulatory constraints. It is generally agreed that there is no evidence that any universal set of best practices is appropriate for promoting well-functioning banks. The ownership structure of banks varies due to the complexities of each country's economic, legal and political system. In addition, there is outstanding variation in the banking regulation and supervision systems. Therefore, there is not a simple set of best practices to banking regulation and supervision that can be applied in all countries around the world.

China has adopted its own method to reform its banking system according to its unique political, economic and legal systems. The following chapters will detail the evolution of corporate governance in China's SOCBs based on ownership structure, internal governance mechanisms, and regulation and supervision.

## **CHAPTER THREE**

### **THE CORPORATE GOVERNANCE REFORM OF THE SOCBs BEFORE CHINA'S ACCESSION TO THE WTO**

#### **3.1 Introduction**

In 1978, under the re-emerging leadership of Deng Xiaopin, China began its economic reform and opened up to the outside world. Since then, the Chinese economy has been significantly modernised. The Chinese banking industry has been one of the first industries to participate in economic reform. As a key component of the national economy and taking a dominant role in China's financial market, the Chinese banking industry has received much attention. Four SOCBs, in particular, ABC, BOC, CCB and ICBC still perform the most significant role in the domestic financial landscape, representing more than half of the total assets and total liabilities in the entire banking system.<sup>1</sup> Thus, the discussion below will focus on China's four SOCBs.

This chapter offers a blueprint of China's banking system reform and its legal and supervisory framework from 1978 until the end of 2001. In addition, discussions and analyses are based on the issues of how the Chinese government dealt with the problems of corporate governance facing SOCBs. The first part provides a brief overview of the evolution of the banking system in China during this period. The second part discusses existing shortcomings. The third part focuses on legal and supervisory aspects of banking, describing the development of banking rules, laws and the institutional structure of banking regulation and supervision in China. This is followed by an examination of the

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<sup>1</sup> This can be evidenced by the PBOC's data on *Sources & Uses of Credit Funds of 4 largest State-owned National-operating Commercial Banks (RMB)* (2010)  
<<http://www.pbc.gov.cn/publish/html/2010s03c.htm>> accessed 15 December 2010. See also page 21.

prudential regulation and supervision, including issues related to prudential standards, monitoring and enforcement practices. Brief concluding remarks are given in the last part.

### **3.2 Administrative governance in SOCBs before China's accession to the WTO**

Before the economic reforms, under the planned economy, China's banking sector was a simple and closed system exclusively dominated by the PBOC, which conducted the functions of both a central and commercial bank.<sup>2</sup> The PBOC, on the one hand, acted as the state treasurer, which issued notes and coins, and a cashier for the disbursement of funds as well as the extension of credit on behalf of the State Planning Commission and the Ministry of Finance to state-owned enterprises that relied on planning quotas set by the central government.<sup>3</sup> On the other hand, it carried out the role of a commercial bank that collected household deposits, handled remittances and settlements, and set interest rates for deposits and loans.<sup>4</sup> After China began to initiate its transition from a planned economy to a market economy the mono-banking system could no longer meet the needs of commercial activities in the new economic environment.<sup>5</sup> Reforms to its banking sector thus became inevitable and have been gradually carried out.

The primary task was the establishment of a modern banking framework through the introduction of a two-tier banking system, defining the PBOC as the central bank of the nation and other banks as specialised banks.

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<sup>2</sup> Lawrence S áez, *Banking Reform in India and China* (Palgrave MacMillan TM 2004) 17.

<sup>3</sup> Fred Hu, 'Chinese Banking Industry—Past, Present and Prospect' (2006) Goldman Sachs and Tsinghua University 3.

<sup>4</sup> Yuwa Wei, 'The Banking Reform in China: a Move Leading to Financial Safety or Vulnerability' (2009) *International Company and Commercial Law Review* 328.

<sup>5</sup> *ibid.*

Beginning in 1979, the first stage of the banking reforms concentrated on institutional development through restructuring the PBOC and the creation of the specialised banks.<sup>6</sup> By 1979, the PBOC became independent of the Ministry of Finance.<sup>7</sup> In 1983, the Chinese government issued the *Decision Regarding the Limiting of the People's Bank of China to the Function of Central Bank* that terminated the monopoly of the PBOC.<sup>8</sup> The decree released by the State Council meant that the PBOC would no longer be allowed to carry out commercial activities, such as deposits and loans; such business was replaced by the implementation of the monetary policy in order to exercise overall direction over the economy.<sup>9</sup> On 23<sup>rd</sup> February 1979, the promulgation of the *State Council Notification Regarding the Re-establishment of the Agricultural Bank of China* resulted in the re-establishment of the Agricultural Bank of China,<sup>10</sup> which mainly provides rural credit and loan services for farmers, rural enterprises and rural credit cooperatives, and is also responsible for formulating and implementing credit programmes for rural areas.<sup>11</sup> On 13<sup>th</sup> March of the same year, the Bank of China was created from the PBOC; it was designed to support the opening up of China's economy to the outside world, and primarily specialised in foreign exchange business.<sup>12</sup> It is the main organisation through which foreign trade organisations and export-oriented manufactures obtain loans and credit either in foreign currency or in Renminbi (RMB).<sup>13</sup> In April 1984, the Industrial

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<sup>6</sup> David Eu, 'Financial Reforms and Corporate Governance in China' (1996) *Columbia Journal of Transnational Law* 470, 489.

<sup>7</sup> C J Li, 'China's Financial Reform and its Implications' in Joseph J Norton, C J Li and Huang Yangxin (eds), *Financial Regulation in the Greater China Area: Mainland China, Taiwan and Hong Kong SAR* (Kluwer 2000) 320.

<sup>8</sup> Chien-Hsun Chen and Hui-Tzu Shih, *Banking and Insurance in the New China* (Edward Elgar 2004) 4.

<sup>9</sup> *Ibid.*

<sup>10</sup> Chen and Shih (n 8) 3.

<sup>11</sup> Laurence J. Brahm and Stephen XM Lu, *Banking and Finance in China* (Butterworths Asia 1996) 33-4.

<sup>12</sup> Li (n 7).

<sup>13</sup> Brahm and Lu (n 11) 34-5.

and Commercial Bank of China was established, which took over the function of the PBOC as lender to the commercial sector, responsible for receiving deposits from urban and rural individuals, and providing working capital and settlements for Industrial and Commercial enterprises.<sup>14</sup> In November 1985, the China Construction Bank was set up; it provides fixed-asset loans and working capital loans for construction units as well as industrial and commercial enterprises, and also provides loans for infrastructure projects.<sup>15</sup>

While reforming and developing the state-owned banking system, China continued to develop a variety of other financial institutions, which includes other banks with different ownership structures and non-banking financial institutions such as securities, insurance, trust and finance companies. During the period the of late-1980s to the early 1990s, many other banking and non-banking financial institutions were established, by relaxing barriers to entry, to inject competition into the banking sector and to meet the increasingly complex growing needs in a modernising economy.<sup>16</sup> The most significant change was the establishment of a new type of joint stock commercial bank in which the shareholders could be enterprises as well as central and local governments. Therefore, between the late 1980s and early 1990s the Bank of Communications, the China International Trust and Investment Corporation, China Merchant Bank, Everbright Bank, Shenzhen Development Bank and Pudong Development Bank, Hua Xia Bank, were set up.<sup>17</sup> China Minsheng Bank, which is owned by private investors, was set up in 1996.

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<sup>14</sup> Li (n 7) 321.

<sup>15</sup> *ibid.*

<sup>16</sup> Hu (n 3) 4.

<sup>17</sup> *ibid.*

Although the specialised banking system had been established and the PBOC had been separated, the Chinese government directly controlled the operations of the PBOC and the four state-owned specialised banks. The PBOC is not an independent central bank that regulated the banking sector; instead it is a ministry subject to the administrative control of the State Council. The PBOC was authorised to take responsibility for making and implementing monetary policy.<sup>18</sup> However, such policy faced interference by the macroeconomic policies formulated by other government agencies, such as the State Development and Planning Commission, the State Economic and Trade Commission, and the Ministry of Finance.<sup>19</sup> Due to the lack of comprehensive and clearly defined regulations and laws, independent institutional framework, qualified staff and policy enforcement efficiency, in addition to the poor status of the collection and analysis of regulatory data, the supervisory effectiveness of the PBOC over the banking sector were restricted.<sup>20</sup>

In the same way, the four state-specialised banks, under heavy administrative controls, actually had semi-government characteristics and became part of the government bureaucracy. Each of the four state-owned specialised banks were authorised to operate in specific sectors of the economy.<sup>21</sup> The administrative division of business scope between the four state-specialised banks ensured their quasi-monopolistic position. Under the division, specialised banks' clientele was 'limited to certain geographic areas and/or

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<sup>18</sup> Article 1, Decisions of the State Council on the PBOC's Exclusive Role as Central Bank, issued by the State Council on 17 September 1983.

<sup>19</sup> Wei Sun, 'China's Banking Reform: A Corporate Governance Perspective' (DPhil thesis, University of Leeds 2007) 76. See also Wanda Tseng, Hoe Ee Khor, Kalpana Kochhar, Dubravko Mihaljek and David Burton, *Economic Reform in China: A New Phase* (International Monetary Fund November 1994) 19.

<sup>20</sup> Sun (n 19).

<sup>21</sup> Jianbo Lou, *China's Troubled Bank Loans Workout and Prevention* (Kluwer Law International 2001) 44. The State Council approved the PBOC's report concerning the division of business scope with regard to fixed-asset loans among specialised banks on 13 May 1984.

industries.’<sup>22</sup> In addition, the business scope division between state-specialised banks seriously impeded the competition between banks.

The government had traditionally intervened in China’s banking sector through three areas, namely credit allocation controls, financial intermediation controls and interest rate controls.<sup>23</sup> The government formulated and implemented an annual credit plan, which ‘governed each bank’s credit volume directly and translated the government’s investment plan into reality’.<sup>24</sup> Under the credit plan, four specialised banks were required to lend to designated borrowers and acted largely as ‘passive channels, allocating credit to priority sectors, sub-sectors, and projects selected by national and local governments.’<sup>25</sup> Due to interest rates being set administratively by the PBOC, state-specialised banks had no choice but to sometimes subsidise the development of certain priority industries or loss-making enterprises at significantly low interest rates.<sup>26</sup>

China adopted a Soviet-style political and economic system when the People’s Republic of China was founded in 1949. However, the main feature of this type of political and economic system is that there is no clear boundary between the Communist Party of China (CPC) and the government, or the government and business enterprises.<sup>27</sup> Under the principle of “Party control cadres”, candidates of key positions in the four state specialised banks were required to be party members and appointed by the Department of

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<sup>22</sup> *ibid* 46.

<sup>23</sup> James Laurenceson and Joseph C.H. Chai, *Financial Reform and Economic Development in China* (Edward Elgar 2003) 8.

<sup>24</sup> Lou (n 21) 40. The annual credit plan set mandatory quota for all banks in aggregate, by different types of lending, and sometimes by different sectors, sub-sectors, and even individual borrowers. See Lou (n 21) note 150 .

<sup>25</sup> Lou (n 21) 41-2.

<sup>26</sup> Lou (n 21) 43.

<sup>27</sup> Yuanyuan Peng, *The Chinese Banking Industry: Lessons from history for today’s challenges* (Routledge 2007) 9.

Organisation of CPC. For a considerable length of time, state bank managers remained an integral part of the government bureaucracy. As a matter of fact, presidents of the four state-owned specialised banks were government officials with the ranks of vice-ministers. Likewise, branch managers corresponded with official ranks, such as director-general or section chief.<sup>28</sup> The presidents of the four state-owned specialised banks carried out double roles as banker and administrative officials. Since the local government typically had the power to appoint bank managers at branch or sub-branch level, the branches and sub-branches of the banks had very close relationships with local governments; relationships which were even closer than those with their own bank head offices.<sup>29</sup>

Although many other financial bodies had a positive function in the Chinese financial market, the four specialized state-owned banks during this period were ‘major players in allocating relatively scarce capital and assisting unusually rapid economic growth’.<sup>30</sup> But besides commercial banking business, the state-owned specialised banks also provided policy loans.<sup>31</sup> As a result, a number of critical problems existed in the four specialised banks including massive non-performing loans (NPLs) and low rate of capital adequacy. In addition, state-owned specialised banks resembled government agencies rather than commercial enterprises.<sup>32</sup> Therefore, these banks were less diligent in improving management, which led to increasing operation costs.<sup>33</sup> Consequently, these problems

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<sup>28</sup> *ibid* 8.

<sup>29</sup> Sun (n 19).

<sup>30</sup> Li (n 7) 321.

<sup>31</sup> Chen and Shih (n 8) 4.

<sup>32</sup> Xiaochuan Zhou, ‘Some Issues Concerning the Reform of the State-owned Commercial Banks’ (IIF Spring Membership Conference, Shanghai, 16 April 2004) <<http://www.bis.org/review/r040714g.pdf>> accessed 5 November 2010.

<sup>33</sup> Li (n 7) 321.

threatened the financial health of banks and the sustainable development of the Chinese economy at large.<sup>34</sup>

The second wave of reforms started in 1994. With the enactment of the *Decisions on Issues Concerning the Establishment of the Socialist Market Economy System* on the 3<sup>rd</sup> Plenum 14<sup>th</sup> National Congress of the CPC in November 1993, the Chinese government promoted the development of the financial sector as a part of its socialist market economy strategy.<sup>35</sup> Accordingly, one month later the State Council instituted the *Resolution on Financial System Reform* aimed at ‘strengthening the supervision of the financial system by PBOC and separating the banking business from investment, insurance and trust business as well as separating the commercial banking business from public policy-oriented business.’<sup>36</sup> These two significant documents laid a solid political and legal foundation for the development of a market-oriented economy and the establishment of a modern commercial banking system. A series of measures were taken to reform three key areas over the next four years.

The main priority was to transform the PBOC into an independent central bank. In July 1993, Zhu Rongji was appointed as the governor of the PBOC. Zhu’s position as vice premier and his forceful style gave him the authority to appoint and remove the heads of the PBOC’s provincial branches. After Zhu took over, the headquarters of the People’s Bank was able to re-centralize authority for all PBOC lending and the allocation of credit

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<sup>34</sup> *ibid.*

<sup>35</sup> Lou (n 21) 3.

<sup>36</sup> Yangxin Huang, ‘The Banking Market System’ in Joseph J Norton, C J Li and Huang Yangxin (eds), *Financial Regulation in the Greater China Area: Mainland China, Taiwan and Hong Kong SAR* (Kluwer 2000) 28-9.

quotas.<sup>37</sup> Another unprecedented move came at the beginning of 1994, when the PBOC ended the practice of lending money to the Ministry of Finance (MOF) to cover the state budget deficit.<sup>38</sup> The promulgation of the Law of People's Bank of China in March 1995 set up the authority and independence of the PBOC as China's central bank.<sup>39</sup> However, although the Law of People's Bank of China in 1995 empowered the PBOC to implement monetary policy and to exercise supervision over the banking sector, the PBOC in practice still lacked sufficient independence and supervision effectiveness.<sup>40</sup>

A second goal had been to convert the four specialised banks into commercial banks as part of a long-term plan. The Commercial Banking Law in 1995 focused on the need for banks to incorporate the commercial criteria into their lending practices. SOCBs were granted more autonomy in lending decisions within their individual credit ceilings and some independence to pursue commercial objectives even though there was the strict credit plan in 1994 and 1995.<sup>41</sup> But the four state-owned commercial banks were still under administrative control by the government. According to Article 17 of the Commercial Banking Law in 1995, a bank which had been established prior to the promulgation of this Law may follow the original provisions if its organization form and structure do not entirely conform with the Company Law of the PRC, and the time limit for the retention thereof would be decided by the State Council.<sup>42</sup> Due to their sole state ownership, the organisational structure of state commercial banks is unique.<sup>43</sup> The

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<sup>37</sup> Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Brookings Institution Press 1998) 174-75.

<sup>38</sup> Lou (n 21) 191-92.

<sup>39</sup> Li (n 7) 322.

<sup>40</sup> For example, 'the determination of the interest rates on loans remained subject to government control, and the supervision effectiveness was still constrained to some extent by its capabilities'. See Sun (n 19) 79.

<sup>41</sup> Lou (n 21) 205.

<sup>42</sup> Commercial Banking Law 1995, art 17.

<sup>43</sup> Lou (n 21) 245.

organisational structure of state-owned commercial banks is the same as that of the wholly state-owned companies provided for in the 1993 Company Law.<sup>44</sup> They did not hold a meeting of shareholders as a balance and check of power, which led to weak corporate governance.<sup>45</sup> The state-authorized investment institution or the department authorised by the state should authorise the board of directors of the company to exercise part of the functions and powers of the shareholders' meeting and allow it to make decisions on important matters of the company. However, the merger, division, dissolution, increase and reduction of capital and issuance of company bonds must be decided by the state-authorized investment intuition or by the department authorized by the state.<sup>46</sup> A wholly state-owned company shall have a board of directors, which shall exercise its functions and powers in accordance with the provisions of Article 46 and Article 66 of the Company Law.<sup>47</sup> A wholly state-owned company should have a manager, who shall be engaged and dismissed by the board of directors. The manager shall exercise his functions and powers in accordance with the provisions of Article 50 of the Company Law.<sup>48</sup> The state-authorized investment institution or the department authorised by the state should exercise supervision and administration over the state-owned assets of the wholly state-owned company in accordance with the provisions of the laws and administrative rules and regulations.<sup>49</sup> The 1995 Commercial Banking Law makes provision in principle for the compositions of a board of supervisors and its

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<sup>44</sup> A wholly state-owned company means a limited liability company invested in and established solely by the state-authorized investment institution or a department authorized by the state. See 1993 Company Law, art 64.

<sup>45</sup> Lou (n 21) 245.

<sup>46</sup> Company Law 1993, art 66.

<sup>47</sup> *ibid* art 68.

<sup>48</sup> *ibid* art 69.

<sup>49</sup> *ibid* art 67.

duties.<sup>50</sup> On 12<sup>th</sup> November 1997, the PBOC released the *Interim Provisions on Boards of Supervisions in Solely State-owned Commercial Banks*, which were approved by the State Council. The 1997 interim provisions gave the PBOC the following powers: (a) the PBOC had one representative on the board of supervisors;<sup>51</sup> (b) the PBOC detailed supervisors' qualifications;<sup>52</sup> (c) representatives from the different departments in a board of supervisors shall be nominated by these departments and appointed by the PBOC upon verification of their qualifications;<sup>53</sup> (d) the chairman of a board of supervisors shall be nominated from among the supervisors by the PBOC and submitted to the State Council for the appointment.<sup>54</sup> In addition, a board of supervisors shall be responsible to the PBOC and report on its work to the PBOC at regular intervals.<sup>55</sup> Furthermore, the PBOC shall bear the expenses necessary for the performance of functions and responsibilities of a board of supervisors.<sup>56</sup> All of these facts reflected that 'the board of supervisors should represent the benefits of the State as the owner of the banks, rather than an agent of the PBOC as banking regulator and supervisor.'<sup>57</sup>

Removing the burden of the huge NPLs from the specialised banks was a significant step towards their commercialization.<sup>58</sup> Therefore, the third goal was to establish three policy banks to separate policy lending from commercial lending. In 1994, the State Council approved the establishment of three policy banks, namely the State Development of China, the Import-Export Bank of China and the Agricultural Development Bank of

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<sup>50</sup> Commercial Banking Law 1995, art 18.

<sup>51</sup> Interim Provisions on Boards of Supervisions in Solely State-owned Commercial Banks 1997, art 5.

<sup>52</sup> *ibid* art 6.

<sup>53</sup> *ibid* art 7.

<sup>54</sup> *ibid* art 8.

<sup>55</sup> *ibid* art 4.

<sup>56</sup> *ibid* art 20.

<sup>57</sup> Lou (n 21) note 95.

<sup>58</sup> Eu (n 6) 490.

China.<sup>59</sup> They took over policy lending functions from the four state-owned specialised banks. For instance, the primary role of the State Development Bank of China is to finance large-scale infrastructure projects and strategic industries of national priority; the Export and Import Bank of China, provides foreign trade finance; and the Agricultural Development Bank of China finances agricultural development projects.<sup>60</sup>

In addition, China made great efforts to enhance its legal system so as to keep pace with the ongoing financial reform.<sup>61</sup> In 1995, the National People's Congress approved four pieces of legislation: the Law of People's Bank of China, the Commercial Banking Law of China, the Law of China on Negotiable Instruments and the Insurance Law of China. These laws have regulated the activities of banks as well as the activities of other financial institutions, and promoted a more market-driven banking system. Also, this stronger legal structure has played a critical role in strengthening the operational independence of banks and avoiding political interference.

The outbreak of the Asian financial crisis in 1997 represented a steep learning curve for the Chinese government because it highlighted the importance of maintaining a healthy financial system.<sup>62</sup> China's political leaders realised that 'the major problems existing in Japan, Korea, Thailand and Malaysia that caused the crisis, such as the weak banking system, a large portion of policy loans and insufficient loan loss reserves', were similar in China.<sup>63</sup> The main reason that China did not become involved in this crisis was that its

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<sup>59</sup> Li (n 7) 322.

<sup>60</sup> *ibid.*

<sup>61</sup> Li (n 7) 323.

<sup>62</sup> Lou (n 21) 4.

<sup>63</sup> Li (n 7) 323.

domestic currency lacked strong links with the foreign capital market.<sup>64</sup> Besides external pressures, there had been internal pressures such as the collapse of several financial institutions in the late 1990s to handle the problems and draw much attention to the health of the financial system.<sup>65</sup> On 17-19 November 1997, a high-level National Financial Work Conference was held by the Central Committee of the Communist Party of China and the State Council in Beijing. The meeting discussed China's financial system and possible solutions to the crisis.<sup>66</sup> The Chinese government decided to establish a financial system compatible with the socialist market economy and to strengthen the risk management capacity of financial institutions in approximately three years.<sup>67</sup> A series of reforms were carried out in order to liberate the banks from direct government interference.

In January 1998, the PBOC abolished the quota lending system that had been implemented in China for as long as half a century<sup>68</sup> and converted it into an asset/liability ratio management system.<sup>69</sup> Unlike the former compulsory plan that 'had strict control over the maximum amounts of loans that could be made and the minimum amounts of loans that must be disbursed to the designated sectors and industries on an

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<sup>64</sup> *ibid.*

<sup>65</sup> 'That is, the closures of China Rural Trust and Investment Corporation in January 1997, Hainan Development Bank on 21 May 1998, China New Technology Venture Capital Corporation on 22 June 1998, and Pudong United Trust and Investment Corporation, a Shanghai-based finance company in the third quarter of 1998, and the most notorious, Guangdong International Trust and Investment Corporation in 1999'. See Lou (n 22) note 7.

<sup>66</sup> Li (n 7) 323.

<sup>67</sup> *ibid.*

<sup>68</sup> People's Bank of China, 'Circular Concerning Improvement of Administration of Loan Scope of State-owned Commercial Banks' (1998) 41 Bulletin of the People's Bank of China 3-6. According to the PBOC Circular, after the abolition of compulsory credit plan, commercial banks should issue loans according to lending rules set by the PBOC and industrial policies set by the government.

<sup>69</sup> *ibid.*

annual basis',<sup>70</sup> the new guiding plan permitted commercial banks to utilise new deposits to create loans in accordance with commercial principles after depositing the required reserve, repaying the borrowed money to the PBOC and purchasing government bonds.<sup>71</sup> Commercial banks are required to draft and issue annual and quarterly credit plans based on the guidelines of the PBOC regarding credit policies and asset-liability ratio management requirements.<sup>72</sup>

Another huge move is that China has established a management system that brought into existence an independent management and supervision system over the banking, securities and insurance sectors, so as to prevent and eliminate financial risks.<sup>73</sup> In 1998 all organisations engaged in securities trading supervised by the PBOC were put under the China Security Regulatory Commission (CSRC).<sup>74</sup> The China Insurance Regulatory Commission (CIRC) was also established in 1998 to supervise the insurance market.

China continued to make efforts to decontrol the interest rates during this period. A float interest rate system was introduced in 1996. On 2<sup>nd</sup> March 1999, the PBOC promulgated the *Provisions on RMB Interest Rate Administration* (hereafter the 1999 Interest Rate Provisions) which came into effective on 1<sup>st</sup> April 1999. The PBOC has been authorised to exercise the power of interest rate management, with which no other entity or individual may interfere.<sup>75</sup> However, individual financial institutions are allowed to determine floatable interest rates within the floatable scope set by the PBOC, interest

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<sup>70</sup> Li (n 7) 323.

<sup>71</sup> PBOC (n 68).

<sup>72</sup> Li (n 7) 323-24.

<sup>73</sup> *ibid* 326. See also DK Srivastava and Charu Sharma 'Banking Law in China after WTO: Sailing through the Winds of Change' (2003) *Journal of Chinese and Comparative Law* 151.

<sup>74</sup> Although established in October 1992, the CSRC did not become a fully operating regulatory body until the government's action six years later.

<sup>75</sup> The 1999 Interest Rate Provisions, art 3.

rates for internal fund flows, inter-bank interest rates and discount rates.<sup>76</sup> The development of the floating rate system has given banks an increasing level of discretion in adjusting lending interest rates within the stipulated floating scope based on the amount and risk of the loan, the creditworthiness and the liability-asset ratio of the borrowers, as well as whether the loan is secured.<sup>77</sup>

Another important reform has been the PBOC organisational restructuring in 1998. By the end of 1998, the new structural system had come into existence with nine regional branches instead of the old organizational structure with 32 branches, which had allowed the local government (especially the provincial government) to interfere in the PBOC's duties to implement monetary policy and carry out financial regulation and supervision.<sup>78</sup> According to the speech by Wen Jiabao, who was one of the four vice premiers, at the meeting of the directors of PBOC nationwide branches on 14<sup>th</sup> November 1998 the reshuffling of the PBOC branches would enhance the authoritativeness of the PBOC in implementing monetary policy, the independence of the PBOC in carrying out financial regulation and supervision and would help improve the efficiency as well as integration of financial regulation and supervision.<sup>79</sup>

On 28<sup>th</sup> February 1998, the Chinese government injected RMB270 billion (USD 32.6 billion) into the big four state banks by issuing special treasury bonds.<sup>80</sup> In April 1998,

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<sup>76</sup> *ibid* art 6.

<sup>77</sup> Zhou Rongfan and Chao Deyun, 'The Reform and Development of China's Floating Interest Rate System' (1998) 10 *China Finance* 23-4.

<sup>78</sup> See the People's Daily Commentator, 'A Significant Reform of the PBOC Organizational System'[zhongyan yinhang guanli tizhi de zhongda gaige] (16 November 1998) *People's Daily* (Overseas Edition) 1.

<sup>79</sup> J. Shui and M. Shi, 'The CCP Central Committee and the State Council Decide to Reform the PBOC Organizational System'[zhonggong zhongyan guowuyuan zuochu jue ding, zhongguorenmingyinhang guanli tizhi shixing gaige] (16 November 1998) *People's Daily* (Overseas Edition) 1, 4.

<sup>80</sup> Li (n 7) 324.

the PBOC released the *Guiding Principles for Loan Risk Classification* (trial implementation) to officially incorporate the Five-Grade Credit System that classifies loans into five categories namely “pass”, “special mention”, “substandard”, “doubtful” and “loss”.<sup>81</sup> The new method classifies loans based on ‘the credit risk of loans rather than on the payment status, which was carried out by the old system for a long time’.<sup>82</sup> Meanwhile, the Chinese government recognised that political interference led to the emergence of NPLs; the State Council subsequently issued directives to prohibit government official at all levels from influencing bank’s credit decisions.<sup>83</sup> In 1999, four asset management companies (AMCs), which are China Huarong Asset Management Corporation (Huarong), China Great Wall Asset Management Corporation (Great Wall), China Orient Asset Management Corporation (Orient), and China Cinda Asset Management Corporation (Cinda), were set up by the Chinese government to dispose of a total of RMB1.3 trillion of non-performing assets from the four SOCBs.<sup>84</sup>

### **3.3 Existing problems of corporate governance in SOCBs**

From the early 1990s to the end of 2001, the Chinese government had made great efforts to reform the banking system. These enormous achievements have generally been acknowledged. However, the banking system is still problem-ridden. For example, it suffers from huge NPLs, under-capitalisation, government intervention, weak corporate

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<sup>81</sup> “Pass” refers to loans where no problem with repayment of interest or principle occurred or perceived. “Special mention” refers to loans where though there are no repayment delays yet, problems that would affect the repayment have been detected. “Substandard” refers to loans where the repayment cannot be fully made with normal business income. “Doubtful” refers to loans where the repayment cannot be fully made even with securities or guarantees being exercised. “Loss” refers to loans where the repayment cannot be made after taking all the possible measures and necessary legal procedures.

<sup>82</sup> Li (n 7) 325.

<sup>83</sup> Jing Leng, ‘China’s Banking Reform in the context of Globalization and Transition’ (2006) European Business Law Review 1281.

<sup>84</sup> *ibid* 1276. See more details about disposal of NPLs in ch 4.

governance and lacks prudential regulation and supervision. The following sections provide detailed discussion of these points.

### **3.3.1 Unspecified property rights**

The Chinese government has imposed strict control on ownership in the banking industry for a considerable length of time in order to tightly control the financial resources. Therefore, the four state banks were born under a government-led banking system. However, this type of banking system is not beneficial for the effective establishment of the principle-agent relationship and the improvement of bank efficiency. Furthermore, it seriously affects the corporate governance of banking.<sup>85</sup>

Over the past decades, the long-term state-controlled property right system in the Chinese banking industry has given rise to severely negative influences on the development of corporate governance for banking.<sup>86</sup> First of all, the state-owned assets are not the personal property of bank executives and therefore, the agents of state-owned assets such as bank executives do not have strong motivation to care about a bank's performance. Under the state-owned property rights system, there has been the issue that the business management of state banks, which is also heavily influenced by government intervention, does not draw a clear line between the functions of the government and enterprises. As a principle, the government not only requires the agents in state banks to pursue commercial objectives, but also to implement policy goals. Consequently, this has given rise to a huge amount of NPLs as well as the increasing burden on banking operations. In

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<sup>85</sup> Zhihui Li, *The Development and Evolution of Chinese Banking Industry [zhongguo yinhangye gaige] (zhongguo gaige sanshi nian congshu)* [30-year Chinese reform series], Ge Zhi Chu Ban She[Ge Zhi Press] 2008) 128 (in Chinese).

<sup>86</sup> *ibid.*

addition, banks under heavy administrative controls often have not had the opportunity to develop internal control systems. Furthermore, the government-owned property rights system implicitly provides a kind of deposit insurance. Thus, it is easier to run the risk that creditors, including depositors have no incentive to supervise agents. Also, it determines that state-owned banks are vague about bankruptcy or close down because those with huge losses could be offset by financing. Thus, there is no doubt that it continues to increase the agent's moral risks.

The four SOCBs were wholly owned by the state. Theoretically, from the perspective of state ownership, the Chinese people own the property rights of the state banks. Due to the impossibility for Chinese people to implement their rights to state banks' assets and monitor their management, the government acts on behalf of the people and has finally become the owner of the state banks.<sup>87</sup> There has been an asymmetry in the allocation of rights and obligations with the unclear assignment of property rights.<sup>88</sup> In fact, multiple government departments and agencies acted in ownership roles.<sup>89</sup> 'Across agencies both horizontally and vertically there is fragmentation and partial exercise of ownership function, with no single entity responsible for the enterprise's bottom line.'<sup>90</sup> The lack of clear identification of the owners of state banks in China has confused ownership and operational rights, and left the issue of who should be monitoring the managers because state banks have multiple principals that may not have the authority, capacity, nor

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<sup>87</sup> Peng (n 27) 8.

<sup>88</sup> Harry G. Broadman, 'The Chinese State as Corporate Shareholder' (IMF Finance & Development, September 1999) <<http://imf.org/external/pubs/ft/fandd/1999/09/pdf/broadman.pdf>> accessed January 2009.

<sup>89</sup> *ibid* 53.

<sup>90</sup> *ibid*.

motivation to monitor state banks.<sup>91</sup> Moreover, it is impossible to arrange a meeting with shareholders and the boards of directors of state banks without clear identification of the owners.<sup>92</sup>

### **3.3.2 Multiple objectives**

During the period of the transition economy, SOCBs were endowed with two main functions: profit maximisation and financial support, so as to accelerate the capital accumulation in key state-owned economic sectors and to adjust the economic structure. These functions urged the senior management in four SOCBs to face multiple objectives. On the one hand, their main priority as government organisations was to follow government orders and directives. On the other hand, state-owned commercial banks as market players needed to exercise the market principle of profit making. Even the Governor of PBOC, Xiaochuan Zhou, commented that state banks were more like government organisations rather than commercial enterprises.<sup>93</sup> Multiple objectives raise ‘transaction costs and distort internal incentives for bank managers, and also have an advert impact on their balance sheet.’<sup>94</sup>

### **3.3.3 Political interference and poor bank management**

The PRC administration is characterised by a dual hierarchy, ‘with the administrative hierarchy paralleled by, and interwoven with, the party hierarchy’, which has greatly

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<sup>91</sup> World Bank, *Bureaucrats in Business: the Economics and Politics of Government Ownership* (Oxford University Press 1995), cited in Peng (n 28) 8.

<sup>92</sup> Peng (n 27) 8.

<sup>93</sup> Xiaochuan Zhou, ‘Some Issues Concerning the Reform of the State-owned Commercial Banks’ (IIF Spring Membership Conference, Shanghai, 16 April 2004) <<http://www.bis.org/review/r040714g.pdf>> accessed 5 November 2010.

<sup>94</sup> Peng (n 27) 8.

strengthened the ruling party's (CCP) control over the state bureaucracy.<sup>95</sup> The CCP plays a dominant role in state governance. The president is under the leadership of the secretary of the party committee at every level of the four state-owned commercial banks.<sup>96</sup> Although the banks' staff are not all party members, candidates of key positions are required to be party members and are appointed by the Department of Organisation of the CCP. Therefore, these reasons have led to strong political interference in the aspects of personnel appointment, wage settings or even deployment of demobilised soldiers.<sup>97</sup> As Sebastian Heilmann explains in his paper, 'China's banking sector cannot be free of political interference and cannot have an efficient management system and desirable corporate governance.'<sup>98</sup> According to Heilmann, China's political leaders aim to establish a regulatory system which is in accordance with international standards for obtaining credibility in the construction of financial markets.<sup>99</sup> But the government officials still control regulatory bodies and financial firms by means of Communist Party care, appointment and supervision.<sup>100</sup>

Due to heavy administrative intervention and controls, banks always had fewer opportunities to develop their risk-management capacities. Banks lacked real experience in real commercial banking after decades of policy-directed lending which was strictly controlled by a few government departments and agencies. China's commercial banks are handicapped by operational deficiencies that are caused by the absence of critical

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<sup>95</sup> *ibid* 9.

<sup>96</sup> *ibid*. 'In most case, the posts of bank president and party secretary are held by the same person. In this case, "yiyuanhua lingdao" (unified leadership) is in its purest form.' See *ibid*.

<sup>97</sup> *ibid*.

<sup>98</sup> Dongwook Lee, 'The Hidden Bombs are Ready to Tick: China's Market for Foreign Investors after the WTO Accession', (2005) *Hong Kong Law Journal* 205, 212.

<sup>99</sup> Sebastian Heilmann, 'Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry' (2005) 181 *The China Quarterly* 1.

<sup>100</sup> *ibid*.

management processes, such as planning, budgeting and reporting; a lack of familiarity with asset and liability management techniques; inadequate accounting standards that render performance and risk assessment difficult; substandard information systems; inappropriate internal incentive systems for staff; and poorly articulated institutional structures and legal frameworks.<sup>101</sup>

### **3.3.4 Principal-agent problem**

Currently, directors, who are the decision-makers and executives in SOCBs, are appointed by the State Council or the superior administrative departments. Compared with those of banks in developed economies, there are fundamental distinctions underlying methods of business management and attitudes towards innovation. A governance structure which allows the manager (agent) to have the necessary degree of autonomy without endangering the interests of the owner (principal) has not been set up in China's SOCBs.<sup>102</sup> Due to the political appointment, senior managers in state-owned commercial banks are concerned with how to build a good relationship with superior government departments in order to receive promotion at an administrative level. Thus, to a large extent, they are not concerned about the economic interests of SOCBs, nor profit maximisation for shareholders.<sup>103</sup>

The agency problem is considerably more dangerous in banks than in other manufacturing enterprises because of the nature of the banking business, such as the

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<sup>101</sup> Deepak Bhattassali, 'Accelerating Financial Market Restructuring in China' (2002) World Bank <<http://siteresources.worldbank.org/INTRANETTRADE/Resources/bhattfin services.pdf>> accessed 12 December 2009.

<sup>102</sup> *ibid.*

<sup>103</sup> Due to the ignorance of duty of care and duty of fiduciary by the agent, managerial misbehaviour in state-owned commercial banks has commonly taken place at most of time such as the misuse of company funds and expropriation.

accumulation of a huge amount of money and the larger scale of the banking business.<sup>104</sup>

The consequences of the agency problem in the banking sector could trigger a series of crises that cause economic ruin to a country, region or even the world. Therefore, it is important for SOCBs to establish an oversight mechanism and to develop their risk-management capacities so as to ensure the safe operation of banks.

### **3.4 The legal and regulatory framework for bank governance**

This section concentrates on those aspects of the legal, regulatory and prudential framework in the Chinese banking sector before the WTO entry.

#### **3.4.1 Legal sources of banking regulation**

China's legal framework for banking is mainly made up of three forms including banking laws, banking administrative regulations, and banking rules.<sup>105</sup> Prior to 1995, no single formal banking law existed in China, and the legal system that regulated the Chinese banking market mainly took two forms: administrative regulations stipulated by the State Council and a wide range of rules or measures by the PBOC and other related government departments.<sup>106</sup> In 1986, the State Council released the Provisional Regulations on Banking Management, which was the first comprehensive legislation in China to regulate the banking sector.<sup>107</sup> However, due to immature markets, the

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<sup>104</sup> Peng (n 27) 10.

<sup>105</sup> James R Barth, Zhongfei Zhou, Douglas W Arner, Berry F.C. Hsu, and Wei Wang, 'The WTO and Financial Restructuring in China' in James R Barth, Zhongfei Zhou, Douglas W Arner, Berry F.C. Hsu and Wei Wang (eds), *Financial Restructuring and Reform in Post-WTO China* (Kluwer Law International 2007).

<sup>106</sup> *ibid* 16.

<sup>107</sup> Regulations on Banking Management (Beijing: State Council, 7 January 1986).

legislation was relatively rough and simple.<sup>108</sup> China's banking law framework took shape in 1995 with the enactment of two main banking laws, namely the Law of People's Bank of China (PBOC law—the central bank law) and the Law on Commercial Banks (Commercial Banking Law).<sup>109</sup> Efforts to build a modern banking legal system have accelerated since the late 1990s. The promulgation of the two banking laws, along with the Law on Security and the Law on Negotiable Instruments, supplemented by the Company Law, Interim Regulations on the Board of Supervisors of Important State-owned Financial Institutions and a variety of administrative rules and measures, provide a solid legal foundation for China's reform on banking regulatory system, and safeguard the efficient operation of banks.

#### **3.4.1.1 Law of People's Bank of China**

Adopted on 18<sup>th</sup> March 1995, the PBOC Law is the first formal banking law in China, since the Communist Party took power in 1949. This law came into force on the date of its promulgation and also confirms the position of the PBOC as the central bank of China, which is responsible for ensuring the correct formulation and implementation of the monetary policies, establishing and accomplishing a system of macroeconomic control by a central bank, and strengthening the supervisory administration of the financial industry in the PRC.<sup>110</sup>

##### **3.4.2.1.1 *The PBOC as the Central Bank***

The PBOC Law clearly stipulates that the PBOC is the central bank of the PRC, that is under the leadership of the State Council and that its functions and responsibilities are to

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<sup>108</sup> Barth, Zhou, Arner, Hus, and Wang (n 105) 16.

<sup>109</sup> Both laws were amended in 2003.

<sup>110</sup> PBOC Law 1995, arts 1 and 51.

implement monetary policies, to eliminate financial risks and to strengthen the supervisory administration of the financial industry in China.<sup>111</sup> The aims of monetary policies are to maintain the stability of the value of the currency and to stimulate economic development.<sup>112</sup> The Law mandates that the PBOC should report its decisions with regard to the annual money supply, interest rate, foreign exchange rates and other important matters to the State Council for approval.<sup>113</sup> The Law provides that the PBOC is free from any intervention by local governments, government departments at various levels, associations or individuals.<sup>114</sup>

The PBOC is owned by the state and all capital of the PBOC is allocated by the state.<sup>115</sup> The Governor of the People's Bank of China is nominated by the Premier of the State Council, approved by the National People's Congress or the Standing Committee of the National People's Congress and appointed by the President of China.<sup>116</sup> As a leader of PBOC, the Governor is a chief executive officer who undertakes overall responsibility.<sup>117</sup> The PBOC is the only legitimate and authorised body which can print and issue RMB.<sup>118</sup>

Article 30 of the PBOC Law explicitly provides that the PBOC shall exercise supervision and control over banking institutions and their business operations to maintain the legitimate, stable and sound operation of the banking industry in accordance with the law.<sup>119</sup> Article 30 is a milestone in the coming of a new era of concentration on the rule

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<sup>111</sup> *ibid* art 2.

<sup>112</sup> *ibid* art 3.

<sup>113</sup> *ibid* art 5.

<sup>114</sup> *ibid* art 7.

<sup>115</sup> *ibid* art 8.

<sup>116</sup> *ibid* art 10.

<sup>117</sup> *ibid* art 11.

<sup>118</sup> *ibid* art 17.

<sup>119</sup> *ibid* art 30.

of law in financial regulation.<sup>120</sup> It is foreseeable that China will gradually move from its administrative regulatory framework to an increasingly transparent legal framework.<sup>121</sup>

#### **3.4.2.1.2      *The PBOC as Banking Supervisor***

The 1995 PBOC Law gives the PBOC broader power to supervise and control the entire financial industry, manifesting in three areas. First of all, the PBOC examines and approves the establishment, change, termination and scope of business of the banking institutions in accordance with relevant regulations.<sup>122</sup> Moreover, the PBOC is empowered to audit, check and supervise the deposit, loans, account setting, bad debts and other business affairs of banking institutions at any time.<sup>123</sup> In addition, the PBOC is authorised to check and supervise the raising or lowering of interest rates on deposits or loans by banking institutions in violation of regulations.<sup>124</sup> Thirdly, the PBOC has the power and right to require banking institutions to submit balance sheets, statements of profit and loss, and other financial and accounting reports and materials with the pertinent regulations.<sup>125</sup> The PBOC is also responsible for compiling comprehensive statistics and accounting statements for the national banking system and for publishing them in accordance with relevant state provisions.<sup>126</sup>

Article 35 of the PBOC Law provides that the PBOC shall guide and supervise the business operations of the state banks responsible for implementing state policies. Therefore, it remains doubtful that the PBOC has overall powers of supervisory functions

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<sup>120</sup> Timothy Haosen Wan, *Development of Banking Law in the Greater China Area: PRC and Taiwan* (Kluwer Law International 1999) 203.

<sup>121</sup> *Ibid.*

<sup>122</sup> PBOC Law 1995, *ibid* art 31.

<sup>123</sup> *ibid* art 32.

<sup>124</sup> *ibid.*

<sup>125</sup> *ibid* art 33.

<sup>126</sup> *ibid* art 34.

towards policy-oriented state banks.<sup>127</sup> It may be interpreted that the Chinese government may prefer the PBOC not to interfere with state banks as they perform policy-oriented business.<sup>128</sup>

#### **3.4.1.2 Commercial Banking Law**

The Law of Commercial Banks of the PRC, which has been another crucial step towards the establishment of a legal framework for the administration of the banking industry in China,<sup>129</sup> was adopted by the 13<sup>th</sup> Conference of the Standing Committee of the Eighth National People's Congress of the PRC on 10 May 1995 and took effect on 1 July 1995.<sup>130</sup> This law regulates the activities of commercial banks in China, replacing regulation by rules promulgated by the State Council, the People's Bank of China and the State Administrative of Exchange Control.<sup>131</sup>

##### **3.4.1.2.1 Definition of 'Commercial Bank'**

A 'commercial bank' refers to a business company established in accordance with the Commercial Banking Law and the Company Law to receive money deposits from the public, to extend loans, to provide settlement services and to carry out other relevant businesses.<sup>132</sup> The Law clearly stipulates that the establishment of a commercial bank shall be subject to the examination and approval of the PBOC, and no entity or individual may engage in absorbing public deposits or other business of a commercial bank, nor

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<sup>127</sup> Wan (n 120) 204.

<sup>128</sup> *ibid.*

<sup>129</sup> Wan (n 120), 205.

<sup>130</sup> Commercial Banking Law 1995.

<sup>131</sup> Victor Luk, 'The PRC's Commercial Banking Law',  
<<http://sunzi.lib.hku.hk/hkjo/view/15/1500536.pdf>> accessed on 12 July 2009.

<sup>132</sup> Commercial Banking Law 1995, art 2.

shall any entity use the title of “bank” without the approval of the PBOC.<sup>133</sup> The PBOC shall order correction if any institution uses the title “bank” without authorisation.<sup>134</sup> If such an entity or individual obtains illegal gains, these illegal gains are to be confiscated, and a fine may be imposed of not less than one time, but not more than five times, if the amount of the illegal gains exceeds RMB 50,000.<sup>135</sup> If there are no unlawful gains or such gains are less than RMB 50,000, it shall be fined not less than RMB 50,000 yuan but not more than RMB 500,000.<sup>136</sup>

#### **3.4.1.2.2      *Business scope***

Commercial banks may engage in some or all of the following business operations:

- 1) taking in deposits from the general public;
- 2) granting short-term, medium-term and long-term loans;
- 3) handling domestic and foreign settlements;
- 4) handling the acceptance and discounting of negotiable instruments;
- 5) issuing financial bonds;
- 6) acting as an agent for the issue, honoring and underwriting of government bonds;
- 7) buying and selling government bonds and financial bonds;
- 8) engaging in interbank lending;
- 9) buying and selling foreign exchange and acting as an agent for the purchase and sale of foreign exchange;
- 10) engaging in the business of bank cards;
- 11) providing letter of credit services and guarantees;

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<sup>133</sup> *ibid* art 11.

<sup>134</sup> *ibid* art 79.

<sup>135</sup> *ibid*.

<sup>136</sup> *ibid*.

- 12) acting as an agent for the receipt and payment of money and acting as an insurance agent;
- 13) providing safe deposit box services; and
- 14) other business operations as approved by the PBOC.<sup>137</sup>

Pursuant to Article 4 of the Commercial Banking Law, the business operations of commercial banks shall be governed by the principles of safety, liquidity and efficiency. Commercial banks shall make their own decisions regarding their business operations, take responsibility for their own risks, assume sole responsibility for their profits and losses and exercise self-restriction.<sup>138</sup> Thus, commercial banks must, according to the law, conduct business operations without interference from any unit or individual.<sup>139</sup> Commercial banks must independently assume civil liability with their entire legal person property.<sup>140</sup>

#### **3.4.1.2.3      *Establishment procedures***

The minimum registered capital for establishing a commercial bank is RMB 1 billion.<sup>141</sup> The minimum registered capital for establishing an urban cooperative commercial bank is RMB 100 million, and the minimum registered capital for establishing a rural cooperative commercial is RMB 50 million.<sup>142</sup>

The PBOC may increase the amount of minimum registered capital in accordance with economic development.<sup>143</sup> Article 16 of the Commercial Banking Law explicitly provides that the PBOC will issue a license to any commercial bank whose establishment has been

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<sup>137</sup> *ibid* art 3.

<sup>138</sup> *ibid* art 4, para 1.

<sup>139</sup> *ibid* art 4, para 2.

<sup>140</sup> *ibid* art 4, para 3.

<sup>141</sup> *ibid* art 13, para 1.

<sup>142</sup> *ibid*.

<sup>143</sup> *ibid* art 13, para 2.

approved and the bank concerned should register with the State Administration for Industry and Commerce and obtain a business license.<sup>144</sup>

The stipulations of the Company Law which were promulgated by the State President on 29<sup>th</sup> December 1993 and became effective on 1<sup>st</sup> July 1994 apply to the organizational forms and setups of commercial banks.<sup>145</sup> However, a commercial bank which had been established before the enactment of the Commercial Banking Law, and does not entirely conform to the Company Law, may follow the original forms and structures until the date the State Council determines to comply with the Company Law.<sup>146</sup>

According to Article 19 of the Commercial Banking Law, commercial banks may set up their branches under the approval of the PBOC.<sup>147</sup> The branch organisations, which do not have the status of a legal person, operate their business under the authorization of the bank's headquarters.<sup>148</sup> The headquarters must assume civil liabilities incurred by its branches.<sup>149</sup>

#### **3.4.1.2.4      *Protection of Depositors***

The Commercial Banking Law includes a special chapter entitled "Protection of Depositors".<sup>150</sup> It stipulates that a commercial bank must abide by the following principles in the business of taking savings deposits from individual clients: savings to be voluntary, savings to be withdrawn freely, interest to be paid on savings and privacy of

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<sup>144</sup> Commercial Banking Law 1995, art 16.

<sup>145</sup> *ibid* art 17, para 1.

<sup>146</sup> *ibid* art 17, para 2.

<sup>147</sup> Commercial Banking Law 1995, art 19.

<sup>148</sup> *ibid* art 22.

<sup>149</sup> *ibid*.

<sup>150</sup> Commercial Banking Law 1995, arts 29 – 33.

depositors.<sup>151</sup> A commercial bank must publicly announce its interest rates for deposits in accordance with the upper and lower limits of interest on savings set by the PBOC.<sup>152</sup> Also, commercial banks are required to hand in deposit reserves to the PBOC and to maintain special reserves for payment of cash demands.<sup>153</sup> A commercial bank should guarantee the payment of the principal and interest of the deposits and must not delay nor refuse to pay the principal and interest of the deposits.<sup>154</sup>

In terms of privacy of customers, commercial banks have the right to refuse any agency or individual to inquire, freeze and deduct from individual deposits except the cases as stipulated by law.<sup>155</sup> A commercial bank has the right to refuse any inquiries made by an agency or individual about the deposits of any other unit except the cases as stipulated by law and administrative regulations.<sup>156</sup> In other words, a commercial bank may reveal information with regard to its unit customers if allowed by the administrative regulations.<sup>157</sup> But the commercial banks have the right to refuse any agency or individual to freeze and deduct the deposits of any other agency except the cases as stipulated by law.<sup>158</sup>

Due to this loophole, the PBOC or other related authorities may easily get information respecting the deposits of unit customers by releasing administrative regulations. This coupled with the account requirement, greatly facilitates the supervision of business enterprise units because competent authorities are able to monitor all activities of

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<sup>151</sup> *ibid* art 29, para 1.

<sup>152</sup> *ibid* art 31.

<sup>153</sup> *ibid* art 32.

<sup>154</sup> *ibid* art 33.

<sup>155</sup> *ibid* art 29, para 2.

<sup>156</sup> *ibid* art 30.

<sup>157</sup> Wan (n 120), 208.

<sup>158</sup> Commercial Banking Law 1995, art 30.

business enterprise unit customers through the information released from their basic account.<sup>159</sup>

#### **3.4.1.2.5      *Basic rules of business operation***

Commercial banks are required to comply with distinct ratios of assets and liabilities. The capital adequacy ratio must not be less than eight percent in order to keep in line with the capital adequacy requirements set forth by the Basel Committee.<sup>160</sup> The ratio between the balance of total loans and the balance of total deposits must not exceed 75 percent.<sup>161</sup> The ratio between the balance of liquid assets and the balance of liquid liabilities must not be lower than 25 percent.<sup>162</sup> The ratio between the balance of loans of one borrower and the balance of capital of the commercial bank must not exceed 10 percent.<sup>163</sup> In addition, commercial banks should abide by other stipulations on the ratio between assets and liabilities governed by the PBOC.<sup>164</sup>

Any commercial bank which had been set up before the promulgation of the Commercial Bank Law that fails to conform to these required ratios between assets and liabilities must meet such ratios in a certain period of time decided by the State Council.<sup>165</sup>

Commercial banks must not lend unsecured loans to their connections, and the conditions for granting secured loans to their connections must not be more preferential than those

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<sup>159</sup> Pursuant to Article 48 of the Commercial Banking Law, enterprises and institutions can choose a commercial bank to open their own basic accounts for daily transference, and settlement of accounts, cash receipts and payment, but cannot open two or more basic accounts.

<sup>160</sup> Commercial Banking Law 1995, art 39, para 1, subpara 1.

<sup>161</sup> *ibid* subpara 2.

<sup>162</sup> *ibid* subpara 3.

<sup>163</sup> *ibid* subpara 4 .

<sup>164</sup> *ibid* subpara 5.

<sup>165</sup> Commercial Banking Law 1995, art.39, para 2.

for granting the same type of loans to other borrowers.<sup>166</sup> The term “connections” refers to directors, supervisors, administrators and loan officers of the commercial bank and close relatives of such persons, or companies, enterprises and other economic organisations in which the persons mentioned above have invested or in which they hold senior administrative positions.<sup>167</sup>

#### **3.4.1.2.6      *Supervision and management***

The PBOC plays the role of supervisory authority to the banking industry in China. Therefore, it is responsible for examining and scrutinizing the business operations of commercial banks. The PBOC has the right at any time to carry out inspections of and exercise supervision over commercial banks and can require them to provide financial and accounting information, business contracts and other information concerning their operation and management in compliance with the requirements of the PBOC.<sup>168</sup> In addition, commercial banks are subject to the supervision of audit institutions.<sup>169</sup>

#### **3.4.1.2.7      *Takeover and termination***

The PBOC may take over a commercial bank when a commercial bank has suffered or will possibly suffer a credit crisis, thereby seriously affecting the interests of the deposits.<sup>170</sup> The purpose of the takeover by the PBOC is to take necessary measures to protect the interests of the depositors and to enable the commercial bank to resume

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<sup>166</sup> Commercial Banking Law 1995, art 40, para 1.

<sup>167</sup> *ibid* para 2.

<sup>168</sup> Commercial Banking Law 1995, art 62, para 1.

<sup>169</sup> *ibid* art 63.

<sup>170</sup> *ibid* art 64, para 1.

normal business.<sup>171</sup> However, the original relations of the rights and the obligations of the received commercial bank shall remain unchanged.<sup>172</sup>

The period for the takeover is to be determined by the PBOC; but the whole period for the takeover may not be longer than two years.<sup>173</sup> The takeover is to be terminated upon the expiration of the period for takeover, the resumption of the normal business of the received commercial bank, or the merger or the bankruptcy of the received commercial bank.<sup>174</sup>

#### **3.4.1.2.8      *Anti-corruption provisions***

The Commercial Banking Law stipulates that commissions charged by the commercial banks for the business operations or the provision of services are to be in accordance with relevant regulations of the PBOC.<sup>175</sup>

The employees of commercial banks are not allowed to use their positions to demand, receive or accept bribes, and the reception or acceptance of rebates or commissions is in violation of the pertinent regulations.<sup>176</sup> Criminal responsibilities will be affixed on employees of commercial banks who, taking advantage of their own positions, ask for and accept bribery or violate state regulations to accept various forms of discounts or service charges; the violator will undertake the responsibility for the whole or part of the damages stemming from the violation.<sup>177</sup>

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<sup>171</sup> *ibid* art 64, para 2.

<sup>172</sup> *ibid*.

<sup>173</sup> *ibid* art 67.

<sup>174</sup> *ibid* art 68.

<sup>175</sup> *ibid* art 50.

<sup>176</sup> *ibid* art 52.

<sup>177</sup> *ibid* art 81.

### 3.4.1.3 The Company Law

When the People's Republic of China was founded by the Communist Party in 1949, the new government immediately announced that the Six Codes, which represented the legal system of the Nationalist Government, were to be abolished.<sup>178</sup> Since the 1950s, the communist government enforced a planned economy and subsequently, new regulations and laws were introduced into nationalise and collectivize the economy.<sup>179</sup> Consequently, companies, either state-owned or collectively-owned, directly and immediately lost their corporate nature during the period of nationalisation and became non-independent economic units.<sup>180</sup>

During the 1980s, the central government issued a range of laws adopted by the National People's Congress that were beneficial for corporate development, including the Foreign Joint Venture Law in 1979, which made the first efforts to reintroduce independent business organizations with limited liability,<sup>181</sup> the General Principles of the Civil Law in 1986, which set the conditions for the establishment of legal person enterprises that possess property and are able to bear civil liability independently,<sup>182</sup> and the Law on Industrial Enterprises Owned by the Whole People in 1988, which forced all state-owned enterprises to obtain the status of legal persons with civil liability for the property which the state has authorised them to operate and manage.<sup>183</sup>

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<sup>178</sup> The Six Codes originally referred to the Constitution, the Civil Code, the Commercial Code, the Civil Procedure Code, the Criminal Code, and the Criminal Procedure Code. It later generally to referred to the collective body of statutes of the Republic of China.

<sup>179</sup> Jiangyu Wang, 'An Overview of China's Corporate Law Regime' (2008) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1222061](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1222061)> accessed 10 May 2010.

<sup>180</sup> *ibid* 5.

<sup>181</sup> *ibid*.

<sup>182</sup> *ibid*.

<sup>183</sup> Law on Industrial Enterprises Owned by the Whole People 1988, art.2, paras. 2 and 3.

The most crucial development of China's corporate legal system is certainly the promulgation of the first nationally unified Company Law by the National People's Congress in 1993 since the founding of PRC in 1949, which became effective on 1<sup>st</sup> July 1994.<sup>184</sup> The 1993 Company Law aims to meet the needs of establishing a modern enterprise system, standardising the organisation and activities of companies, protecting the legitimate rights and interests of companies, shareholders and creditors, maintaining socio-economic order, and promoting the development of the socialist market economy.<sup>185</sup> The law defines two types of companies namely the limited liability company and the joint stock company, as well as stipulating their corporate finance and corporate governance structure, and prescribing the responsibilities, rights and liabilities of shareholders, directors, supervisors and corporate managers.<sup>186</sup> Although there are many weaknesses in the 1993 Company Law, it was the first attempt to effectively create a comprehensive corporate legal framework in the PRC, and laid a solid foundation for corporate and economic development. The 1993 Company law was subsequently amended by the 1999 Company Law, in which the Standing Committee of the National People's Congress added a new provision requiring the establishment of the supervisory board of wholly state-owned companies.<sup>187</sup>

Wholly state-owned commercial banks belong to the category of wholly state-owned companies under company law.<sup>188</sup> A wholly state-owned company is defined as a limited liability company in which a state-authorised investment institution or a state-authorised

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<sup>184</sup> Company Law 1993.

<sup>185</sup> *ibid* art 1.

<sup>186</sup> Wan (n 120) 6.

<sup>187</sup> Company Law 1999, art 67.

<sup>188</sup> The four biggest SOCBs are subordinated directly to the State Council.

department is the sole investor, and is established solely by a state-authorized investment institution or by a state-authorised department.<sup>189</sup>

A wholly state-owned company does not have shareholders' meetings.<sup>190</sup> The company's board of directors is authorised by the state-authorised investment institution or the state-authorised department to exercise part of the powers of the shareholders' meeting and to decide on the major issues of the company.<sup>191</sup> But the merger, division, dissolution of the company, increase and reduction of capital and issuance of corporate bonds must be decided on by the state-authorised investment institution or the state-authorised department.<sup>192</sup>

The board of directors in a wholly state-owned company shall exercise its powers in line with the provisions of Article 46 and Article 66 of the 1999 Company Law.<sup>193</sup> The term

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<sup>189</sup> Company Law 1999, art 64.

<sup>190</sup> Company Law 1999, art 66.

<sup>191</sup> *ibid.* According to Article 38 of the Company Law 1999, the meeting of shareholders of a limited liability company exercises the following powers: (1) to decide on the company's operational policies and investment plans; (2) to elect and replace directors and decide on matters relating to the remuneration of directors; (3) to elect and replace supervisors who are representatives of the shareholders, and decide on matters relating to the remuneration of supervisors; (4) to examine and approve reports of the board of directors; (5) to examine and approve reports of the supervisory committee or any supervisor(s); (6) to examine and approve the company's proposed annual financial budget and final accounts; (7) to examine and approve the company's plans for profit distribution and recovery of losses; (8) to decide on increases in or reductions of the company's registered capital; (9) to decide on the issue of bonds by the company; (10) to decide on transfers of capital contribution by shareholders to a person other than a shareholder; (11) to decide on issues such as mergers, divisions, changes in corporate form or dissolution and liquidation of the company; (12) to amend the company's articles of association.

<sup>192</sup> *ibid.*

<sup>193</sup> *ibid* art 68, para 1. According to Article 46 of the Company Law 1999, the board of directors is responsible to the shareholders' meeting and exercise the following powers: (1) to be responsible for convening shareholders' meetings and report on its work to the shareholders' meeting; (2) to implement the resolutions of the shareholders' meeting; (3) to decide on the operational plans and investment plan of the company; (4) to formulate the company's proposed annual financial budget and final accounts; (5) to formulate plans for profit distribution and recovery of losses; (6) to formulate plans for increases in or reductions of the company's registered capital; (7) to prepare plans for merger, division, change in corporate form and dissolution of the company; (8) to decide on the set up of the company's internal management structure; (9) to appoint or dismiss the company's manager (general manager)(the "manager") and pursuant to the manager's nominations to appoint or dismiss the deputy manager and the financial officers of the company and decide upon their remuneration; (10) to formulate the company's basic management system.

of office of the directors is three years.<sup>194</sup> The board of directors has three to nine members, who are appointed or replaced by the state-authorised investment institution or the state-authorised department in accordance with the directors' terms.<sup>195</sup> Members of the board of directors shall be composed of representatives of the employees of the company.<sup>196</sup> The employee representatives are democratically elected by the employees.<sup>197</sup> The chairman and the vice-chairman are designated from among the directors by the state-authorized investment or the state-authorized department.<sup>198</sup>

A manager in a wholly state-owned company is appointed or dismissed by the board of directors. Members of the board of directors may act concurrently as manager with the consent of the state-authorised investment institution or the state-authorised department.<sup>199</sup> The manager exercises his powers in accordance with the provisions of Article 50 of the 1999 Company Law.<sup>200</sup>

Pursuant to Article 70 of the Company Law 1999, the chairman and vice-chairman of the board of directors, directors and the manager of a wholly state-owned company may not act concurrently as officers of other limited liability companies, companies limited by shares or other economic organisations without the consent of the state-authorised

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<sup>194</sup> *ibid.*

<sup>195</sup> *ibid* para 2.

<sup>196</sup> *ibid.*

<sup>197</sup> *ibid.*

<sup>198</sup> *ibid.*

<sup>199</sup> Company Law 1999, art 69.

<sup>200</sup> *ibid.* According to Article 50 of the Company Law 1999, the manager is responsible to the board of directors and exercises the following powers: (1) to be in charge of the company's production, operations and management and organise the implementation of the resolutions of the board of directors; (2) to organise the implementation of the company's annual business plan and investment plan; (3) to propose plans for the putting in place of the company's internal management structure; (4) to propose the company's basic management system; (5) to formulate specific rules and regulations for the company; (6) to propose the appointment or dismissal of the company's deputy manager(s) and financial officers; (7) to appoint or dismiss management officers other than those required to be appointed or dismissed by the board of directors; (8) other powers conferred by the company's articles of association and the board of directors.

investment institution or the state-authorised department in order to avoid conflicts of interest.<sup>201</sup>

The 1999 Company Law stipulates that the state-authorised investment institution or the state-authorised department shall handle the procedures for examination and approval of the transfer of property rights in accordance with the provisions of law and administration regulations.<sup>202</sup> It aims to prevent the illegal transformation of state assets to non-state ownership and safeguard state assets in wholly state-owned companies.

The separation of government and business functions is one objective of the 1999 and 1993 Company Law. It is also reflected in the provisions for wholly state-owned companies. According to Article 72 of the Company Law 1999, the State Council may authorise large scale wholly state-owned companies with a sound system of operation and management and whose operational situation is relatively good to exercise rights as the owner of the assets.<sup>203</sup>

#### **3.4.1.4 Interim Regulations on the Board of Supervisors of Important State-owned Financial Institutions**

In contrast to the 1993 Company Law, the 1999 Company Law adds a new article in the section for wholly state-owned companies, in that a wholly state-owned company shall establish a supervisory board. In the banking sector, the Commercial Banking Law also stipulates that a board of supervisors shall be established in a wholly state-owned commercial bank.<sup>204</sup> According to the Commercial Banking Law and Insurance Law, the

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<sup>201</sup> *ibid* art 70.

<sup>202</sup> *ibid* art 71.

<sup>203</sup> *ibid* art 72.

<sup>204</sup> Commercial Banking Law 1995, art 18.

State Council released the Interim Regulation on the Board of Supervisors of Important State-owned Financial Institutions on 15<sup>th</sup> March 2000. The Provisional Regulations detail various aspects of the supervisory board in wholly state-owned commercial banks and other major state-owned financial institutions.

The board of supervisors of a wholly state-owned commercial bank shall be dispatched by the State Council, be directly responsible to the State Council and shall supervise the quality of the state-owned commercial bank as well as the value maintenance and appreciation of state-owned assets.<sup>205</sup> The board of supervisors does not participate in or intervene in neither operational strategies nor the management of wholly state-owned commercial banks.<sup>206</sup>

Financial supervision is the core function of the board of supervisors. The supervisory board also exercises supervision of operational activities and management of the directors, managers and other persons of authority, in order to ensure that the interests of state-owned assets are not violated.<sup>207</sup>

The board of supervisors performs the following functions and powers:<sup>208</sup> (1) to examine wholly state-owned commercial banks' implementation of financial and economic laws, regulations and rules; (2) to examine wholly state-owned commercial banks' financial affairs, to review their financial and accounting materials and other materials respecting their operations and management, and to verify the truthfulness and legality of financial statements and funds operations reports; (3) to examine operational activities of the board

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<sup>205</sup> Interim Regulations on the Board of Supervisors of Important State-owned Financial Institutions, art 3.

<sup>206</sup> *ibid* art 5.

<sup>207</sup> *ibid*.

<sup>208</sup> *ibid* art 6.

of directors, managers and other major persons in charge, to assess their performance and to put forth proposals for rewards, punishments, appointments and removals.

The board of supervisors shall conduct regular examinations of wholly state-owned commercial banks twice annually, and may conduct a targeted examination if necessary.<sup>209</sup> Depending on the needs of supervision and examination, the chairman of the supervisory board may attend or designate other members of the supervisory board to attend meetings of the board and other meetings of wholly state-owned commercial banks.<sup>210</sup>

Wholly state-owned commercial banks should submit their true financial statements and fund operation reports to the supervisory board on a regular basis and report major business operations on a timely basis.<sup>211</sup>

The supervisory board is comprised of a chairman and several supervisors.<sup>212</sup> The chairman is appointed by the State Council and must be a civil servant ranked as deputy minister of the government ministry.<sup>213</sup> The term of office is three years, and the chairman and full time supervisors must not be re-appointed consecutively in the same wholly state-owned commercial bank.<sup>214</sup> The chairman and other supervisors should not assume office in wholly state-owned commercial banks where they previously worked and/or have close relatives in senior management.<sup>215</sup> The government financial department will provide appropriate funds for the examinations conducted by the

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<sup>209</sup> *ibid* art 7.

<sup>210</sup> *ibid* art 8.

<sup>211</sup> *ibid* art 13.

<sup>212</sup> *ibid* art 15.

<sup>213</sup> *ibid* art 16.

<sup>214</sup> *ibid*.

<sup>215</sup> *ibid* art 19.

supervisory board.<sup>216</sup> The supervisory board is prohibited from accepting any gift or reward from a wholly state-owned commercial bank.<sup>217</sup>

### **3.4.2 Institutional structure of the Chinese commercial banking regulator and supervisor**

The purpose of banking regulation and supervision is to ‘protect depositors’ funds, maintain a stable monetary system, and promote an efficient and competitive banking system and protect consumer rights related to banking relationships and transactions.’<sup>218</sup>

Reforming and instituting the bank regulatory and supervisory framework in China is one of the significant steps for the reform of the Chinese banking sector. Prior to entry into the WTO, the evolution of institutional structures of banking regulation and supervision in China can be divided into two periods, 1984 to 1998, and 1998 to 2001.

#### **3.4.2.1 The PBOC as bank regulator and supervisor in China between 1984 and 1998**

This period had been regarded as the creation stage of China’s banking regulatory and supervisory system. During this period, administrative controls over financial institutions were used as the main method of financial regulation and supervision by the PBOC. The regulatory and supervisory system and banking regulations were still underdeveloped.

Since the ICBC was formally established on 1<sup>st</sup> January 1984 to take over the deposit-taking and lending functions of the PBOC, the PBOC has exclusively served as the

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<sup>216</sup> *ibid* art 20.

<sup>217</sup> *ibid* art 21.

<sup>218</sup> Han Deng, ‘Banking Supervision and Its Regulations: Comparative Study between U.S. and China’ (2009) Cornell Law School Inter-University Graduate Student Conference Papers No.32, 1 <[http://scholarship.law.cornell.edu/lps\\_clacp/32](http://scholarship.law.cornell.edu/lps_clacp/32)> accessed 20 May 2010.

country's central bank.<sup>219</sup> The *Interim Regulations on Bank Administration* issued by the State Council on 7<sup>th</sup> January 1986 provided the legal base for the PBOC to carry out the role of a comprehensive financial regulator and supervisor, executing administrative control over all financial institutions and the whole financial market.<sup>220</sup> The PBOC focused more of its attention on examining and approving the establishment of financial institutions, their business scope and their alteration than their risk-management capacity and asset quality between 1984 and 1993.<sup>221</sup> The main purposes of the PBOC had been to ensure that the business activities of financial institutions were carried out in compliance with the economic and financial policies of the state; the laws, decrees and regulations of the state and central bank; and credit, cash, foreign currency and financial plans.<sup>222</sup> With the adoption of the 1995 Central Bank Law, the PBOC was granted with formal legal authority the pure status of a central bank to carry out monetary policy, and to regulate and supervise financial institutions.<sup>223</sup>

However, the PBOC must have sufficient and considerable independence and political power to achieve the above objectives. The situation has greatly changed and improved in the 1990s. The headquarters of People's Bank had been able to re-centralise authorities for all PBOC lending and the allocation of credit quotas when Zhu Rongji assumed the roles as the vice premier who had been in charge of national economic affairs and the

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<sup>219</sup> Lou (n 21) 184.

<sup>220</sup> *ibid* 185.

<sup>221</sup> For example, instead of setting limitations to restrict excessive risk-taking by banks, during the period 1986-1994, an interest-sharing scheme was run by the PBC, which allowed state bank headquarters and their local lending branches to share interest repayments as part of their own operational revenue. This gave banks a strong incentive to increase lending without examining the creditworthiness of their borrowers. See Yonghao Pu, 'Why China Won't Be Asia's Next Basket Case Economy', <[http://www.chinaonline.com/commentary\\_analysis/ac\\_c9041941.html](http://www.chinaonline.com/commentary_analysis/ac_c9041941.html)> accessed 18 May 2009.

<sup>222</sup> *Interim Regulations of the People's Republic of China on Bank Administration* issued by the State Council on 7 January 1986, arts 12-21.

<sup>223</sup> Zhongfei Zhou and Jingwei Li, 'Independence and Accountability of the People's Bank of China: A Legal Perspective' (2006) 17 *European Business Law Review* 1310.

governor of the PBOC in July 1993.<sup>224</sup> Another unprecedented move was that at the beginning of 1994 the PBOC ended the practice of lending money to the Ministry of Finance to cover the state budget deficit.<sup>225</sup> Subsequently, it was embedded in the provisions of the 1995 Central Banking Law.<sup>226</sup>

In November 1998, the PBOC was restructured towards greater vertical control so that a new structure with nine regional branches replaced the old organizational structure with 32 branches which had allowed the local government (especially the provincial government) to interfere in the PBOC's duties to implement monetary policy and carry out financial regulation and supervision.<sup>227</sup> Consequently, local intervention was effectively ended.

For a relatively long period, the PBOC focused its banking supervision on approving the establishment, merger, or dismantling of specialised banks and other financial organisations. With the comprehensive economic reform and the development of the financial market in China, the setting up of an effective supervisory mechanism for the whole financial system had been a significant move. Since 1993, the PBOC has gradually taken a series of measures to improve its supervisory capacity and introduced international advanced supervisory and monitoring techniques. The PBOC has increased its supervisory departments with clarified responsibilities for supervising and overseeing a financial institution from market entry, through business operation to market exit.<sup>228</sup>

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<sup>224</sup> Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Brookings Institution Press 1998) 174-75.

<sup>225</sup> Lou (n 21) 191-92.

<sup>226</sup> Commercial Banking Law 1995, art 29.

<sup>227</sup> See the People's Daily Commentator, 'A Significant Reform of the PBOC Organizational System'[zhongyan yinhang guanli tizhi de zhongda gaige] (16 November 1998) People's Daily (Overseas Edition) 1.

<sup>228</sup> Lou (n 21) 198.

Although the PBOC has made progress in building supervisory capacity and organisational structural restructuring, the independency and autonomy of the PBOC and its supervisory authority and effectiveness have been impeded and challenged by the bureaucratic administration system, which accompanies tremendous political interference and weaknesses in legal enforcement. The PBOC has difficulties in supervising banks especially the Big Four, which have been viewed as quasi-government agencies to finance state-owned enterprises in order to support employment and social welfare as well as to extend loans to projects demanded by political leaders that did not meet commercial lending standards. The central bank had no political power or means to punish and sanction those state-owned banks that infringed laws or regulations because they were protected by the government. In many situations, bank management had discretion in determining its capital adequacy even though the 1995 Law of Commercial Banks adopted the eight percent minimum capital adequacy requirement. Meanwhile, despite the *Guiding Principles for Strengthening Internal Control in Financial Institutions* issued by the PBOC in May 1997, the establishment of an internal control committee and internal audit department has been neglected in the majority of banks. In addition, the opaque system in banks also handicapped the supervisory effectiveness.

The 1997 Asian financial crisis acted as a warning to the senior leadership in China. After the National Financial Working Conference, the focus of financial regulation and supervision shifted, or is shifting in the following four aspects:<sup>229</sup> (1) from administrative control to ensure that financial institutions comply with laws and regulations towards

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<sup>229</sup> Z. Wang, 'Financial Supervision: Opportunities and Challenge' [jingrong jiaguan:fazhanyutiaozhan] (1999) 12 (16) *Journal of China Finance* 16 and B. Wang, 'The Enhancing Financial Supervision and Administration in China'[changyin zaishou-woguo jinrong jiaquan buduan jiaqiang] (10 October 1999) *Jinrong Shibao* 1.

prudential regulation and supervision against over-risk-taking and irregularities of financial institutions; (2) from the examination and approval of the establishment and the business scope of financial institutions towards comprehensive supervision covering the market entry, operations and market exit of financial institutions; (3) from the segregation of supervision between local currency/foreign currency businesses, on-balance-sheet/off-balance-sheet businesses, domestic/off-shore businesses towards consolidated regulation and supervision; and (4) from the sole reliance upon on-site inspection towards the coordination between on-site inspection and off-site examination.

The independence and autonomy of the PBOC is limited. The 1995 PBOC Law grants some independence to the PBOC. Organically, the PBOC is equal to other ministries in the administrative hierarchy.<sup>230</sup> Functionally, the PBOC is authorised to formulate and implement monetary policies and exercise supervision and control over the financial industry under the leadership of the state Council.<sup>231</sup> The PBOC enjoys full financial autonomy: it is owned solely by the State with its entire paid-up capital allocated by the state.<sup>232</sup> Therefore, it is free from intervention by local governments or other interest groups.

#### **3.4.2.2 The CFWC as bank regulator and supervisor in China between 1998 and 2001**

One key feature of the reforms in China's banking sector after 1997 was directly under the control of the Communist Party Central Financial Work Commission (CFWC), which was created on June 16<sup>th</sup> 1998 to supervise the financial system on behalf of the CCP and

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<sup>230</sup> Lou (n 21) 197.

<sup>231</sup> The PBOC Law 1995, arts 2 and 3.

<sup>232</sup> *ibid* art 8.

to prevent deviations on the part of CCP-appointed managers.<sup>233</sup> By means of both Party control over senior financial executives and Party-sponsored institutional reorganisation, China's political leadership pushed through a centralisation of financial supervision.<sup>234</sup> Although the CFWC had only approximately 200 officials during its existence, it was a very powerful body, ranking above ministerial level since its head was Wen Jiabao who was a vice-premier of the State Council.<sup>235</sup> The CFWC had political supervision and personnel authority over the People's Bank of China and state financial regulatory bodies as well as China's most important national financial firms. The CFWC consisted of several core departments: the Organization Department, the Financial Discipline Inspection Work Commission and the Department of Supervisory Board Work.<sup>236</sup> Since only some of the CFWC's staff had professional experience in financial businesses, but most were familiar with Party work, the main responsibilities were cadre management, disciplinary matters and ideological work.<sup>237</sup> In practice, its most important task was to recruit and supervise executive personnel in key regulatory bodies and financial firms.<sup>238</sup> Despite the fact that the CFWC did not have formal authority in formulating financial regulation and interfering in the management decision of financial institutions, the Party control of "leadership cadres" by means of appraisal, appointment, removal and discipline inspection had been 'at the centre of the incentives and constraints that influenced the behaviour of key decision makers in the financial companies.'<sup>239</sup> Sebastian Heilmann argues that the CFWC was created as part of a strategy to stop the breakdown

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<sup>233</sup> Sebastian Heilmann, 'Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry' (2005) *The China Quarterly* 2.

<sup>234</sup> *ibid.*

<sup>235</sup> *ibid* 7.

<sup>236</sup> *ibid.*

<sup>237</sup> *ibid* 7-8.

<sup>238</sup> Heilmann (n 233) 6.

<sup>239</sup> Heilmann (n 233) 4.

of the hierarchies in the Chinese financial industry and to restore central policy decisiveness in the aftermath of the Asian financial crisis.<sup>240</sup> While the CFWC succeeded in implementing a centralised, vertical leadership system in national financial institutions, the hierarchical institutions under Party control failed to produce market-driven incentive structures for financial executives and handicapped the emerging new forms of corporate governance in China.<sup>241</sup>

### **3.4.3 Prudential standards, monitoring and enforcement of Chinese banking regulation and supervision**

It is important to ensure that the banking regulatory and supervisory authorities have powers to review and assess standards and intervene to prevent any imprudent practices of banks. Therefore, this section focuses on the areas of capital adequacy, loan classification, loan loss provisions, and internal control systems for implementing appropriate reforms that ensure that the Chinese banking system is ‘safe and sound’ in line with evolving international standards. In addition, it discusses issues related to effective monitoring and enforcement practices designated to ensure that banks apply and maintain relevant regulatory and supervisory standards.

#### **3.4.3.1 Prudential standards**

The areas of improving prudential standards include loan classification, capital adequacy, loan loss provisions and internal control systems.

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<sup>240</sup> *ibid* 3.

<sup>241</sup> *ibid* 20.

#### 3.4.3.1.1 *Loan classification*

Loan classification and provisioning practices play a crucial part in the sound management of credit risks in banks.<sup>242</sup> Prior to the economic reform, there was no need for loan classification because banks in China at that time were not modern banks and thus, loans were not commercial loans.<sup>243</sup> The situation changed from the late 1980s when some specialised state banks commenced exploring approaches to classify their loans.<sup>244</sup>

In 1988, the Ministry of Finance released the Accounting Rules for Financial and Insurance Enterprises, which classifies loans into “normal”, “overdue”, “dead” and “irrecoverable”.<sup>245</sup> The last three are classified as NPLs. In the same year, the MOF issued Interim Provisions on State Specialised Banks’ Irrecoverable Loan Reserves (hereinafter referred to as ‘Irrecoverable Loan Reserves Provisions’), which further details irrecoverable loans.<sup>246</sup> In 1995, the PBOC enacted the General Rules on Loans,

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<sup>242</sup> ‘Such practices can significantly affect the accuracy of public financial reporting and the potential for market discipline. In addition, loan accounting treatments have a bearing on the effectiveness of supervisory approaches, including capital requirements...Weak or inadequate loan loss provisioning practices and poor transparency are major sources of risk to individual banks and the banking system as a whole.’ Points made by William J McDonough, Chairman of the Basel Committee and President of the Federal Reserve Bank of New York, cited in BIS Press Release, ‘Basle Committee Issues Consultative Paper on Loan Valuation, Loan Loss Provisioning and Credit Risk Disclosure’, <http://www.bis.org/press/p981014.htm> accessed 11 June 2007.

<sup>243</sup> Xianglong Dai, ‘To Accomplish a Solid Base for a Modern Banking System, We must Ameliorate Loan Classification and Improve Asset Quality’, (1998) 7 China Finance 4.

<sup>244</sup> *ibid.* ‘Each of the major banks in China had its own system and standards for classifying non-performing loans. However, the biggest flaw shared by these systems is that there were ceilings on the portion of loans that could be classified, irrespective of the actual quality of a bank’s loan portfolio.’ See Li (n 7) 325.

<sup>245</sup> Under the Rules: ‘(1) irrecoverable loans are defined as any outstanding loans which are three years overdue against the prescribed period (including the extension period); (2) dead loans are defined as outstanding loans which are two years overdue against the prescribed period (including the extension period); and (3) overdue loans are defined as outstanding loans which are six months overdue against the prescribe period (including the extension period)’. See Lou (n 21) 255.

<sup>246</sup> According to Article 3 of Irrecoverable Loan Reserves Provisions, the following loans/overdue loans are classifies as irrecoverable loans: (1) any outstanding loan (overdue or not) where both the borrower and its guarantor are bankrupt; (2) any outstanding loan where the borrower is dead or declared missing or dead according to the General Principle of Civil Law; (3) any outstanding loan where the borrower has suffered huge losses from uninsured natural disasters, or if the borrower is insured, the loan balance after the

attempting to unify loan classification norms among Chinese banks.<sup>247</sup> According to the General Rules on Loans,<sup>248</sup> NPLs comprise overdue loans, dead loans and irrecoverable loans. The definitions of overdue loans and dead loans are stricter in the PBOC rules than those in the MOF rules, while the same definition is given to irrecoverable loans as that in the MOF rules. Overdue loans refer to those loans which are not paid back on time.<sup>249</sup> Dead loans are classified as any outstanding loans which are two years overdue against the prescribed period (including the extension of period), or any loan and/or overdue loans which are less than two years overdue against the prescribed period but where the borrower has ceased production or the project construction has stopped (for project loans).<sup>250</sup> Furthermore, the General Rules on Loans restrict the extension of the original maturity of any loan. Short-term loans which are defined as loans of one year or less than one year's duration are not supposed to be extended for a period longer than the original duration; medium-term loans, which are defined as loans of one to five years' duration can be extended for a period of no more than one-half of their initial length; long-term loans which refer to those of more than five years' duration, cannot be extended by more than three years.<sup>251</sup>

It is generally recognised that China's loan classification system of 1995 was far more lenient than the minimum requirements set by the Basel Committee's Sound Practices for Loan Accounting and Disclosure, and that of prevailing banks in developed

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borrower repays part of the loan with the insurance compensation; and (4) overdue loans specifically authorized by the State Council to be written off.

<sup>247</sup> Lou (n 21) 257.

<sup>248</sup> General Rules on Loans, art 34.

<sup>249</sup> *ibid.*

<sup>250</sup> *ibid.*

<sup>251</sup> *ibid* arts 11 and 12.

economies.<sup>252</sup> First, China's loan classification system was primarily based on payment status rather than risk assessment. Secondly, according to the research by Li, China's banks are allowed to delay classifying loans as non-performing. This is because the specified time periods during which delay of repayment that is allowed are longer, and also that in the Chinese classification of loans they are generally tied to the failure to repay principle rather than interest.<sup>253</sup>

With the development of financial reform, the new five-level loan classification system, which is mainly based on a borrower's financial condition and paying capacity, replaced the old four-category system. The new system was applied nationwide after the system was trialled in Guangdong by the end of July 1998.<sup>254</sup> At the end of 1998, the PBOC began to make use of the five-grade credit system to inspect the asset quality of domestic commercial banks and rural credit cooperatives.<sup>255</sup>

The new five-grade loan classification system also applies to the direct credit substitutes on the off-balance sheets, such as stand-by loan guarantees or letters of credit directly.<sup>256</sup> In addition, commercial banks are required to carry out an overall classification of their loan portfolio at least every six months,<sup>257</sup> and the PBOC should carry out on-site examinations once a year in principle.<sup>258</sup> Therefore, it is expected that the new loan classification system which is based on borrowers' repayment ability, credit history and the collateral value in conformity with international norms, will facilitate the modernisation of China's banking system.

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<sup>252</sup> Li (n 7) 325 and Lou (n 21) 256.

<sup>253</sup> Li (n 7) 325.

<sup>254</sup> Lou (n 21) 258.

<sup>255</sup> *ibid.*

<sup>256</sup> PBOC Guideline on Risk-based Loan Classification, art 4.

<sup>257</sup> *ibid* art 27.

<sup>258</sup> *ibid* art 16.

#### **3.4.3.1.2      *Loan provisioning requirement***

Loan provisioning is a significant tool for maintaining the solvency of banks. There are two types of loan provision in most banking systems. Special provisions refer to funds put aside against loans that have already been classified as non-performing. While general provisions indicate reserves set aside as insurance against the general portfolio, but not ascribed to particular assets.<sup>259</sup>

Prior to 2001, loan provisioning had always been vulnerability in China's loan classification and provisioning system.<sup>260</sup> Banks made provision for NPLs on the basis of the total outstanding loans rather than that of classified loans. Therefore, banks did not have to increase their loan provision as the quality of the loans decreased. At the beginning of 1988, the big four started to make irrecoverable loans at fixed percentages of their outstanding loans and the percentages put a ceiling on the reserves.<sup>261</sup> Then, the ceiling was raised to one per cent of the total outstanding loans at the beginning of 1992 and in 1998 it was further increased to one per cent of the total outstanding loans at the end of the year.<sup>262</sup>

The actual amounts set aside for NPLs were very inadequate. Reserves in the big four were not adequate to avoid the shock of NPLs and therefore they had to further raise their

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<sup>259</sup> Lou (n 21) 268.

<sup>260</sup> Lou (n 21) 267.

<sup>261</sup> *ibid.* Pursuant to Articles 5, 6 and 7 of Irrecoverable Loan Reserve Provisions, the percentages required were then quite low: 0.1 per cent for working capital loans to industrial production enterprises, commercial enterprises and construction enterprises; 0.2 percent for loans to the agricultural sector, loans to urban and township collective enterprises, and loans to private enterprises and individual proprietor; 0.15 per cent for export and import loans; 0.2 percent for foreign exchange loans, loans for fixed assets and loans for technology updating. No reserves were allowed to provide for loans substituting budgetary grants, special-purpose loans trusted by local governments and authorities in charge of the enterprise, loans secured with collateral, or inter-financial-institution loans.

<sup>262</sup> Lou (n 21) 268.

loan provision to facilitate the writing-off of bad loans. The PBOC Guideline on Risked-based Loan Classification only provided in principle that commercial banks must set up general provisions and special provisions based on loan classification results. But it did not give any detailed rules with regard to loan provisioning. Thus, China needs to update its NPL provisioning requirements to international standards.

#### **3.4.3.1.3      *Capital adequacy***

The PBOC on 15<sup>th</sup> February 1994 issued the Notice on Asset Liabilities Management of Commercial banks that required banks to comply with the standards of the Basel Accord I. It was the first time for China attempted to incorporate capital adequacy requirements. It introduced:

[T]he minimum tier-one capital ratio of 4%, the minimum capital adequacy ratio of 8%, maximum loan-to-deposit ratio of 75%, maximum long-term loan to long-term deposit ratio of 120%, minimum liquid assets to liquid liabilities ratio of 25%, minimum deposit reserve ratio of 5% to 7%, maximum loan concentration ratio for the largest lender of 15%, for ten largest lenders of 50% of capital and the NPL ratio limit of 2%.<sup>263</sup>

The 1995 Commercial Banking Law further legitimized the asset-liability management requirements.<sup>264</sup> At the end of 1996, the PBOC released the Monitoring and Supervisory Indexes of Asset-Liability Ratio Management for Commercial Banks. It further detailed

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<sup>263</sup>Horst Leochel, Natalie Packham and Helena Xiang Li, 'International Banking Regulation and Supervision after the Crisis: Implications for China' (EU-China BMT Working Paper Series No.013 December 2010) 8-9.

<sup>264</sup> According to Article 39 of the Commercial Banking Law 1995, a commercial bank should abide by the regulations on the ratios of assets and liabilities in the following: (1) the capital adequacy rate shall not fall short of eight percent; (2) the ratio of the outstanding balance of loans to that of deposits shall not exceed 75 per cent; (3) the ratio of liquid assets to liquid liabilities shall not fall short of 25 percent; (4) the ratio of loans to one borrower to the capital of the bank shall not exceed 10 percent; (5) other stipulations by the PBOC on asset and liability management.

the ratios set by the Commercial Banking Law and added new ratio management requirements including market risk and off-balance-sheet items.

Although capital adequacy requirements were set the same as international standards so as to regulate and improve the quality of banking assets and to effectively control credit risks, there were discrepancies in defining capital, assessing risk-weight assets and market risk.<sup>265</sup>

#### **3.4.3.1.4 Internal control systems**

The 1995 Commercial Banking Law set rules for the bank internal controls of banks. Article 4 of the Law provides that a commercial bank shall exercise a self-regulation mechanism on the principle of economic efficiency, safety and liquidity.<sup>266</sup> Article 17 of the Law stipulates that the Company Law of the PBC is applicable to the form and structure of the organisation of a commercial bank.<sup>267</sup> In addition, a commercial bank is required to formulate its business rules, establish and improve its business management, the system of cash control and its security system in accordance with the stipulations of the PBOC.<sup>268</sup> Also, a commercial bank is required to establish and improve its systems of examining and checking deposits, loans and settlement, bad and doubtful accounts and other business activities, and to conduct regular examination and checks on its branches.<sup>269</sup>

Despite these efforts, there were many deficiencies in the internal controls of Chinese commercial banks before the issuance of the *Guidelines of the PBOC for Enhancing Internal Controls of Financial Institutions*. These were:

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<sup>265</sup> Sun (n 19) 138.

<sup>266</sup> Commercial Banking Law 1995, art 4.

<sup>267</sup> *ibid* art 17.

<sup>268</sup> *ibid* art 59.

<sup>269</sup> *ibid* art 60.

First, the internal auditing system within a commercial bank was not independent and did not have sufficient authorities and resources to carry out efficient, effective internal examinations and checks. Secondly, there was no clear division of responsibilities among different departments within a bank. Thirdly, there was no efficient and effective accounting control. Fourthly, the personal affairs management system could not satisfy the need of risk-control. There were no transfer or training systems for bank staff. Fifthly, there were no effective internal controls for newly emerging business, such as off-balance-sheet businesses.<sup>270</sup>

With the promulgation of the PBOC *Guidelines for Enhancing Internal Controls of Financial Institutions* on May 16 1997<sup>271</sup> and *Provisions on Enhancing Internal Accounting Controls and Management in Banks* on 30 July 1997,<sup>272</sup> Chinese commercial banks enhanced their internal controls somewhat. However, the improvement was limited because of the wholly state-owned organisational structure in state commercial banks and the lack of an effective check and balance system. Furthermore, due to poor disclosure

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<sup>270</sup> Lou (n 21) 235-36.

<sup>271</sup> The Guidelines contain 32 articles in six chapters and cover internal controls of commercial banks and non-bank financial institutions. See Guidelines for Enhancing Internal Controls of Financial Institutions, art 4. Internal controls are defined as a self-regulating mechanism for a financial institution, which is combination of measures, methods and procedures to ensure the accomplishment of established targets, to avoid and mitigate financial risks, and provide efficient controls on internal departments and staff against the risks involved in the performance of their duties. See Guidelines for Enhancing Internal Controls of Financial Institutions, art 2. The Guidelines set three objectives for internal controls of financial institutions: to ensure the implementation of laws, administrative regulations, and the PBOC rules; to ensure efficient control of risks involved in the institution's business; and to ensure the full accomplishment of development policies and strategies of the institution. See Guidelines for Enhancing Internal Controls of Financial Institutions, arts 6 and 7. The Guidelines covers every primary element of bank internal controls including management oversight and control culture, risk recognition and assessment, control activities and segregation of duties, information and communication, monitoring activities and correcting deficiencies.

<sup>272</sup> It specifies rules for bank internal accounting control systems.

and accounting practices, information and communication was the weakest element of the internal bank controls in China.<sup>273</sup>

### 3.4.3.2 Monitoring

In 1995, the PBOC began to use both on-site examination and off-site surveillance to evaluate the financial performance and condition of banks under the authorisation of the 1995 PBOC Law and Commercial Banking Law.<sup>274</sup> The PBOC in April 1995 issued the *Interim Provisions on Off-site Surveillance*. It states that off-site surveillance shall concentrate on: (1) the risk management capacity and asset quality of the financial institution and (2) whether financial institutions operate in compliance with laws and administrative regulations.<sup>275</sup> It is likely the PBOC focused on its resources on problematic institutions by a combination of on-site examination and off-site surveillance.<sup>276</sup>

A rating system is essential for bank supervisors if they are to analyse information and determine the financial condition of a bank. The PBOC attempted to set up its own rating system when the regulatory and supervisory focus shifted to the risk management capacity and asset quality of commercial banks. The *Monitoring and Supervisory Indexes of Asset-Liability Ratio Management for Commercial Banks*, which was issued by the

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<sup>273</sup> Lou (n 21) 251. The PBOC has taken efforts to help commercial banks solve the information problem. In April 1996, the PBOC instituted a borrowing licenses system in order to encourage banks to lend prudently. Then, in early 2000, the *Measures on Bank Credit Registration and Information Management (Trial)* were promulgated to implement a national bank credit registration and information management system. See Lou (n 22) 252. Efforts have also been taken to monitor the creditworthiness of individual borrowers. On 1 April 2000, a real-name identification system for household savings was introduced. Meanwhile, China's first consumer credit bureau, the Shanghai Personal Credit Data Centre, was established.

<sup>274</sup> The PBOC Law, arts 32 and 33; Commercial Banking Law, arts 61 and 62.

<sup>275</sup> *Interim Provisions on Off-site Surveillance*, arts 9 and 10.

<sup>276</sup> Lou (n 21) 220.

PBOC on 12<sup>th</sup> December 1996, provided a basis for the PBOC to collect and analyse information from commercial banks.<sup>277</sup>

The success of off-site surveillance mainly relies on a reporting system. According to Article 33 of the PBOC Law 1995, the PBOC shall have the power to demand banking institutions submit balance sheets of their assets, statements of profit and loss and other financial and accounting reports and materials in pursuance of regulations.<sup>278</sup> This is supplemented by Article 61 of the Commercial Banking Law 1995, providing that a commercial bank shall periodically submit balance sheets, profit and loss statements and other financial statements and information to the PBOC.<sup>279</sup> Moreover, the PBOC issued a set of new regulations to consummate the reporting system. The PBOC issued the *Circular of the PBOC on Collecting Financial Statements from Banks for Supervisory Purposes* on 6 March 1996. Banks were required to submit to the PBOC on a consolidated basis: (1) a report of financial condition (attached with monthly accounting record, balance sheet, profit and loss report, etc.); (2) a report on asset-quality; and (3) a report on the asset-liability ratio management.<sup>280</sup> The PBOC is authorised by the *Monitoring and Supervisory Indexes of Asset-Liability Ratio Management for Commercial Banks*, which came into force on 1<sup>st</sup> January 1997, to demand banks report in terms of the new indexing system.<sup>281</sup> Along with the promulgation of *Forms of off-site*

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<sup>277</sup> *ibid.*

<sup>278</sup> The PBOC Law 1995, art 33.

<sup>279</sup> Commercial Banking Law 1995, art 61.

<sup>280</sup> Lou (n 21) 221.

<sup>281</sup> *ibid.*

*Surveillance Reports for Commercial Banks and Their Description* on 16<sup>th</sup> December 1997, banks began to use the unified reporting contents and forms.<sup>282</sup>

#### **3.4.3.3 Enforcement**

Prompt Corrective Action (PCA) as an enforcement measure is designed to prevent more widespread contagion of problems in situations where banks fail to meet supervisory requirements or where their solvency comes into question. This is done by conducting appropriate intervention and by encouraging banks to become better capitalised.

China has developed an array of supervisory measures to bring about PCA. These measures consist of ‘cease and desist’ orders, civil penalties, administrative penalties, criminal penalties and the ultimate sanction that is the revocation of a bank’s license. Under Article 74 of the Commercial Banking Law 1995, for instance, when a commercial bank submits false financial statements or financial statements which conceal important facts, the PBOC may order the commercial bank to make corrections, confiscate the illegitimate gains if there is any, and mete out a fine ranging from one to five times the amount of the illegitimate gain; or, if there is no illegitimate gains, mete out a fine ranging from RMB 100,000 to RMB 500,000; if the case is particularly serious or the offender fails to make correction within the specified time, the PBOC may order it to suspend business and make rectification and consolidation, or revoke its banking permit; if the case constitutes a crime, the commercial bank shall be investigated for criminal responsibilities.<sup>283</sup> Pursuant to Article 73 of the Commercial Banking Law 1995, a commercial bank shall assume the responsibility of paying interest accrued and other

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<sup>282</sup> *ibid.*

<sup>283</sup> Commercial Banking Law 1995, art 74.

civil responsibilities of compensation for damages to the property of depositors or other clients under one of the situations listed below: (1) delaying or refusing repayment of the principal and interests of a deposit with no proper reason; (2) refusing to cash checks and to debit or credit accounts in violation of regulations regarding bill acceptance and other settlements or intentionally delaying the acceptance of bills or instruments, or dishonouring a bill in violation of the regulations; (3) illegally investigating, freezing or withholding and transferring the savings deposit of an individual depositor or the deposit of an institutional depositor; and (4) other actions inflicting damages to depositors or other clients in violation of the provisions of this law.<sup>284</sup>

The State Council issued the *Regulations Concerning the Punishment of Irregular Financial Activities* on 22<sup>nd</sup> February 1999, which completed the supervisory measures intended to bring about the PCAs.<sup>285</sup>

### 3.5 Concluding remarks

The significant contributions of the reform during this period were embodied in three aspects. First, a two-tier banking system with commercial banks was established, which changed the traditional highly centralised system into one that is more decentralised and liberalised. Secondly, a basic legal framework for bank regulation and supervision was established. Thirdly, the focus of regulation and supervision has shifted to prudential regulation and supervision against the irregularities of financial institutions.

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<sup>284</sup> *ibid* art 73.

<sup>285</sup> Lou (n 22) 228.

However, due to the absolute dominance of the state by the big four, there were no shareholders' meetings, leading to a weak check and balance system in the big four's organisational structure and consequently poor corporate governance. Moreover, the existence of ambiguous property rights may result in a lack of incentive to monitor banks by the government on fully commercial principles.<sup>286</sup>

There were problems with banking regulation and supervision in China. First, due to its limited independence and autonomy, the PBOC's regulation and supervision of banks and other financial institutions was vulnerable to administrative intervention from the State Council, local governments and party leaders.<sup>287</sup> Secondly, administrative restrictions over commercial banks have not been lifted completely, such as interest rate control and credit plans.<sup>288</sup> Thirdly, there are problems with banking supervision in China. The licensing and structural change approval procedures are not transparent enough. Monitoring measures need to be improved, including 'clearer rules are needed for on-site examinations; attention needs to be paid to how to make good use of external independent auditors; a more efficient early warning system needs to be established'.<sup>289</sup> 'The sanctions provisions in China are mainly ex post punishment rather than incentives for banks to correct their operations.'<sup>290</sup>

After Chinese entry into the WTO, Chinese banks, especially the big four, have faced challenges from foreign counterparts. Therefore, the Chinese government needs to find appropriate solutions to these problems.

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<sup>286</sup> Zhongfei Zhou and Jingwei Li, 'In Search of Approaches to Improving Corporate Governance in China's State-owned Commercial Banks' (2002) *International Lawyer* 216, 235.

<sup>287</sup> Lou (n 21) 230.

<sup>288</sup> *ibid.*

<sup>289</sup> Lou (n 21) 230-31.

<sup>290</sup> *ibid* 231.

## **CHAPTER FOUR**

### **THE CORPORATE GOVERNANCE REFORM OF THE SOCBs AFTER CHINA'S ACCESSION TO THE WTO**

#### **4.1 Introduction**

China joined the WTO on 10<sup>th</sup> December 2001. It marked a major step in the integration of Chinese banking and financial markets into the global financial system. In fulfilling its commitments to the WTO, China lifted the geographic and client restrictions over foreign banks within five years of its entry.<sup>1</sup> Following this development, Chinese SOCBs had to face direct competition from foreign counterparts, which placed Chinese SOCBs in a disadvantageous position. Compared with commercial banks in some developed economies, Chinese SOCBs lacked capital, developed skills and capabilities, advanced information technology and management expertise, resulting in them being less experienced in handling complex banking business in a market economy. Facing the challenge, the Chinese government began to accelerate the banking reforms in order to improve the competitiveness of the SOCBs. China has thus made great efforts to transform the SOCBs into stock enterprises. This has involved reducing the government's administrative control over the banks' operations, setting up a new corporate governance mechanism, and improving the regulatory and supervisory system.

This chapter draws a picture of China's banking system reform, and its legal and regulatory framework from 2002 until the end of 2010. The chapter also examines the approach of the Chinese government to various problems of corporate governance which

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<sup>1</sup> Daniel C. Crosby, 'Banking on China's WTO Commitments: "same bed, different dreams" in China's Financial Services Sector' [2008] *Journal of International Economic Law* 81.

occurred as a result of the special ownership regime of the SOCBs. The first part details the development of the SOCBs with a focus on the process and steps involved, and then analyses the features. The second part discusses bank restructuring, the shareholding system and corporate governance reforms in the SOCBs. The third part concentrates on the legal and regulatory aspects of banking, describing the development of banking laws and regulations, and also the new watchdog of banking regulation and supervision in China—the China Banking Regulatory Commission (CBRC). The fourth part examines prudential regulation and supervision, including issues related to prudential standards, monitoring and enforcement practices. Brief concluding remarks are given in the final part.

## **4.2 Instituting corporate governance in SOCBs after entry into the WTO**

Before China's accession to the WTO, corporate governance in SOCBs was very weak. SOCBs lacked the basic attributes of a profit-making bank.<sup>2</sup> In fact, they did not have clearly identifiable owners or boards of directors to monitor management.<sup>3</sup> Instead, they possessed an external supervisory board that monitored in accordance with banking law and regulations but had no role in the oversight of banking management.<sup>4</sup> China's accession to the WTO in December 2001 set out a five-year transition for moving impediments to the operations of foreign banks in China. By the end of 2006, foreign

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<sup>2</sup> Alicia García-Herrero, Sergio Gavilá and Daniel Santabárbara, 'China's Banking Reform: An Assessment of its Evolution and Possible Impact' <<http://www.bde.es/webbde/Secciones/Publicaciones/PublicacionesSeriadas/DocumentosOcasionales/05/Fic/do0502e.pdf>> 14.

<sup>3</sup> *ibid.*

<sup>4</sup> *ibid.*

banks were to be treated in the exact same manner as Chinese banks.<sup>5</sup> Domestic banks would no longer be protected from foreign competition in both RMB and foreign currency business.<sup>6</sup>

China's official entry into the WTO created huge challenges for its financial sector which were manifested in the following areas.<sup>7</sup> First, the system of supervision and regulation had not yet prepared for the complexities of the new situation. Second, in spite of some progress which had been made, capital markets were still unable to allocate capital. The banking industry was the main channel for business financing.<sup>8</sup> Third, there was still a gap between the management and operational capacity of the SOCBs and that of the world's leading banks. Fourth, there were still serious NPLs in the state banking system. The Chinese government thus needed to take decisive measures to address these issues in order to maintain social, political and economic stability. The development of the reform of SOCBs can be divided into the following stages namely, the reduction of government interference in the banks' operations and the establishment of corporate governance structures.

In order to free SOCBs from direct government intervention, liberalization efforts have been performed in several directions. First, in 1998 the direct credit quotas were officially

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<sup>5</sup> Liu Mingkang, 'Creating a Favorable Environment for the Further Opening of China's Banking Industry' (International Investment Forum CFIIT, Xiamen, 8 September 2004) <<http://www.cbrc.gov.cn/EngdocView.do?docID=900>> accessed 19 November 2008.

<sup>6</sup> Domestic banks will confront foreign banks in competition for a share of (1) foreign currency deposits, (2) local currency business, (3) international settlement services, (4) loaning services, (5) retail business, and (6) personal consumption credit business. See Kui-Wai Li and Jun Ma, 'The Economic Intricacies of Banking Reform in China' (2004) 37 *Journal of Chinese Economy* 50.

<sup>7</sup> See Li Wei, 'China's Banking Industry Faces Four Major Problems' *People's Daily* (Beijing, 14 September 2004) <[http://english.peopledaily.com.cn/200409/14/eng20040914\\_156920.html](http://english.peopledaily.com.cn/200409/14/eng20040914_156920.html)> accessed 18 May 2006.

<sup>8</sup> Jiangxi Wang, 'Commercial Banking Reform' in Min Zhu, Jinqing Cai and Avery Martha (eds), *China's Emerging Financial Markets: Challenges and Global Impact* (John Wiley & Sons 2009).

abolished by the PBOC.<sup>9</sup> However, SOCBs are still subject to the so-called “guiding plan”, in which they are not compelled to carry out policy lending as in the old credit plan.<sup>10</sup> SOCBs have since been given more responsibility for their lending decisions and no longer have any obligation to lend to state-owned enterprises.

Second, another important step was in interest rate liberalisation. Interest rate controls have been a dominant feature of China’s financial system. Before economic reform, bank interest rates were always fixed for long periods of time.<sup>11</sup> Since reform began, the Chinese government has taken the gradual approach towards interest rate liberalisation, which is not yet been completed.<sup>12</sup> The establishment and improvement of the floating rate system has played a crucial role in liberalising China’s interest rate regime.<sup>13</sup> In December 1990, the PBOC promulgated the *Interim Provisions on Interest Rate*

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<sup>9</sup> The government influences the operation of the SOCBs through the credit plan. Before 1998 each state bank received a credit quota from the PBOC. According to the credit plan, state banks then gave the bank loans to state-owned enterprises and projects. Consequently, the credit plan had seriously weakened internal controls, especially risk management ability. See Lou (n 364) 41-2.

<sup>10</sup> Rainder Polster and Yanfen Huang, ‘The risk-analysis of the banking sector in China’ <<http://www.cenet.org.cn/download/14521-1.pdf>> accessed 10 March 2008. A new bank credit management system was introduced immediately after the removal of the credit plan. As of 1 January 1998, the PBOC makes an annual and a quarterly guidance plan for new lending of commercial banks. According to the official statement by the PBOC, the guidance plan sets an indicative and non-binding target. However, Polster and Huang point out that SOCBs must still implement the plan because whether the SOCBs have carried out the guidance or not is linked to the stability and rising of the position of leaders in the SOCBs.

The PBOC actually still monitors the credit operations of banks. This is done through the practice of *window guidance*, which is, as defined by Ikeya, ‘...more than a guidance. Despite its soft image, there has not been a case in which a bank refused the guidance, as PBOC is also the banking supervisory authority and has a great influence on banks. PBOC meets officers from commercial banks monthly to check whether the operation of banks is in line with the plan and, if necessary, to give banks additional or adjusted guidance. Therefore, this system is a mechanism to control credit creation by banks.’ See Ikeya Makoto, ‘China-Unique Strengths and Weaknesses of Monetary Policy: Diehard Socialism behind Window Guidance’ (R & I Asian Focus, 22 January 2002) cited in Anne-Laure Delatte, ‘Monetary Policy and Macro control in China: the Actual Impact of Window Guidance’

<[http://www.hkimr.org/cms/upload/seminar\\_app/sem\\_paper\\_0\\_262\\_Delatte07.pdf](http://www.hkimr.org/cms/upload/seminar_app/sem_paper_0_262_Delatte07.pdf)> accessed 10 May 2011.

<sup>11</sup> Hongru Liu, ‘Developments in the Reform of China’s Banking and Financial System’ (1988) 2 Journal of Chinese Law 323.

<sup>12</sup> Garc ía-Herrero, Gavil á and Santab árbara (n 2) 19.

<sup>13</sup> Rongfan Zhou and Deyun Chao, ‘The Reform and Development of China’s Floating Interest Rate System’ (1998) 10 China Finance 23.

*Administration*, which provided procedures for the PBOC to administrate RMB interest rates.<sup>14</sup> The 1995 Commercial Banking Law further confirms that commercial banks shall fix their interest rates for deposits and loans according to the ceiling and floor of interest rates defined by the PBOC.<sup>15</sup> In October 2004, the upper limit on the interest rate of loans and the lower limit on the interest rate of deposits were removed.<sup>16</sup> This was a critical step for increasing the competitiveness of SOCBs and improving the risk management skills of SOCBs.

Third, to curb the intervention from local government, the PBOC reformed its institutional structure.<sup>17</sup> It had abolished its branches at provincial and municipal levels, under which banks were vulnerable to local government intervention. By the end of 1998, a new structure system had come into existence, establishing trans-provincial branches in nine major regions. Under its new PBOC organisational structure, it is possible for the PBOC to improve the efficiency and integration of financial regulation and supervision.<sup>18</sup>

Meanwhile, according to precepts of the modern enterprise system, consisting of the ‘clarification of property rights, clarification of rights and responsibilities, separation of bureaucracy and business, and scientific management’,<sup>19</sup> the Chinese government has simultaneously launched a radical programme that seeks to set up an effective corporate governance mechanism in the SOCBs. The subsequent Chinese bank reform has been

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<sup>14</sup> Interim Provisions on Interest Rate Administration issued by the PBOC in December 1990.

<sup>15</sup> Commercial Banking Law 1995, arts 31 and 38.

<sup>16</sup> Garc ía-Herrero, Gavil á and Santab ábara (n 2) 19.

<sup>17</sup> See details in ch 3 p 155.

<sup>18</sup> Jianbo Lou, ‘China’s Bank Non-Performing Loan Problem; Seriousness and Causes’ (2000) *International Lawyer* 1147, 1169.

<sup>19</sup> At the 3<sup>rd</sup> Plenum of the 14<sup>th</sup> National Congress of the Communist Party of China, the Modern Enterprise System was proposed as a corporate form compatible with the Socialist Market Economy. For the full text of the “Decisions on Issues Concerning the Establishment of the Socialist Market Economy System”, see *China Daily, Supplement*, 17 November 1993.

based upon three main pillars.<sup>20</sup> The first is bank restructuring through the cleaning up of NPLs by the creation of four AMCs and recapitalisation through additional funds in order to improve asset quality.<sup>21</sup> The second is a strengthening of the legal, supervisory and regulatory framework for bank governance. This has been reflected in the many laws, regulations, codes and standards necessary for a complete system of governance that have been enacted, in the creation of a new banking watchdog-namely the CBRC for the purpose of strengthening supervision and upgrading supervisory practices in line with international norms, and in also increasing transparency and exposure of SOCBs to scrutiny by the market.<sup>22</sup> The third is establishing an internal governance mechanism in the SOCBs. The key elements have been placed on the structural ownership reform of SOCBs in order to find owners capable of monitoring bank performance effectively, shareholding restructuring in order to improve checks and balances regimes, and the establishment of internal controls and risk management systems.<sup>23</sup>

It is worth noting that a breakthrough in reforms occurred with the establishment of the China Central Huijin Investment Company (Huijin) on 16<sup>th</sup> December 2003, which is wholly owned by the state.<sup>24</sup> The company has been authorised to manage capital injection in the SOCBs on behalf of the Chinese government.<sup>25</sup> In addition, the company has exercised its rights and performed its responsibilities as the major shareholder.<sup>26</sup> The effort of the government to experiment with SOCB ownership reform was a courageous

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<sup>20</sup> See OECD, *Governance in China* (OECD 2005) 375.

<sup>21</sup> Garc ía-Herrero, Gavil á and Santab ábara (n 2) 16.

<sup>22</sup> OECD, *Governance in China* (OECD 2005) 386, 390.

<sup>23</sup> See Jing Leng, 'China's Banking Reform in the Context of Globalisation and Transition' (2006) 17 *European Business Law Review* 1286, 1289.

<sup>24</sup> See the details of China Central Huijin Investment Company at the website, <[http://www.huijin-inv.cn/hjen/aboutus/aboutus\\_2008.html?var1=About](http://www.huijin-inv.cn/hjen/aboutus/aboutus_2008.html?var1=About)> accessed 18 August 2010.

<sup>25</sup> Wang (n 8) 114.

<sup>26</sup> Leng (n 23) 1287.

move. First, the Central Huijin Investment Company was set up to represent the owners of the SOCBs, which represented a large step towards clarifying the ownership of the SOCBs, because the functions of ownership could be realised.<sup>27</sup> Second, as a commercially oriented shareholder, Huijin would realise its responsibilities and functions regarding capital safety and returns on capital.<sup>28</sup> Third, the formation of a holding company would correspond to most rules of a market economy, and be more convenient for capital investment and management.<sup>29</sup> The significant purpose of Huijin is to remove the state from direct ownership of the SOCBs.<sup>30</sup>

The new round of reform has clear goals and has been implemented gradually. Financial restructuring has initially changed the financial conditions in SOCBs that allow them to have adequate capital; this is a necessary condition for the setting up of a modern corporate governance structure. Moreover, corporatization and the bringing in of strategic investors can establish a corporate governance framework, with shareholders' meetings, a board of directors and supervisors. It is the basis of proper decision-making, and a check and balance mechanism. It is also a necessary prerequisite for carrying out effective oversight, implementing risk controls, and improving asset quality. In addition, a strict supervisory and regulatory framework can help standardise the behaviour of banks in the manner of efficiency, safety and liquidity, and thereby guarantee the interests of shareholders, depositors, and legal persons of the banks.<sup>31</sup>

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<sup>27</sup> Yuanyuan Peng, *The Chinese Banking Industry: Lessons from History for Today's Challenges* (Routledge 2007) 11. See also, Wang (n 8) 114.

<sup>28</sup> Wang (n 8) 114.

<sup>29</sup> Ibid.

<sup>30</sup> Leng (n 23) 1287.

<sup>31</sup> Wang (n 8) 110-12.

### **4.3 Bank restructuring**

A noteworthy issue in China's state banking system was the staggering amount of NPLs. The NPL problem had not only been a major obstacle that prevented the SOCBs from becoming genuine commercial banks, but had also threatened the stability and growth of China's economy.<sup>32</sup> In order to combat the problem of the NPLs, two clearly differentiated steps have been taken by the Chinese government: first, capital injections and, second, the clean-up of NPLs by the use of four AMCs.<sup>33</sup>

#### **4.3.1 The NPL problem**

China's SOCBs had served primarily as a funding source for SOEs under state control. As a result, the huge amount of NPLs remained on the books of the SOCBs. Therefore, strengthening the balance sheets of the SOCBs became a top priority for the Chinese government.

##### **4.3.1.1 The Seriousness of the NPL problem**

It is a difficult task to pinpoint the precise amount of NPLs. Scholars have estimated about the proportion of NPLs in the whole bank assets varied from 10 percent to 40 percent.<sup>34</sup> Dai Xianglong, the former governor of the PBOC, in 1999 officially recognised that the ratio of NPLs to total outstanding loans at the Big Four was 25%.<sup>35</sup> In 2001, Standard and Poor's predicted that the Big Four would require USD 540 billion to

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<sup>32</sup> Lou (n 18) 14-20. DK Srivastava and Charu Sharma, 'Banking Law in China after WTO: Sailing through the Winds of Change?' (2003) 6 *Journal of Chinese and Comparative Law* 151, 159.

<sup>33</sup> Garc ía-Herrero, Gavil á and Santab ábara (n 2) 16.

<sup>34</sup> Hui Cao, 'Asset Securitisation: Is It a Resolution Option For China's Non-Performing Loans?' (2003) 28 *Brooklyn Journal of International Law* 565, 571.

<sup>35</sup> *ibid.*

account for NPLs.<sup>36</sup> According to the Chinese government, the official number was approximately USD 240 billion in the middle of 2003.<sup>37</sup> However, some western analysts have disagreed with the official number and given figures ranging widely from USD 410 to 815 billion.<sup>38</sup>

#### **4.3.1.2 Causes of NPLs**

It is generally argued that government intervention in SOCBs directly contributes to the formation of enormous NPLs, though the poor corporate governance in SOCBs is also responsible for this.<sup>39</sup> SOCBs not only lacked independence from the central government, but were also vulnerable to direct and indirect interference from local governments.<sup>40</sup> SOCBs could not operate independently from the intervention of the government; they were effectively governmental or semi-governmental entities. Under government pressure, they generally assumed policy burdens, such as loans to finance investment projects and to keep the loss-making SOEs alive.<sup>41</sup> Due to the “dual leadership” of its head office and the local governments, lending decisions of local branches of the SOCBs were also subject to frequent interventions from local government.<sup>42</sup>

According to the report of Zhou Xiaochuan, the governor of the PBOC, released in April 2004, the NPLs came mainly from excessive government intervention, the poor legal

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<sup>36</sup> *ibid.*

<sup>37</sup> Weitseng Chen, ‘WTO: Time’s Up For Chinese Banks—China’s Banking Reform and Non-Performing Loan Disposal’ (2006) 7 *Chicago Journal of International Law* 239, 240.

<sup>38</sup> *ibid.*

<sup>39</sup> Peng (n 27) 18.

<sup>40</sup> Peng (n 27) 13-7.

<sup>41</sup> Yifu Lin and Zhiyun Li, ‘China’s SOE and Financial Reforms: 1978-2002’ (China Centre for Economic Research 2006) <<http://old.ccer.edu.cn/download/6459-1.pdf>> accessed 20 May 2008.

<sup>42</sup> Peng (n 27) 15-7.

environment, and inadequate management of the customer bases.<sup>43</sup> He further disclosed some reliable figures regarding the causes of China's NPLs: (1) intervention by the central and local governments accounted for 30 percent of NPLs; (2) mandatory credit support to state-owned enterprises was responsible for 30 percent; (3) 10 percent resulted from poor local legal and administrative environments; (4) 10 percent arose from industrial restructuring organised by the government; and (5) only 20 percent was ascribed to banks' own mismanagement and business losses.<sup>44</sup>

Moreover, the central government had adopted a performance-oriented system that measured and rewarded the performance of local officials and cadres on the sole basis of their economic achievement, namely "Gross Domestic Product Growth" related indicators.<sup>45</sup> This performance evaluation system, which tied performance to the amount of capital accumulated, provided further incentives for local officials and cadres to access credit by informal means, such as connections and bribery.<sup>46</sup> Such behaviour had a negative effect on the banking system and was attributable to increased NPLs.

#### **4.3.1.3 Negative effects of NPLs and the necessity of banking reform**

Although there were no agreements on the actual amount of NPLs on the SOCBs' balance sheets, it was widely recognised that the NPLs threatened the stability of the SOCBs and the Chinese economy.<sup>47</sup>

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<sup>43</sup> Xiaochuan Zhou, 'Some Issues Concerning the Reform of the State-Owned Commercial Banks' (IIF Spring Membership Conference, Shanghai, April 2004).

<sup>44</sup> *ibid.*

<sup>45</sup> Leng (n 23) 1274 and Chen (n 37) 243.

<sup>46</sup> Chen (n 37) 243.

<sup>47</sup> Lou (n 18) 21.

The existence of a large amount of NPLs not only damaged the profitability and competitive ability of the SOCBs, but also impeded them from improving economic efficiency.<sup>48</sup> As the SOCBs are the key providers of funds to industry and commerce in China, if the banking system is burdened with a large amount of NPLs will eventually impede the establishment of a market economy in China and damage the economy as a whole.<sup>49</sup>

Furthermore, as part of its WTO commitments, China agreed to remove geographical and product restrictions on foreign banks and promised to open its financial market to foreign banks by December 11, 2006. These had pressed the Chinese government to facilitate banking reforms.

#### **4.3.2 Recapitalising the SOCBs**

Restructuring of the SOCBs was a prerequisite for the subsequent shareholding system reform and the introduction of strategic investors. According to Lou, government bail-outs of the SOCBs in China can be justified at least by the following elements: the state ownership of the SOCBs, the low profitability of the SOCBs and the difficulties of raising capital in other ways encountered by the SOCBs.<sup>50</sup> Subsequently, the Chinese government spent huge amounts of money to strengthen the financial conditions of the SOCBs, though recapitalisation of the SOCBs caused a moral hazard.<sup>51</sup>

In March 1998, the equivalent of USD 32.6 billion was injected into the four SOCBs by issuing special treasury bonds; meanwhile, the equivalent of USD 170 billion of NPLs

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<sup>48</sup> *ibid* 16.

<sup>49</sup> *ibid* 16-20.

<sup>50</sup> Lou (n 18) 74-6.

<sup>51</sup> Leng (n 23) 1281, 1283.

was stripped away.<sup>52</sup> However, the USD 32.6 injection failed to bring about the expectation that the capital adequacy of the four SOCBs would reach the 8 percent required under the Basel Capital Accord. This was because the SOCBs did not change their management systems or bank lending behaviour after the recapitalisation.<sup>53</sup>

In December 2003, the PBOC injected USD 45 billion into the BOC and CCB by making use of China's foreign exchange reserves (USD 22.5 billion for each bank) in order to strengthen the balance sheets of the two banks.<sup>54</sup> The ICBC, China's largest lender, received a capital injection of USD 15 billion from the country's international reserves in April 2005.<sup>55</sup> The aim of this move was to increase the capital adequacy to pave the way for its subsequent shareholding restructuring and overseas listings. On 29<sup>th</sup> October 2008, Huijin injected assets equivalent to USD 19 billion in foreign exchange into the ABC, the weakest and smallest of the four SOCBs.<sup>56</sup>

Compared to the prior injection, these funds came from China's rich pool of foreign exchange reserves. The innovative bail-out approach of using foreign exchange reserves to recapitalise banks not only greatly alleviated fiscal pressures but also created a new channel for using the country's vast foreign exchange reserves.<sup>57</sup>

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<sup>52</sup> Garc ía-Herrero, Gavil á and Santab ábara (n 2) 16.

<sup>53</sup> See Lou (n 18) 84 and Leng (n 23) 1281.

<sup>54</sup> OECD, *Governance in China* (OECD 2005) 394.

<sup>55</sup> Garc ía-Herrero, Gavil á and Santab ábara (n 2) 17.

<sup>56</sup> China Daily, 'Agricultural Bank Gets 130 Billion Yuan Recapitalisation' *China Daily* (Beijing, 22 October 2008) <[http://www.chinadaily.com.cn/china/2008-10/22/content\\_7131014.htm](http://www.chinadaily.com.cn/china/2008-10/22/content_7131014.htm)> accessed 12 May 2010.

<sup>57</sup> Wei Sun, 'China's Banking Reform: A Corporate Governance Perspective' (DPhil thesis, University of Leeds 2007).

However, the method of using foreign exchange reserves for bank capital injections has been criticised.<sup>58</sup> First, it could cause a moral hazard resulting from the banks' expectation that the government would bail them out in the future.<sup>59</sup> Furthermore, the potential risks of making use of foreign exchange reserves to recapitalise the SOCBs would ruin the stability of China's financial system, and additionally damage the PBOC's independence and regulatory credibility.<sup>60</sup>

### 4.3.3 The NPL disposal

In order to combat the issue of NPLs, the most significant step taken by the Chinese government was to create four AMC's in 1999.<sup>61</sup> The AMC's are state-owned non-banking financial institutions with their own independent legal status.<sup>62</sup> Each AMC was responsible for taking over the NPL assets of one of the four SOCBs, in other words, Great Wall for ABC, Orient for BOC, Cinda for CCB and Huarong for ICBC.<sup>63</sup>

By 2000, the four AMC's had initially received the nearly RMB 1.4 trillion NPLs in total from the four SOCBs.<sup>64</sup> The loans were mostly made prior to 1996, and most of those

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<sup>58</sup> Leng (n 23) 1283.

<sup>59</sup> *ibid.*

<sup>60</sup> *ibid.*

<sup>61</sup> The four AMC's are China Huarong AMC, China Great Wall AMC, China Orient AMC and China Cinda AMC. According to a report by Business China, the four AMC's have moved into commercial operations since completing their assigned tasks. As early as the end of 2006, the four AMC's submitted proposals for commercial transformation separately in order to change themselves into financial holding groups. So far, their businesses have extended to insurance, securities, fund management and leasing. See 'China Great Wall AMC Receives Insurance Agency' *21<sup>st</sup> Century Business China* (Guangzhou, 21 June 2010) <<http://en.21cbh.com/HTML/2010-6-21/2NMDAwMDE4MzA2Ng.html>> accessed 22 July 2010.

<sup>62</sup> AMC Regulations, s 2 (State Council Decree no. 297 of 2000, 10 November 2000). The Ministry of Finance injected RMB 10 billion into each AMC as registered capital. See AMC Regulations, s 5 (State Council Decree no. 297 of 2000, 10 November 2000).

<sup>63</sup> Berry F.C. Hsu, Douglas Arner and Qun Wan, 'Financial Restructuring and China's Asset Management Companies' in James R Barth, Zhongfei Zhou, Douglas W Arner, Berry F.C. Hsu and Wei Wang (eds), *Financial Restructuring and Reform in Post-WTO China* (Kluwer Law International 2007).

<sup>64</sup> Srivastava and Sharma (n 32) 159.

created by the SOCBs were policy loans.<sup>65</sup> The AMCs had the mandate to purchase these NPL assets at their face value.<sup>66</sup> Each AMC issued a ten- year bond with an annual 2.25% interest for 83% of that amount and paid the remaining 17% in cash acquired from the PBOC.<sup>67</sup> The first transfer was the direct replacement of bad assets with good assets without taking account of the market value of the NPLs, which benefited the SOCBs in terms of enhancing their asset quality.<sup>68</sup>

Since the second transfer in June 2004, auctions have been used to transfer NPLs.<sup>69</sup> Cinda AMC in 2004 won an auction by beating out the other three AMCs to purchase RMB 278.7 billion of NPLs from CCB and BOC, paying a 50 percent discount of the book value.<sup>70</sup> In 2005, four AMCs purchased USD 55.6 billion of NPLs from ICBC and CCB at 50 percent of the book value by auction.<sup>71</sup> From then on, a market-oriented bidding system was introduced, bringing more competitiveness in the Chinese NPL market.

The effects were that the ratio of the NPLs of the four SOCBs decreased remarkably after the transfer. However, the development of AMCs has faced difficulties and problems. First, the AMCs were wholly state-owned institutions and were not operated on a commercial basis; thus, they had poor corporate governance and transparency. The performance of AMCs in China has been criticised, in that according to a work report

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<sup>65</sup> Hsu, Arner and Wan (n 63) 136.

<sup>66</sup> AMC Regulations, s 12 (State Council Decree no. 297 of 2000, 10 November 2000).

<sup>67</sup> Garc ía-Herrero, Gavil á and Santab árbara (n 2) 18.

<sup>68</sup> Sun (n 57) 102.

<sup>69</sup> Garc ía-Herrero, Gavil á and Santab árbara (n 2) 18.

<sup>70</sup> Min Xu, 'Resolution of Non-Performing Loans in China' (Glucksman Institution for Research in Securities Market, 1 April 2005) < [http://web-docs.stern.nyu.edu/glucksman/docs/Xu\\_2005.pdf](http://web-docs.stern.nyu.edu/glucksman/docs/Xu_2005.pdf) > accessed 19 October 2008.

<sup>71</sup> Guangjian Xu, 'A Study on Non-Performing Loans of China's Major Commercial Banks: Evolution, Resolution and Control' <[http://www.meijigakuin.ac.jp/econ/academics/publications/annual/PDF/23\\_asia%20east\\_3.pdf](http://www.meijigakuin.ac.jp/econ/academics/publications/annual/PDF/23_asia%20east_3.pdf)> accessed 10 May 2009.

released by China's National Audit Office in 2005, substantial irregular dealings and corruption occurred at AMCs, involving a total of RMB 6.7 billion.<sup>72</sup> The National Audit Office further pointed out in the report that there were many problems in the AMCs: a number of financial creditor's rights could not be realised due to inadequate control of the acquirement of NPLs; some banks tried to escape responsibilities and cover losses caused by operation that violate regulations through peel-off; the AMCs' dark box operations, falsification and disposal of creditor's rights at low prices caused a loss of state-owned assets; some AMCs' inadequate finance management had given rise to false reports of recovered cash or the embezzlement of recovered cash; some even used the recovered cash to pay for high salaries and benefits for employees.<sup>73</sup> The CBRC also reported that the AMCs violated laws and regulations.<sup>74</sup>

Moreover, there was a weak legal framework. China lacked a real bankruptcy law prior to the adoption of a new law in August 2006.<sup>75</sup> Thus there were numerous difficulties in protecting credit rights without a bankruptcy law and the implementation of the law, leading to problems in the disposal of the NPLs.<sup>76</sup>

In addition, the transfer price of the NPLs in 1999 was far from the market value in general. The initial transfer at book value, which would be below 20-30 percent of book value, created an inevitable loss for the AMCs.<sup>77</sup> Therefore, it also prevented incentives for the AMCs to maximise the recovery price. However, the transfers in 2004 at market

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<sup>72</sup> 'Audit Finds Four AMCs Violating Regulations' *People's Daily* (Beijing, 21 January 2005) <[http://english.peopledaily.com.cn/200501/21/eng20050121\\_171487.html](http://english.peopledaily.com.cn/200501/21/eng20050121_171487.html)> accessed 15 August 2009.

<sup>73</sup> *ibid.*

<sup>74</sup> *ibid.*

<sup>75</sup> Before 2006, the main governing bankruptcy law in China was the Enterprise Bankruptcy Law of the PRC (Trial Implementation) which was enacted in 1986 and exclusively applied to state-owned enterprises.

<sup>76</sup> Xu (n 71) 126.

<sup>77</sup> Xu (n 70) 24.

value were helpful in improving the performance of AMCs.<sup>78</sup> Finally, there was a lack of proper valuation and asset pricing mechanisms in the process of NPL disposal.<sup>79</sup>

In addressing the irregularities and improving the management at the AMCs, the CBRC had taken measures with regard to strengthening corporate governance, enhancing supervision and improving the market infrastructure for the disposal of NPLs.<sup>80</sup> The CBRC also encouraged the AMCs to continue to cooperate with foreign buyers due to their expertise and experience.<sup>81</sup>

#### **4.3.4 Summary**

Due to China's unique political, economic and institutional environment, the Chinese government adopted government recapitalisation and used AMCs to improve balance sheets and deal with the NPLs of the SOCBs. However, the government bailout of the SOCBs, and the write-off of NPLs by the AMCs have likely cause a moral hard that the banks would foster the expectation of future bail out.

The Chinese government has made some efforts to avoid this moral hazard. To begin with, Huijin was created to ensure the proper management of the funds injected after the second wave of capital injections. Furthermore, a clear cut-off had been made, which subjected the banks' managers to new strict discipline. Since the Commercial Banking Law was amended in 2003, the SOCBs have not been required to grant policy loans for

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<sup>78</sup> Xu (n 71) 126.

<sup>79</sup> Leng (n 23) 1279-80.

<sup>80</sup> Hsu, Arner and Wan (n 63) 170. More stringent regulations have been put into operation to strengthen the supervision of the transfer, disposition and management of NPLs, such as the Guidelines on the Due Diligence in Disposing of Non-performing Financial Assets, the Rules on Information Disclosure by Asset Management Companies, and the Rules on the Punishment of Violations Committed by Asset Management Companies.

<sup>81</sup> Leng (n 23) 1280.

development purposes. In addition, the SOCBs have been allowed to access the capital market through Initial Public Offerings or subordinated bond offerings, which has enabled them to strengthen their balance sheets.<sup>82</sup>

In order to effectively address the existing stock problem and solve the flow problem of the SOCBs, further banking reform measures are needed beyond continuous capital injections and the disposal of NPLs.<sup>83</sup> Key components of these measures include the creation of a corporate governance framework, and the improvement of banking supervision and regulation.

## **4.4 Shareholding system and corporate governance reforms**

After a series of measures to improve the financial conditions of the SOCBs through both recapitalisation and NPL transfer, the SOCBs were ready for shareholding system reform.

### **4.4.1 New changes in ownership**

In the past, the four SOCBs were wholly owned by the state. Due to situation, the government continuously intervened in the banks, which led to a lack of incentives for the banks to improve their operations.<sup>84</sup> Furthermore, the government did not clarify which government department or agency should take full responsibility for bank performance.<sup>85</sup> The lack of clear identifiable owners of the SOCBs confused ownership and control rights, resulting in it being impossible to set up a modern corporate structure.

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<sup>82</sup> Sun (n 57) 106.

<sup>83</sup> Leng (n 23) 1281.

<sup>84</sup> Lou (n 18) 248.

<sup>85</sup> Peng (n 27) 8.

Thus, it was imperative for the Chinese government to diversify the banks' ownership in order to support a sound governance regime.

In partially addressing China's longstanding "absent principal" quandary, Huijin was set up in 2003, incorporated in accordance with the Chinese Company Law and approved by the State Council.<sup>86</sup> As an investor in significant financial institutions, it is entitled to exercise its rights and to discharge its obligation on behalf of the Chinese government.<sup>87</sup> Huijin, as the controlling shareholder, appointed board members and supervisory board members to the SOCBs, which began to play a positive role in their corporate governance. In addition, the involvement of foreign strategic investors was a key part of the diversification of the SOCBs' ownership, which has contributed to the improvement of governance in the banks. Initially, this has been helpful in resisting government intervention. Meanwhile, it has allowed the SOCBs to absorb the skills and experiences required in modern banking from foreign participation.<sup>88</sup> Moreover, it has increased bank capital and caused their shares to be listed on the market, which has lowered the cost of reform and induced improvements in corporate governance and management.<sup>89</sup> Since 2005, the CCB, BOC and ICBC have acquired foreign strategic investors, although the

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<sup>86</sup> See Nicholas Calcina Howson, 'China's Restructured Commercial Banks: Nomenkla Accountability Serving Corporate Governance Reform' in Min Zhu, Jinqing Cai and Avery Martha (eds), *China's Emerging Financial Markets: Challenges and Global Impact* (John Wiley & Sons 2009) and also Wang (n 8) 114.

<sup>87</sup> Wang (n 8) 114.

<sup>88</sup> *ibid.*, 117.

<sup>89</sup> *ibid.* See also Lamin Leigh and Richard Podpiera, 'The Rise of Foreign Investment in China's Banks-Taking Stock' (2006) IMF Working Paper WP.06/292, <<http://www.imf.org/external/pubs/ft/wp/2006/wp06292.pdf>> accessed 10 May 2009.

ABC has not. The Bank of America has invested in CCB, a consortium led by the Royal Bank of Scotland in BOC and Goldman Sachs led an investor group in ICBC.<sup>90</sup>

#### **4.4.2 Shareholding System Reform and Initial Public Offering**

After bank restructuring, the BOC, CCB, ICBC and ABC were transformed from wholly state-owned to shareholding companies. On August 26 2004, the BOC announced the completion of its shareholding restructuring, followed by the CCB on September 21, 2004.<sup>91</sup> On October 28 2005, the ICBC announced that it had completed its shareholding<sup>92</sup> and on January 16 2009, the ABC became a shareholding company.<sup>93</sup> They set up a modern corporate governance framework comprised of shareholder meetings, boards of directors, boards of supervisors and senior management, with established functions for each organ. A check and balance mechanism was gradually established, and the boards of directors with sub-committees and board of supervisors began to play a crucial role. Management began to set up objectives that put the shareholders' value in the most important position.<sup>94</sup>

After the incorporation of the SOCBs, the Chinese government pushed them to go public in order to strengthen the market controls for banks.<sup>95</sup> In October 2005, as the first to complete shareholding restructuring, the CCB went public in Hong Kong; it thus formed the benchmark for reform in China's state-owned banks.<sup>96</sup> In October 2006, the Bank of

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<sup>90</sup> See more details about the transaction are in Wang (n 8) 117. Ownership by a single foreign investor is limited to 20 percent, while the combined share of all foreign investors in one bank is limited to 25 percent.

<sup>91</sup> Wang (n 8) 115.

<sup>92</sup> *ibid.*

<sup>93</sup> 'Agricultural Bank of China Becomes Shareholding Company' *Xinhua News* (Beijing, 16 January 2009) <[http://news.xinhuanet.com/english/2009-01/16/content\\_10668113.htm](http://news.xinhuanet.com/english/2009-01/16/content_10668113.htm)> accessed 10 March 2009.

<sup>94</sup> Wang (n 8) 116.

<sup>95</sup> Violaine Cousin, *Banking in China* (Palgrave Macmillan 2011) 13.

<sup>96</sup> 'Report on Competitive Ranking on Asian Banks',

China, the third to complete shareholding restructuring, went public on the Hong Kong and Shanghai bourses at the same time. It historically raised USD 21.9 billion from the market, making its initial public offering the largest the world has ever seen; its stocks were anticipated to be investors' 'darlings' at the second market.<sup>97</sup> The Agricultural Bank of China went public on July 6<sup>th</sup> 2010 and sold USD 19.2 billion of stock in Hong Kong and Shanghai.<sup>98</sup>

#### 4.4.3 Summary

The shareholding restructuring of the SOCBs allowed the banks to break through the old systems of solely state-owned banking asset control and ownership forms.<sup>99</sup> The Huijin model was relatively successful in resolving the long-term issue of there being no specification of ownership representative in SOCBs.<sup>100</sup> As the majority owner of the SOCBs, Huijin represented the state's interest in exercising its rights and responsibilities.

After shareholding system reform, the SOCBs set up standard corporate governance structures that required the formation of shareholder meetings, boards of directors, supervisory boards and executive management, with specific responsibilities for each. Check and balance mechanisms were reinforced through the shareholder general meetings, boards of directors, boards of supervisors and management. The boards of directors, supervisory boards, and their respective committees, began to play a significant role. The rights and responsibilities of the shareholder general meeting, boards of directors, boards of supervisors and senior management are thus gradually being defined.

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<<http://www.zgirw.com/news/20061129/NEWS/495981762100.html>> accessed 27 February 2007.

<sup>97</sup> 'Banking Long Road', <<http://www.china.org.cn/english/BAT/185876.html>> accessed 8 March 2007.

<sup>98</sup> Michael Wines, 'China Bank I.P.O. Raises \$19 Billion' *The New York Times* (Beijing, 6 July 2010)

<<http://www.nytimes.com/2010/07/07/business/global/07ipo.html>> accessed 12 August 2010.

<sup>99</sup> Wang (n 8) 119-20.

<sup>100</sup> *ibid.*

Management has set up objectives that put shareholders' value in the position of highest importance.<sup>101</sup>

Bringing in foreign strategic investors and going public not only raised cash needed to restore the health of the banking system, but also forced them to subject themselves to monitoring by shareholders, regulatory authorities, the general public and other related parties.<sup>102</sup> This has been helpful in further improving information disclosure, increasing transparency, strengthening internal controls and risk management, changing operating mechanisms, and setting up effective incentive and accountability mechanisms.<sup>103</sup>

## **4.5 Improving the legal and regulatory framework for bank governance**

This section focuses on those aspects of the banking reform process directly related to the legal, regulatory and prudential framework in the Chinese banking sector.

### **4.5.1 The legal framework**

The Chinese government has made efforts to improve the corporate governance framework for both banks and in the non-financial corporate sector.<sup>104</sup> Many laws, regulations, codes and standards have been amended and promulgated after China's entry into the WTO in order to set up a complete system of governance.<sup>105</sup> The main instruments affecting the corporate governance framework for the SOCBs now are: 1) the Company Law which is binding on banks and non-banks alike as long as the entity is

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<sup>101</sup> *ibid.*

<sup>102</sup> Leng (n 23) 1296 and Zhou (n 43) 4.

<sup>103</sup> Wang (n 8) 120.

<sup>104</sup> OECD, *Governance in China* (OECD 2005) 390.

<sup>105</sup> *ibid.*

organised in the corporate form; 2) the Commercial Banking Law;<sup>106</sup> 3) the Banking Supervision Law; 4) the Code of Corporate Governance for Listed Companies (CCGLC); and 5) Corporate Governance Rules and Guidelines issued by the China Banking Regulatory Commission.<sup>107</sup> The Company Law and the CCGLC apply to financial and non-financial companies, while the other instruments only apply to banks.<sup>108</sup>

#### **4.5.1.1 Revised Company Law**

The 1993 Company Law was amended in 1999 and 2004 respectively. However, the law only touched a very few technical aspects. The latest revision, adopted at the Standing Committee of the National People's Congress on 27 October 2005, simply named 2005 Company Law, left only approximately 24 articles of the 1993 law.<sup>109</sup> In other words, a wide range of changes have been brought into the 2005 Company Law, such as lowering the capitalisation requirement, enhancing shareholder and credit protection, improving corporate governance, increasing information disclosure and transparency, and granting shareholders greater powers to launch anti-director lawsuits.<sup>110</sup>

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<sup>106</sup> The Commercial Banking Law was amended on December 2003. Compared with the old law, Article of 43 of the revised Commercial Banking Law adds that no commercial banks may engage in trust investment or securities business, or invest in immovable property except where otherwise provided for in the regulations of the State, which leaves the possibility of permitting commercial banks to conduct non-banking activities.

<sup>107</sup> *ibid.*

<sup>108</sup> *ibid.*

<sup>109</sup> Jiangyu Wang, 'An Overview of China's Corporate Law Regime' (2008)

<[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1222061](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1222061)> accessed 10 May 2010. The 2004 revision only deleted a paragraph from Article 131 to remove the approval requirement for the securities regulatory authorities to approve issuance of company shares at a premium. "But the 2004 revision makes significantly improvements in corporate governance regulations. Firstly, it increases detailed provisions on shareholders meetings and meetings of the board of directors. Secondly, it enhances the supervisory function of the supervisory board by granting extensive monitoring and discipline powers. Thirdly, the amended Company Law furthers the protection of employees' interests by improving the co-determination system in the company. Fourthly, it introduces more mechanisms of members' remedies." See Yuwa Wei, 'Directors' Duties under Chinese Law: a Comparative Review' (2006) 3 The University of New England Law Journal 31, 40.

<sup>110</sup> Wang (n 109) 6.

The revised law has made a number of revolutionary changes to strengthen corporate governance and shareholders protection. The new Company Law introduces the brand new doctrine of ‘piercing the corporate veil’, which is designed to prevent the abuse of shareholders’ rights.<sup>111</sup> The new article explicitly indicates that if a shareholder uses the independent legal status of the company as a separate legal person or the limited liability status to evade debts and thereby, substantially damages other shareholders of the company or the company’s creditors, the shareholder shall compensate the loss of other shareholders or bear joint liability for the debts of the company.<sup>112</sup>

The directors’ duty regime has been significantly strengthened by the introduction of a whole new chapter on the qualifications and duties of directors.<sup>113</sup> Substantial powers are granted to the board of directors. The key powers include determining the operation plans and investment plans; drawing up the company’s annual financial budget plan and final accounts plan; working out the company’s profit distribution plans and loss recovery plans; working out plans for the merger, division, dissolution and transformation of the company; making decisions on the establishment of the company’s internal management departments; making decisions on hiring or dismissing the company’s manager and his remuneration, and, according to the nomination of the manager, deciding on the hiring or dismissing of vice manager(s) and the person in charge of finance as well as their remuneration; and working out the company’s basic management system.<sup>114</sup> Article 147 sets out the grounds on which a person may be disqualified from being a director, a

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<sup>111</sup> Nils Krause and Chuan Qin, ‘An Overview of China’s New Company Law’ (2007) *Company Lawyer* 316, 318.

<sup>112</sup> Company Law 2005, art 20. ‘Under the old Company Law shareholders are always sheltered by the statutory limited liability, leaving creditors virtually no legal recourse if the shareholders use the company as a sham to defraud the creditors.’ See Wang (n 109) 28.

<sup>113</sup> See Company Law 2005, ch 6.

<sup>114</sup> *ibid* art 47.

supervisor or senior manager of a company.<sup>115</sup> The most significant change is the introduction of a framework of management duties encompassing common law fiduciary duties that directors, supervisors and senior managers owe a duty of care and a duty of loyalty to their companies.<sup>116</sup>

Under the new law, shareholders are granted a large number of new rights. Shareholders now have the right to access and make copies of not only the minutes of shareholders' meetings and company financial statements, but also the resolutions of the board of directors and the board of supervisors.<sup>117</sup> Moreover, shareholders of a limited liability company have the right to be informed on a regular basis of remunerations to the company's directors, supervisors and senior officers.<sup>118</sup> According to Article 106 of the Company Law 2005, the cumulative voting system is permitted to apply in the company. Compared with the ordinary voting system, the cumulative voting system enables

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<sup>115</sup> Company Law 2005, art 147.

<sup>116</sup> Craig Anderson and Bingna Guo, 'Corporate Governance under the New Company Law: Fiduciary Duties and Minority Shareholder Protection' (2006) 20 (3) China Law & Practice London 19. In terms of a director's fiduciary duties, they are stipulated in arts 148 and 149. Article 148 of Company Law 2005 stipulates that directors, supervisors and senior managers shall comply with laws, administrative regulations and the articles of association. They shall assume the duties of loyalty and diligence to the company. Directors, supervisors or senior managers shall not take any bribe or other illegal gains by taking advantage of his authority, or encroach on the properties of the company. Article 149 provides that no director or senior manager may commit any of the following acts: (1) misappropriate funds of the company; (2) deposit the company's funds into an account in his own name or in any other individual's name; (3) without the consent of the shareholders' meeting, shareholders' assembly or board of directors, loan the company's funds to others or provide any guarantee to any other person by using the company's property as in violation of the articles of association; (4) sign a contract or trade with this company by violating the articles of association or without the consent of the shareholders' meeting or shareholders' assembly; (5) without the consent of the shareholders' meeting or the shareholders' assembly, seek business opportunities for himself or any other person by taking advantage of his authorities, or operate for himself or for any other person any like business of the company he works for; (6) take commissions on the transactions between others and this company into his own pocket; (7) disclose the company's secrets without permit; (8) or other acts that are inconsistent with the obligation of fidelity to the company. The income of any director or senior manager from any act in violation of the preceding paragraph shall belong to the company.

<sup>117</sup> Company Law 2005, arts 34 and 98.

<sup>118</sup> *ibid* art 117.

shareholders to vote as many times as there are candidates.<sup>119</sup> This is done to ensure some influence in the election of directors or supervisors by minority shareholders.<sup>120</sup>

For the first time, Article 152 of the Company Law 2005 establishes statutory derivative lawsuits, in which a shareholder derivative lawsuit is an assertion of a company claim initiated by one or more shareholders to prevent or remedy injury to the company; this is a tool for the protection of companies' shareholders, especially minority shareholders.<sup>121</sup>

Private enforcement mechanisms such as shareholder lawsuits enable shareholders to take legal action against the wrongdoings of directors, senior managers, supervisors and third parties who have violated certain corporate governance provisions or caused damage.<sup>122</sup>

Private enforcement may provide a more effective deterrent to violations of shareholders' rights. Hurt shareholders are motivated to seek compensation for the damages owed to them.<sup>123</sup> As Wang wrote:

The shift of the focus of shareholder protection from public enforcement to private enforcement represents arguably the single most important rule of law development in China's corporate law system. Judicial protection would enable minority shareholders to monitor the management in a more efficient

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<sup>119</sup> Baoshu Wang and Hui Huang, 'China's new Company Law and Securities Law: an Overview and Assessment' (2006) 19 *Australian Journal of Corporate Law* 1, 7.

<sup>120</sup> *ibid.*

<sup>121</sup> Craig Anderson and Bingna Guo, 'Corporate Governance under the New Company Law: Shareholder Lawsuits and Enforcement' (2006) 20 (4) *China Law & Practice* 6-7. The Company Law 2005 sets out the circumstances under which the court may allow shareholders to bring derivative action and the procedures for doing so. See Company Law 2005, arts 150 and 152.

<sup>122</sup> Krause and Qin (n 111) 318. Under the Article 152 of the Company Law 2005, shareholders who have held one percent or more of its shares for 180 days or more consecutive days are entitled to request the supervisors or directors to file a law suit in court against the wrongdoings of the directors, senior managers or supervisors that have caused a loss to the company. In addition, the shareholder is able to file a lawsuit directly if the directors or supervisors refuse to take legal proceedings or fail to take legal proceedings within 30 days, or under emergency situations.

<sup>123</sup> Anderson and Guo (n 121) 3.

way and ensure more careful and faithful corporate decisions. Compared with the old Law, the new rules are clearer, more practical, and more enforceable and thus more likely to bring about effective and just settlement of corporate legal dispute.<sup>124</sup>

The new Company Law 2005 has substantially reinforced the powers and functions of the supervisory board. The aim of increasing the power of the board of supervisors and strengthening worker participation is to ‘curtail the insider contract problem and the rampant abuse of powers by management.’<sup>125</sup> Thus the board of supervisors now has the powers to:

supervise the acts of the directors and senior managers in respect of the performance of their duties assigned by the company, and put forward proposals for removal of the directors or senior managers who violate laws, administrative regulations or the company’s articles of association, or the resolutions adopted by the shareholders assembly.<sup>126</sup>

Moreover, the board of supervisors has the power to take legal proceedings against directors or senior managers in accordance with the provisions of Article 152 of this Law.<sup>127</sup> To ensure that the supervisory board adequately represents the interests of various stakeholders,<sup>128</sup> it is required that the board of supervisors should be composed of an appropriate proportion of representatives of the staff and workers

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<sup>124</sup> Wang (n 109) 28.

<sup>125</sup> Wei, ‘Directors’ Duties under Chinese Law: A Comparative Review’, 2006, 53 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1298647](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1298647)> accessed 11 January 2011.

<sup>126</sup> Company Law 2005, art 54 para 2.

<sup>127</sup> Company Law 2005, art 54 para 6.

<sup>128</sup> Wang and Huang (n 119) 7.

of the company, namely, not less than one-third of the number of the board of directors.<sup>129</sup> However, due to inadequacy in monitoring and supervising the management by the supervisory board in practice, the new Company Law states that a listed company must have independent directors in accordance with the relevant regulations promulgated by the State Council.<sup>130</sup>

#### **4.5.1.2 Law of the PRC on Governing Banking Regulation and Supervision**

The Law of the People's Republic of China on Governing Banking Regulation of and Supervision (hereinafter referred to as the Banking Supervision Law) was adopted by the Standing Committee of the Tenth National People's Congress on December 2003 and came into force on 1 February 2004. Enactment of this Law has laid a legal foundation for banking regulation and supervision in China. Article 1 states that the Banking Supervision Law is enacted with a view to improving regulation of and supervision over the banking industry, standardizing such regulation and supervision, preventing and mitigating risks in the banking industry, protecting the lawful rights and interests of depositors and other customers, and promoting the sound development of the banking industry.<sup>131</sup>

The Law grants legal status to the China Banking Regulatory Commission (CBRC) which was founded in April 2003 to undertake bank supervision from the PBOC. The Bank Supervision Law clarifies that the China Banking Regulatory Commission under the State Council shall be responsible for the regulation of and supervision over the

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<sup>129</sup> Company Law 2005, art 52 para 2.

<sup>130</sup> *ibid* art 123. It should be noted that the requirement for independent directors is limited to listed companies only.

<sup>131</sup> Banking Supervision Law 2003, art 1.

financial institutions of the banking industry comprising commercial banks, urban and rural credit cooperatives and policy banks.<sup>132</sup> The Bank Supervision Law applies to the regulation and supervision of the financial asset management companies, trust and investment corporations, finance companies and financial leasing companies and other financial institutions.<sup>133</sup>

The Bank Supervision Law clearly states the regulatory and supervisory responsibilities of the Banking Regulatory Commission under the State Council. They include formulating and promulgating supervisory rules and regulations governing the financial institutions and their business activities;<sup>134</sup> stipulating the establishment, change, termination and business scope of financial institutions,<sup>135</sup> as well as examining the qualifications of a director or senior manager; setting rules of prudent operation of the financial institutions, which cover risk management, internal control, capital adequacy, asset quality, loan loss provisioning, risk concentration, connected transactions, and liquidity management of assets;<sup>136</sup> conducting on-site inspection and off-site supervision of business operations and risk profiles of the financial intuitions;<sup>137</sup> establishing a rating system and early-warning mechanism for supervision over the financial institutions and a system of post responsibility for identifying and reporting emergencies in the banking

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<sup>132</sup> *ibid* art 2, paras 1 and 2.

<sup>133</sup> *ibid* art 2, para 3.

<sup>134</sup> *ibid* art 15.

<sup>135</sup> *ibid* art 16.

<sup>136</sup> *ibid* art 21.

<sup>137</sup> *ibid* arts 23 and 24.

industry;<sup>138</sup> and, guiding and overseeing the activities of the self-regulated organizations of the banking industry.<sup>139</sup>

The Bank Supervision Law clarifies that the Banking Regulatory Commission is entitled to require the financial institutions to submit their balance sheets, profit statements, other financial accounting statements, statistical reports and information concerning business operations and management as well as audit reports prepared by certified public accountants.<sup>140</sup> The Core Principles for Effective Banking Supervision by Basel Committee is largely incorporated into the Law. For example, Article 34 details the measures to conduct on-site inspection including, 1) entering a financial institution of the banking industry for on-site inspection; 2) interviewing staff members of a financial institution and requiring them to provide explanations on the matters under inspection; 3) checking and making copies of the financial institution's documents and materials related to the matters under inspection, and sealing up the documents and materials that are likely to be removed, concealed or destroyed; and, 4) examining the computer system with which the financial institution controls its business data.<sup>141</sup> Article 36 clearly regulates that the banking Regulatory Commission shall instruct financial institutions to truthfully disclose public information such as their financial and accounting reports, statements of risk management, changes in the directors and senior managers and other important matters.<sup>142</sup> The Bank Supervision Law regulates that if a financial institution violates the rules of prudent operation, the Banking Regulatory Commission under the State Council or its office at the provincial level shall instruct it to rectify this within a time limit; if it

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<sup>138</sup> *ibid* arts 27 and 28.

<sup>139</sup> *ibid* art 31.

<sup>140</sup> *ibid* art 33.

<sup>141</sup> *ibid* art 34.

<sup>142</sup> *ibid* art 36.

fails to comply with this by the expiration of the time limit, the Banking Regulatory Commission under the State Council or its office at the provincial level may take some measures which include instructing it to suspend part of its business or cease the giving of approval to its starting of new businesses, restricting the distribution of dividends and other returns, restricting asset transfer, instructing the holding shareholders to transfer their rights or restricting the rights of the shareholders concerned, instructing the institution to replace the directors or senior managers or restricting their rights and ceasing to give approval to its establishment of new branches.<sup>143</sup>

The Bank Supervision Law was amended on October 31, 2006. The revised law adds Article 42, which stipulates that the banking regulatory authority may, subject to approval by the head of the banking industry authority at or above the level of municipality, take the following measures to investigate the institutions and individuals suspected of violating the law during its inspection on banking institutions: (1) to interview relevant institutions and individuals and require them to provide explanations on relevant matters; (2) to check and make copies of the documents and materials related to financial records or property ownership records; and, (3) to record and keep a file of the documents and materials that are likely to be removed, concealed, destroyed or falsified. Where the banking regulatory authority takes the measures specified in the preceding paragraph, it shall send not less than two investigators, who shall produce their legal papers and then written notification of investigation. Where there are less than two investigators, or the investigators fail to produce their legal papers and the written notification of investigation, the units and individuals in question shall have the right to refuse to accept the

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<sup>143</sup> *ibid* art 37.

investigation. When the measures are adopted in accordance with law, the units and individuals concerned shall cooperate with the investigators, give truthful explanations about the relevant matters and provide related documents and materials, and they shall not refuse to cooperate with the investigators, obstruct investigation, or conceal facts.<sup>144</sup> The original Article 42 was changed to Article 43 and adds a new term in paragraph 1 relating to conducting investigation of a relevant unit or individual in violation of the provisions in Article 42 of this Law<sup>145</sup> and amends paragraph 2 of Article 43 to:

Any staff member of the banking regulatory authority engaged in supervision and administration who commits embezzlement, accepts bribes or divulges State secrets, business secrets or individual privacy, which constitutes a crime, shall be investigated for criminal responsibility according to law; and if the case is not serious enough to constitute a crime, he shall be given an administrative sanction according to law.<sup>146</sup>

#### **4.5.1.3 Code of Corporate Governance for Listed Companies**

The Code of Corporate Governance for Listed Companies (hereinafter referred to as the Code) was issued by the China Securities Regulatory Commission and State Economic and Trade Commission on 7 January 2001.<sup>147</sup> The Code aims to promote the establishment and improvement of a modern enterprise system by listed companies, standardize the operation of listed companies and bring forward the healthy development

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<sup>144</sup> Banking Supervision Law 2006, art 42.

<sup>145</sup> *ibid* art 43, para 1, subpara 6.

<sup>146</sup> *ibid* art 43, para 2.

<sup>147</sup> The Code, <[http://www.csrc.gov.cn/csrc\\_en/newsfacts/release/200708/t20070810\\_69223.htm](http://www.csrc.gov.cn/csrc_en/newsfacts/release/200708/t20070810_69223.htm)> accessed 12 February 2009.

of the securities market in China.<sup>148</sup> The Code is the first comprehensive regulation which is applicable to all listed companies within the boundary of the PRC for the purpose of setting up the sound and solid corporate governance in listed companies through the protection of investors' interests and rights, setting the basic behaviour rules and moral standards for directors, supervisors, managers and other senior management members of listed companies, the introduction of an independent directors' system, creating a sound information disclosure system, and tightening the supervision on corporate management.

The Code emphasizes that the shareholders shall enjoy legal rights, and regulates that minority shareholders shall share fair treatment with other shareholders, and that shareholders shall have the right to protect their interests and rights through civil litigation or other legal means in accordance with laws and administrative regulations.<sup>149</sup>

The Code states that institutional investors shall play a role in the appointment of company directors, the compensation and supervision of management and major decision-making processes.<sup>150</sup> The Code clearly clarifies the roles and duties of the board of directors and supervisors. According to the Code, a company shall establish a standardized and transparent procedure for director election so as to ensure the openness, fairness, impartialness and independence of the election,<sup>151</sup> and a listed company that is more than 30 percent owned by controlling shareholders shall adopt a cumulative voting system in order to fully reflect the opinions of minority shareholders.<sup>152</sup> A listed company should introduce independent directors who may not hold any other position within the

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<sup>148</sup> *ibid* preface.

<sup>149</sup> The Code, ch 1, s1.

<sup>150</sup> The Code, ch 1, s2.

<sup>151</sup> The Code, ch 3, s1.

<sup>152</sup> *ibid*.

company.<sup>153</sup> Supervisors should have the right to learn about the operating status of the listed company and no one shall interfere with or obstruct supervisors' work.<sup>154</sup>

Lastly, the Code states that a listed company shall respect the legal rights of banks and other creditors, employees, consumers, suppliers, the community and other stakeholders.<sup>155</sup> In addition, the Code specifies the requirements of information disclosure for listed companies. Listed companies are required to voluntarily and timely disclose all other information that may have a material effect on the decisions of shareholders and stakeholders besides disclosing mandatory information.<sup>156</sup> At the same time, the Code requires listed companies to timely disclose detailed information on controlling shareholders' interests.<sup>157</sup>

#### **4.5.1.4 Guidance on Corporate Governance of Commercial Banks**

The Guidance on Corporate Governance of Commercial Banks (hereinafter is referred to as the Guidance) was issued in July 2011. The purpose of the Guidance is to further improve the corporate governance of commercial banks, to promote sound operation and healthy development of commercial banks, and to safeguard the legitimate rights of depositors and other stakeholders.<sup>158</sup> It is the first comprehensive regulation that is applicable to all commercial banks within the territory of the PRC for the purpose of setting up sound corporate governance.

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<sup>153</sup> The Code, s5.

<sup>154</sup> The Code, ch 4 s1.

<sup>155</sup> The Code, ch 6.

<sup>156</sup> The Code, ch 7 s1.

<sup>157</sup> The Code, s3.

<sup>158</sup> The Guidance, art 1,

<<http://www.cbrc.gov.cn/EngdocView.do?docID=20110726E3B31F1963766665FFCB624208EAB400>>  
accessed 10 October 2011.

According to Article 3 of the Guidance, the term “corporate governance of commercial banks” refers to the relationships among general meetings of shareholders, boards of directors, supervisory boards, senior management, shareholders and other stakeholders. This specifically includes such check-and-balance mechanisms as the organizational structure, division of responsibilities and duty requirements, as well as such operating mechanisms as decision-making, implementation, monitoring and incentives, and discipline.<sup>159</sup>

The Guidance states that the sound corporate governance of a commercial bank should at least contain the following requirements:

- (1) a complete organizational structure; (2) clear division of responsibilities;
- (3) a scientific development strategy, values and codes of conduct as well as social responsibilities; (4) effective risk management and internal control; (5) rational incentives and disciplines mechanisms; (6) well-established information disclosure system.<sup>160</sup>

The Guidance clarifies that a commercial bank should put in place rational incentives and disciplines mechanisms, and conduct decision-making, implementation and monitoring in a scientific, highly efficient manner, based on the principles of independent operation of governance bodies, effective check-and-balance, mutual cooperation and coordinated functioning.<sup>161</sup> The governance bodies are required to:

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<sup>159</sup> *ibid* art 3.

<sup>160</sup> *ibid* art 7.

<sup>161</sup> *ibid* art 4.

[B]e composed of staff with strong professional background, expertise and skills, professional ethics and rich experience in the following areas: (1) to ensure the sound operation of a commercial bank on a legal, compliant basis; (2) to ensure the cultivation of prudential credit culture by a commercial bank; (3) to ensure the fulfillment of social responsibilities by a commercial banks; (4) to ensure the protection of legitimate rights of financial consumers' by a commercial bank.<sup>162</sup>

Pursuant to Article 6 of the Guidance, governance bodies and their members shall enjoy the rights and undertake obligations in accordance with laws and shall take joint efforts to safeguard the overall interest of the commercial bank. No governance bodies or their members should impair or override the interest of the commercial bank<sup>163</sup>

The Guidance emphasizes that a shareholder should fulfill its obligations of integrity to the commercial bank,<sup>164</sup> and regulates that the general meeting of shareholders should fulfill its rights and obligations in accordance with the Company Law of PRC and the Articles of Association of the commercial bank.<sup>165</sup> Under the Guidance, a major shareholder shall also disclose to the board of directors information about affiliated parties in a complete, timely and accurate manner, and should also be committed to timely report to the board when changes take place in the affiliated relationships.<sup>166</sup> The Guidance states that the general meeting of shareholders should adopt the lawyer-witness

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<sup>162</sup> *ibid* art 5.

<sup>163</sup> *ibid* art 6.

<sup>164</sup> *ibid* art 9.

<sup>165</sup> *ibid* art 16.

<sup>166</sup> *ibid* art 9. According to Article 9 of the Guidance, the major shareholder mentioned refers to the shareholder that holds (directly, indirectly or jointly) or controls over 5 percent of the shares or voting rights and has significant influence on the decision-making of the commercial bank. See *ibid* art 9, para 2.

rule and that the lawyer-witness is required to provide legal opinion letters that cover comments on the legitimacy of such issues as the procedures of the general meeting, the qualifications of participating shareholders as well as the resolutions adopted by the general meeting.<sup>167</sup> The Guidance also regulates that the board of directors of a commercial bank shall formulate a set of rules and procedures for the general meeting, which will be executed after being reviewed and adopted by the general meeting.<sup>168</sup>

The Guidance explicitly clarifies the roles and duties of the board of directors, the supervisory boards and the senior management. According to the Guidance, a commercial bank shall formulate proper and transparent procedures for the election of directors, the implementation of which shall be subject to the approval by the general meeting of shareholders.<sup>169</sup> The senior management is required to follow the principles of integrity and credibility, and they shall exercise their defined powers and duties in a prudent and diligent manner.<sup>170</sup> Pursuant to Article 69 of the Guidance, where the board of directors violates the rules of approval and dismissal, the senior management members have the right to request the supervisory board to initiate an opposition, and report the situation to the banking supervisory authority.<sup>171</sup>

Lastly, the Guidance states that a commercial bank should take into account the interests of the shareholders, depositors and other stakeholders. Clarified development strategies and sound value criteria should be established and effectively implemented within the

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<sup>167</sup> *ibid* art 17, para 3.

<sup>168</sup> *ibid* art 18.

<sup>169</sup> *ibid* art 44. The Guidance specifies the general procedures for electing directors and the principles for nominating and electing independent directors. See *ibid* arts 45 and 46.

<sup>170</sup> *ibid* art 66.

<sup>171</sup> *ibid* art 69.

bank.<sup>172</sup> In addition, the Guidance specifies the requirements of risk management and internal controls, incentives and disciplinary mechanisms, and information disclosure.

#### **4.5.2 The CBRC as banking regulator and supervisor after 2003**

With the decision to accelerate banking reform in 2003, the China Banking Regulatory Commission (hereinafter CBRC) was created and the National People's Congress Standing Committee empowered the new banking watchdog to take over the supervisory functions from the People's Bank of China.<sup>173</sup> At the same time, the PBOC as central bank and lender of resort will have significant responsibility for the soundness of the banking system as a whole.<sup>174</sup>

Under the new banking regulatory system, the new ministerial-level state agency undertakes the responsibilities for regulation and supervision. The main functions of CBRC are as follows:

Formulating supervisory rules and regulations; governing the banking institutions; authorizing the establishment, changes, termination and business scope of the banking institutions; conducting on-site examination and off-site

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<sup>172</sup> *ibid* art 70.

<sup>173</sup> Although the CBRC is authorised to regulate and supervise banking financial institutions, financial asset management companies, trust and investment companies, finance companies and financial leasing companies and other financial companies under the Banking Supervision Law, it does not mean that the PBOC would no longer perform banking regulatory functions. The PBOC continues to hold banking regulatory powers in some specific areas in terms of the PBOC Law. According to Article 32 of the PBOC Law, the PBOC has the power to inspect and supervise the activities conducted by financial institutions, units and individuals relating to deposit reserves, special loans, Renminbi, inter-bank loans, foreign exchanges, bullion, exchequer, settlement and anti-money laundering. Pursuant to Article 34 of the PBOC Law, when financial institutions of the banking industry have difficulty in making payment that may trigger off financial risks, the People's Bank of China shall, with a view to maintaining financial stability, have the power to inspect and supervise the financial institutions of the banking industry with the approval of the State Council. According to Article 33 of the PBOC Law, the PBOC may, according to the need to implement monetary policies and maintain financial stability, propose that the banking regulatory authority under the State Council inspects and supervises the financial institutions of the banking industry. The CBRC shall respond within 30 days of receiving the recommendation.

<sup>174</sup> OECD, *China in the Global Economy: Governance in China* (OECD 2005) 387.

surveillance of the banking institutions, and take enforcement actions against rule-breaking behaviours; conducting fit-and-proper tests on the senior managerial personnel of the banking institutions; compiling and publishing statistics and reports of the overall banking industry in accordance with relevant regulations; providing proposals on the resolution of problem deposit-taking institutions in consultation with relevant regulatory authorities; being responsible for the administration of the supervisory boards of the major state-owned banking institutions; and other functions delegated by the State Council.<sup>175</sup>

Meanwhile, pursuant to the amended Central Banking Law of 2003, the PBOC is specifically in charge of monetary policy matters, thus is committed to promoting and maintaining monetary and financial stability as its contribution to a healthy economy. However, the PBOC as a lender of last resort still has enormous influence on the regulation and supervision of the banking organizations.

The reformed system reflects the common phenomenon in many countries that the central bank is responsible for implementing monetary policy and maintaining systemic stability while the specific regulatory agency is in charge of regulation and surveillance on banking institutions. As Shu Nan states, the CBRC was established as a sequel to China's entry into the WTO with a view to creating a modern financial supervisory framework in China.<sup>176</sup> With the promulgation of the Law of the PBOC on Regulation of and Supervision over the Banking Industry in 2003, strong efforts have been made to

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<sup>175</sup> See Banking Supervision Law 2003, arts 15-32.

<sup>176</sup> Shu Nan, 'Supervision Role Split from PBC' (2003) *Business Weekly of China Daily* 23.

establish and improve China's banking supervisory standards and practices.<sup>177</sup> The primary subject of this regulatory body is to bring Chinese regulations and rules on capital adequacy, the loan classification system, risk management, and corporate governance standards into accordance with international norms.<sup>178</sup>

Some Chinese scholars and insiders have argued that by learning from the British model (Financial Service Agency), the unification of different agencies would likely be the ultimate solution for China's financial regulatory system. This is because it seems that separate supervision in the financial system may adversely affect the efficiency of the regulation and supervision of the whole system due to the segregate regulatory powers in various agencies.<sup>179</sup>

The supervision of CBRC focuses on

[C]onducting consolidated supervision to assess, monitor and mitigate the overall risks of each banking institution as a legal entity; staying focused on risk-based supervision and improvement of supervisory process and methods; urging banks to put in place and maintain a system of internal controls;

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<sup>177</sup> Fred Hu, 'Chinese Banking Industry—Past, Present and Prospect' (2006) Goldman Sachs and Tsinghua University 8.

<sup>178</sup> *ibid.*

<sup>179</sup> See Jing Bai, 'Research on China's Financial Regulatory Model', (April 2011) *Dongfang Qiye Wenhua* [Oriental Enterprise Culture] 6 (in Chinese); Bo Jiang, 'Analysis on Financial Regulatory Models from the Perspective of Consolidated Operations', (2011) 7 *Gaige yu zhanlie* [Reform and Strategy] 73 (in Chinese). Also, some experts suggested that thanks to the possibility of acute contradiction between the aim of monetary policy and targets of supervision on banking organizations, this may further stimulate the central bank to enhance banking supervision, based on the fact that commercial banks play a very significant role in the Chinese financial system, in order to implement a smooth monetary policy.

enhancing supervisory transparency in line with international standards and practice.<sup>180</sup>

In contrast to the PBOC as the banking regulator and supervisor, the establishment of the CBRC in 2003 has brought several improvements in regulation.<sup>181</sup> First of all, the CBRC strengthened the implementation of a five-category loan classification system namely “pass”, “special mention”, “substandard”, “doubtful” and “loss” even though China began to adopt the new system replacing the old four-tier loan classification system such as “normal”, “overdue”, “doubtful” and “bad” as early as April 1998.<sup>182</sup> Meanwhile, the new Chinese banking watchdog made this system fully compulsory for all banks by the end of 2005.<sup>183</sup> Secondly, the CBRC in February 2004 formulated the *Regulation Governing Capital Adequacy of Commercial Banks* (hereinafter Regulation) for the purpose of strengthening the supervision of capital adequacy so as to bring China’s practices in line with the international standards and help commercial banks operate in a

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<sup>180</sup> See the website, available at <<http://www.cbrc.gov.cn/english/info/yjhjj/index.jsp>> accessed on 18 November 2010.

<sup>181</sup> According to research by Garcí á-Herrero, A., Gavil á S., & Santab ábarra, D., in 1995, together with the assignment to the PBC of its main objectives, capital adequacy requirements were introduced in all commercial banks, as well as prudential ratios, namely loan to deposit ones and assets to liquid liabilities. These prudential ratios, however, were a formality. In 2002, the PBOC, still the Chinese regulator until 2003, established the international five-tier loan although it was not made fully compulsory. The reasons for this weak situation were the PBOC’s lack of sanctioning power and the decentralized nature of its regulatory and supervisory functions. In fact, the bulk of the work was conducted by local offices, which themselves had to report to the local government. See Alicia Garc á-Herrero, Sergio Gavil á and Daniel Santab ábarra, ‘China’s Banking Reform: An Assessment of its Evolution and Possible Impact’ (2006) available at <<http://www.bde.es/webbde/Secciones/Publicaciones/PublicacionesSeriadas/DocumentosOcasionales/05/Fic/do0502e.pdf>> accessed on 10 July 2007.

<sup>182</sup> “Pass” refers to loans where no problem with repayment of interest or principle occurred or perceived. “Special mention” refers to loans where though there are no repayment delays yet, problems that would affect the repayment have been detected. “Substandard” refers to loans where the repayment cannot be fully made with normal business income. “Doubtful” refers to loans where the repayment cannot be fully made even with securities or guarantees being exercised. “Loss” refers to loans where the repayment cannot be made after taking all the possible measures and necessary legal procedures. “Normal” refers to loans where no problem with payment of principle occurred. “Overdue” refers to loans where repayment of principle is in arrears. “Doubtful” refers to loans where repayment of principal is in arrears for more than one year. “Bad” refers to loans where repayment of principle is in arrears for more than two years.

<sup>183</sup> Alicia Garc á-Herrero, Sergio Gavil á and Daniel Santab ábarra (n 2) 23.

safe and sound manner.<sup>184</sup> The regulation adopts some features of Basel II, introducing supervisory review and disclosure. The regulation requires commercial banks to meet the eight percent minimum capital adequacy ratio defined in Basel I terms and a four percent minimum core capital adequacy ratio by 2007. Thirdly, a new risk assessment system was introduced to evaluate the shareholding commercial banks through a similar CAMEL-type Risk Assessment System by the CBRC in February 2004, which not only uses both quantitative and qualitative criteria for capital, asset quality, management competence, liquidity and profitability.<sup>185</sup> Fourthly, the CBRC has limited related-party lending, especially to large state-owned enterprises. Fifthly, enforcement has also been strengthened to some extent following introduction of the Prompt Corrective Action as an enforcement measure by the CBRC in 2004, which started to impose sanctions for infractions of rules.<sup>186</sup> Finally, the CBRC carries out banking supervision through both on-site and off-site inspections.<sup>187</sup>

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<sup>184</sup> Regulation Governing Capital Adequacy of Commercial Banks, art 1

<<http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=558>> accessed 21 November 2010.

<sup>185</sup> CAMEL is an acronym for capital adequacy, asset quality, management quality, earning's performance, and liquidity. Banks are scored on a scale of 1 (the best) to 5 (the worst) using this five criteria. The examinations are meant to prevent fraud and to ensure a bank is complying with the various rules and regulations related to its balance sheet and off-balance sheet holdings.

<sup>186</sup> According to the Regulation Governing Capital Adequacy of Commercial Banks, the commercial banks are classified into three categories on the basis of their capital adequacy status: adequate, inadequate and significantly inadequate. The CBRC could impose relevant corrective measures according to the severity of problems. For example, for undercapitalized banks, the CBRC will issue supervisory options, which requires the banks to work out a proper plan to raise their capital adequacy ratios (See the Regulation, art 40); for significantly undercapitalized banks, the CBRC will take further actions in addition to actions listed in Article 40 including requiring removal of senior management, taking over the banking institutions, facilitating the restructuring of the institutions, or closing the institutions in accordance with relevant laws and regulations (See Article 41, the Regulation).

<sup>187</sup> According to Article 33 and 34 of the Law of the People's Republic of China on Regulation of and Supervision over the Banking Industry, the banking regulatory authority shall, in light of the need for performing its duties, have the power to require the financial institutions of the banking industry to submit, in accordance with relevant regulations, their balance sheets, profit statements, other financial accounting statements, statistical reports and information concerning business operations and management, as well as the audit reports prepared by certified public accountants in conducting off-site surveillance. The banking regulatory authority may take the following measures to conduct on-site inspection, as required by prudent supervision: (1) to enter a financial institution of the banking industry for on-site inspection; (2) to interview

Although the establishment of CBRC is a milestone of China's financial system reform, it does not remove government control over the banking system by creating the CBRC.<sup>188</sup> The CBRC should be given a higher degree of independence and freedom from political interference in order to achieve efficient regulatory and supervisory operations. It is not completely clear that the CBRC can ensure that Chinese banks are 'sound and safe' because of the issues of enforcement and the lack of a level play field.<sup>189</sup> Concerning the former, the Chinese society is still plagued with the issue of weak rule of law and therefore, it is hard to enforce laws and regulations.<sup>190</sup> Concerning the latter, the CBRC should be sufficiently free from political influence so as to ensure a level playing field for all banks.<sup>191</sup>

### **4.5.3 Prudential regulation and supervision**

#### **4.5.3.1 Licensing of banks**

Although bank entry regulation, which is a set of entry requirements in terms of establishment, activity and personnel, is unable to guarantee that a bank will be well run after it is allowed to open, it can provide the possibility to decrease the amount of unstable institutions that enter the banking system, prevent inexperienced people from operating banks and stop 'over-banking'.<sup>192</sup> China, like other countries, has established a

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staff members of a financial institution and require them to provide explanations on the matters under inspection;(3) to check and make copies of the financial institution's documents and materials related to the matters under inspection, and to seal up the documents and materials that are likely to be removed, concealed or destroyed; and, (4) to examine the computer system with which the financial institution controls its business data.

<sup>188</sup> Details will be discussed in ch 5.

<sup>189</sup> Sun (n 57) 142.

<sup>190</sup> *ibid.*

<sup>191</sup> *ibid.*

<sup>192</sup> Zhoufei Zhou, 'Banking Regulatory Law Reforms in China: A Long Way to Go Towards International Standards' in James R. Barth, Zhongfei Zhou, Douglas Arner, Berry F.C. Hsu and Wei Wang (eds), *Financial Restructuring and Reform in Post-WTO China* (Kluwer Law International 2006).

great deal of mandatory and discretionary criteria for access to the banking business in the form of legislation and administrative rules including those stipulated in the 2003 Commercial Banking Law and the Banking Supervision Law, and also those set by the CBRC.<sup>193</sup> Those entry criteria set by the CBRC in the rules include the Measures on the Administration of Financial License in 2003,<sup>194</sup> the Provisions on the Implementation Procedures for Administrative Licensing of the CBRC in 2006, the Implementation Measures on Administrative Licensing Items of Chinese-funded Commercial Banks in 2006, the Implementation Measures on Administrative Licensing Items of Cooperative Financial Institutions in 2006, the Measures on Administrative of Electronic Banking Business in 2006, and the Interim Measures on the Administration of Derivative Products and Transactions of Financial Institutions in 2004. The Measures on Administrative Licensing of Chinese-funded Commercial Banks apply to Chinese state-owned commercial banks, joint stock commercial banks, city commercial banks and urban joint stock credit companies,<sup>195</sup> while the Measures on Administrative Licensing of Cooperatives apply to rural credit cooperatives, rural credit cooperative unions, rural cooperative banks and rural commercial banks.<sup>196</sup>

According to the Provisions on the Implementation Procedures for Administrative Licensing of the CBRC, the CBRC conducts the administrative licensing process in terms of matters concerning a bank's or other financial institutions' establishment, modification, termination, permissible activities, directors and senior management qualifications.<sup>197</sup>

The CBRC's administrative licensing process includes application and acceptance,

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<sup>193</sup> Zhongfei Zhou, *Chinese Banking Law* (Kluwer Law International 2007) 55.

<sup>194</sup> The Measures were amended during the 55<sup>th</sup> chairman's meeting of the CBRC on December 28<sup>th</sup>, 2006.

<sup>195</sup> Measures on Administrative Licensing of Chinese-funded Commercial Banks, art 2.

<sup>196</sup> Measures on Administrative Licensing of Cooperatives, art 2.

<sup>197</sup> Provisions on the Implementation Procedures for Administrative Licensing of the CBRC, art 5.

review and examination, and decision-making and service.<sup>198</sup> In cases where the CBRC refuses to issue a license, it must state the refusal grounds and inform the applicant of its right to petition for administrative reconsideration or lodge an administrative lawsuit within a special period.<sup>199</sup> If the CBRC approve an application, it shall issue a financial license that is defined as a legal document to permit an applicant to operate financial businesses.<sup>200</sup>

On the one hand, restricted entry may adversely affect banking competition and increase barriers to trade in banking services.<sup>201</sup> On the other hand, easier entry requirements may decrease access barriers but increase risks in banks that might lead some banks to fail.<sup>202</sup> Therefore, a banking law must find a balance to meet the needs of the safety and soundness, competition and the reduction of regulatory barriers.<sup>203</sup>

#### **4.5.3.1.1      *Entry requirements***

The Basel Committee's Core Principles for Effective Banking Supervision requires the licensing authority to set the minimum criteria for bank establishments.<sup>204</sup> These criteria consist of an assessment of ownership structure and governance of the bank and its wider group, including the fitness and propriety of board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition.<sup>205</sup> The Chinese legislative body and licensing authority have

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<sup>198</sup> *ibid* art 6.

<sup>199</sup> *ibid* art 29.

<sup>200</sup> Measures for the Administration of Financial Licenses, art 2.

<sup>201</sup> Zhou (n 192) 52.

<sup>202</sup> *ibid*.

<sup>203</sup> *ibid*.

<sup>204</sup> Basel Committee on Banking Supervision, 2006 *Core Principles for Effective Banking Supervision*, Principle 3. The Basel Committee on Banking Supervision has issued for consultation its revised Core Principles for effective banking supervision in December 2011. See the website, <<http://www.bis.org/publ/bcbs213.htm>> accessed 12 January 2012.

<sup>205</sup> *ibid*.

incorporated these requirements into the laws and licensing practices in accordance with international standards.<sup>206</sup> For example, the 2003 Commercial Banking Law clearly stipulates the basic requirements for establishing a commercial bank: (1) having articles of association that conform to the 2003 Commercial Banking Law and the Company Law; (2) having the minimum amount of registered capital;<sup>207</sup> (3) having directors and senior management with the expertise and experience in work commensurate with the positions they are holding; (4) having a sound internal organization and management system; and, (5) having the required place of business, security and precautionary measures and other facilities relevant to its business operations.<sup>208</sup>

An evaluation of the competence, integrity and qualifications of proposed board directors and senior management is regarded as a key aspect of the licensing process.<sup>209</sup> According to the Basel Committee, the licensing agency should obtain the necessary information about the proposed directors and senior managers to consider individually and collectively their banking experience, other business experience, personal integrity and relevant skill. This evaluation of management should involve background checks on whether previous activities, including regulatory or judicial judgments, raise doubts concerning their competence, sound judgment, or honesty.<sup>210</sup> To issue a bank license, China actually has a fit and proper test for Board directors and senior management. The PBOC released the Temporary Regulations on Qualifications for Posts of Senior Management in Financial Institutions, and Measures on Administration of Qualifications

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<sup>206</sup> Zhou (n 193) 56.

<sup>207</sup> The minimum amount of the registered capital is RMB 1 billion for a nationwide bank, RMB 100 million for a city commercial bank, and RMB 50 million for a rural commercial bank. See Commercial Banking Law 2003, art 13.

<sup>208</sup> Commercial Banking Law 2003, art 12.

<sup>209</sup> Basel Committee on Banking Supervision, *1997 Core Principles for Effective Banking Supervision*, 17.

<sup>210</sup> *ibid.*

for Posts of Senior Management in Financial Institutions in 1996 and 2000 respectively. The fit and proper test has been expanded to cover all directors of the board and senior management rather than only the chairman of the board, the president and other senior management.<sup>211</sup> Accordingly, the CBRC is authorized to exercise control of the qualifications for the positions of directors and senior managers of a bank.<sup>212</sup> In addition, the 2003 Commercial Bank Law explicitly stipulates those who may not serve as a director or a senior manager at a bank: (1) persons who have been sentenced to criminal punishment for the crime of embezzlement, bribery, seizure or misappropriation of property or disruption of the public and economic order, or persons who have been deprived of their political rights for committing a crime; (2) directors of companies or enterprises, or factory directors or managers who have been subjected to bankruptcy liquidation due to mismanagement, and who bear personal liability for the bankruptcy; (3) legal representatives of companies or enterprises that had their business licenses revoked for breaking law, who bear personal liability therefore; and, (4) persons with comparatively large amounts of overdue personal debts.<sup>213</sup>

Unlike the Commercial Banking Law of 1995, the 2003 Commercial Banking Law removed the economic needs standard and instead prescribed an open clause, which requires an applicant to satisfy other prudential requirements.<sup>214</sup> The Measures on Administrative Licensing of Chinese-funded Commercial Banks details what other prudential requirements mean in order to make the 2003 Commercial Banking Law more

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<sup>211</sup> Zhou (n 192) 52-3.

<sup>212</sup> Bank Supervision Law 2003, art 20.

<sup>213</sup> Commercial Banking Law 2003, art 27.

<sup>214</sup> *ibid* art 12.

operational.<sup>215</sup> In the establishment of a joint stock commercial bank, other prudential measures at least include: (1) good corporate governance; (2) sound risk management systems and ability to effectively control connected transaction risks; (3) no share stake and intervention into daily operations in the bank from the local government; (4) among promoting shareholders, at least a qualified foreign strategic investor included however, the qualified foreign strategic investor requirement was revised by the CBRC in December to be a qualified strategic investor; (5) scientific and effective system of human resources management, and high quality professionals; (6) effective system of capital constraint and capital supplement; and (7) contributing to resolving the risk of the current financial institutions and facilitating financial stability.<sup>216</sup> In addition, most of the prudential requirements are discretionary criteria set by the CBRC.

#### **4.5.3.1.2      *Establishment procedures***

Pursuant to the 2003 Commercial Banking Law, the application process for a commercial bank includes two steps. First, an applicant must provide the following documents and information to the CBRC: (1) a written application, in which the name, location, registered capital, scope of business and other information are clearly stated; (2) a feasibility study; and (3) other documents and information required by the CBRC.<sup>217</sup> Second, if an application for the establishment of a commercial bank is in accordance with the provisions above, the applicant must complete an official application form and provide the following documents and information: (1) a draft of the articles of association; (2) the qualification certificates of the prospective directors and senior management; (3)

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<sup>215</sup> Zhou (n 193) 59.

<sup>216</sup> Measures on Administrative Licensing of Chinese-funded Commercial Banks, art 7.

<sup>217</sup> Commercial Banking Law 2003, art 14.

an investment verification certificate issued by a statutory investment verification organisation; (4) a list of the names, capital contributions and shares of shareholders; (5) credit-worthiness certificates and relevant information concerning the shareholders that hold five percent or more of the registered capital each; (6) business policies and plans; (7) information concerning the place of business, security and precautionary measures and other facilities relevant to business operations; and (8) other documents and information as specified by the CBRC.<sup>218</sup>

Upon receiving the application and supporting documents, the CBRC conducts a critical examination of whether an applicant meets the mandatory and discretionary establishment standards discussed above.<sup>219</sup> Under the 2003 Banking Supervision Law, the CBRC shall examine the source of capital, financial strength, ability to replenish capital and the integrity of the shareholders.<sup>220</sup> The qualification checks are extended ‘not only from proposed senior management to directors and senior management, but also from a shareholder who holds 10 percent or more of the registered capital under the Commercial banking Law of 1995 to a shareholder who holds 5 percent or more of the registered capital.’<sup>221</sup> Another element to review during the licensing process is the operating plans proposed for the bank.<sup>222</sup>

Under the Chinese practice, the feasibility study report and the operating plan describe and analyze the market area from which the proposed bank expects

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<sup>218</sup> *ibid* art 15.

<sup>219</sup> Zhou (n 192) 54.

<sup>220</sup> Banking Supervision Law 2003, art 17.

<sup>221</sup> Zhou (n 192) 55.

<sup>222</sup> Basel Committee on Banking Supervision, *1997 Core Principles for Effective Banking Supervision*, 17.

to draw the majority of its business and to establish a strategy for the proposed bank's ongoing operations.<sup>223</sup>

A minimum initial capital amount is stipulated for all banks by the banking law or licensing authorities in most countries. Although Chinese banks face a higher capital requirement than those in other countries, this provides a starting point to ensure that a bank is managed in a safe and sound manner.<sup>224</sup>

According to the Banking Supervision Law, the CBRC makes a decision of approval or disapproval in writing in response to a banking establishment application within six months of receiving the application. If it makes a decision of disapproval, it must explain the reasons for refusal.<sup>225</sup>

#### **4.5.3.1.3      *Permissible activities***

Under the 2006 *Core Principles for Effective Banking Supervision*, the permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word 'bank' in names should be controlled as far as possible. The requirements are clearly set by the Banking Supervision Law and the Commercial Banking Law that no institution or individual may engage in commercial banking business and no institution may use the word 'bank' in its name without approval of the CBRC.<sup>226</sup>

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<sup>223</sup> Zhou (n 192) 55.

<sup>224</sup> *ibid.*

<sup>225</sup> Banking Supervision Law 2003, art 22.

<sup>226</sup> Banking Supervision Law 2003, art 19; Commercial Banking Law 2003, art 11.

In addition to those permissible activities stipulated in the Commercial Banking Law of 1995,<sup>227</sup> upon approval of the PBOC, commercial banks may engage in the business of the settlement and sale of foreign exchange.<sup>228</sup>

The 2003 Commercial Banking Law makes several critical amendments regarding business scope in comparison to the Commercial Banking Law of 1995.<sup>229</sup> Under the 1995 Commercial Banking Law, a bank was required to provide loans for special projects approved by the State Council, and losses arising from the loans were compensated with appropriate measures taken by the State Council.<sup>230</sup> This provision was often criticized as a non-market-based practice. Therefore, the Commercial Banking Law of 2003 deletes this provision and the loan types are left to policy banks. The maximum time for lending and borrowing inter-bank loans did not exceed four months in the Commercial Banking Law of 1995.<sup>231</sup> However, the 2003 Commercial Banking Law leaves the time limit to the decision of the PBOC.<sup>232</sup> Given that it would be time consuming to real estate and equity, the Commercial Banking Law of 2003 extends from one year to two years the time period within which a bank must dispose of the real estate and equity acquired from the execution of mortgage and pledge.<sup>233</sup> According to the Commercial Banking Law of 1995, a bank is prohibited from investing in trusts, stock, real estate, non-financial institutions and enterprises.<sup>234</sup> However, the Commercial Banking Law of 2003 provides that no commercial banks may engage in trust investments or securities business, or

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<sup>227</sup> Commercial Banking Law 1995, art 3.

<sup>228</sup> Commercial Banking Law 2003, art 3.

<sup>229</sup> Zhou (n 193) 73.

<sup>230</sup> Commercial Banking Law 1995, art 41.

<sup>231</sup> Commercial Banking Law 1995, art 46.

<sup>232</sup> Commercial Banking Law 2003, art 46.

<sup>233</sup> *ibid* art 42.

<sup>234</sup> Commercial Banking Law 1995, art 43.

invest in immovable property except where otherwise provided for in the regulations of the State,<sup>235</sup> which leaves the possibility of permitting commercial banks to conduct non-banking activities, in response to strong calls to relax the grip on the cross-industry activities of banks.<sup>236</sup>

Based on the statutory business scope, a bank can specify its own business activities in the articles of association and submit them to the CBRC for approval.<sup>237</sup> With regard to the types of services within the approved business scope, the Banking Supervision Law requires a bank to obtain CBRC approval or submit information concerning these services to the CBRC for their records.<sup>238</sup>

#### **4.5.3.2 Prudential standards**

Although it is important to have a strict licensing process which provides a possibility to decrease the amount of unstable institutions that enter the banking system and prevent inexperienced people from operating banking institutions, it cannot ensure that a bank will be operated in a safe and sound manner. To a large extent, the safe and sound operations of a bank rely on prudential regulation and supervision. Prudential regulation and supervision covers legal, administrative and non-legally binding rules or standards

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<sup>235</sup> Commercial Banking Law 2003, art 43.

<sup>236</sup> Zhou (n 193) 73.

<sup>237</sup> Commercial Banking Law 2003, art 3.

<sup>238</sup> Banking Supervision Law 2003, art 18. Prior to the promulgation of the Banking Supervision Law, the CBRC released the Decision on Adjusting Bank Entry and Procedures in May 2003. Subject to the Decision, a domestic commercial bank that wishes to conduct the following businesses is no longer required to obtain prior approval from the CBRC when: (1) factoring services to domestic traders; (2) clearing services for securities transactions as an agent; (3) insurance businesses as an agent; (4) custody of investment accounts assigned to securities firms by institutional investors; (5) custody of trust assets; and, (6) custody of annuity accounts of an enterprise. A domestic commercial bank that sought to conduct the following businesses was no longer required to file with the CBRC to record: (1) discount of negotiable instruments with interest paid by the purchaser or by the party designated under the contract; (2) overdraft services to legal entities; and, (3) collection of proceeds from sales of trust products. A foreign-funded bank that wants to conduct the following businesses is no longer required to file with the CBRC to record: (1) factoring services to domestic traders; (2) discount of negotiable instruments with interest paid by the purchaser or by the party designated under the contract; and, (3) overdraft services to legal entities.

established by legislature, competent authorities and international organizations.<sup>239</sup> Specifically, prudential regulation includes capital adequacy requirements, large exposure and connected lending limits and provisioning, while prudential supervision is defined as consisting of on-site examination and off-site examination.

#### **4.5.3.2.1      *Capital adequacy***

Over the last several decades, regulators, at national, regional and international levels, have made efforts to strengthen capital adequacy regulation due to the importance of capital adequacy to bank safety and soundness.<sup>240</sup> Because of the long-term problems intrinsic to banks and the lack of effective supplementary rules, the capital adequacy level of Chinese banks has not significantly increased even though the Commercial Banking Law of 1995 stipulated the eight percent capital adequacy requirement.<sup>241</sup> However, the issue of capital adequacy has attracted continuous attention from the Chinese banking regulator and banks.

Along with the significance of capital adequacy regulation to safety and soundness of the whole banking system realised by China, the revised Commercial Banking Law in 2003 reconfirms that a bank should maintain a minimum capital adequacy ratio of 8 percent in issuing a loan. Nevertheless, this requirement excludes all on- and off-balance sheet activities of a bank.<sup>242</sup> To remedy this defect, the CBRC promulgated the Measures on Administration of Capital Adequacy of Commercial Banks (referred to as Capital Adequacy Measures) in February 2004,<sup>243</sup> which adopts the basic framework and main

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<sup>239</sup> Zhou (n 192) 58.

<sup>240</sup> Zhou (n 193) 11.

<sup>241</sup> Zhou (n 192) 58.

<sup>242</sup> Zhou (n 193) 114.

<sup>243</sup> The Capital Adequacy Measures was amended in December 2006.

contents of Basel II and the Amendments to the Capital Accord to Incorporate Market Risks issued by the Basel Committee on Banking Supervision in January 1996.<sup>244</sup>

According to the Capital Adequacy Measures, the capital adequacy ratio refers to the ratio between a bank's eligible capital and risk weighted assets.<sup>245</sup> The Capital Adequacy Measures clearly state that a bank's capital should cover credit risk and market risk,<sup>246</sup> without taking into consideration operational risk.

The classification and definition of capital, and the approach to calculating risk weights and risk-weighted assets are essentially similar to those in the Basel capital documents.<sup>247</sup>

Under the Capital Adequacy Measures, banks must comply with the requirement to maintain a minimum capital adequacy ratio of 8 percent and a minimum core capital adequacy ratio of 4 percent.<sup>248</sup>

Pursuant to the Capital Adequacy Measures, a bank should calculate its capital adequacy ratio on an unconsolidated and consolidated basis separately. The following institutions are included in consolidated capital adequacy ratio:<sup>249</sup>

1) a financial institution in which over 50 percent of whose interest capital is held directly by the bank, or by the bank's wholly-owned subsidiary, or jointly by the bank and its wholly-owned subsidiary;

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<sup>244</sup> Zhou (n 193) 114.

<sup>245</sup> Capital Adequacy Measures, art 2.

<sup>246</sup> *ibid* art 5.

<sup>247</sup> Zhou (n 192) 59.

<sup>248</sup> Capital Adequacy Measures, art 7.

<sup>249</sup> *ibid* art 10.

2) a financial institution where the bank does not hold over 50 percent of the interest capital, but there exists as one of the following cases: (a) more than 50 percent of its voting rights are held by the bank and other investors through an agreement; (b) its financial and operational policies are controlled by bank according to its articles of association or agreements; (c) the majority of members of the board of directors or similar decision-making bodies are appointed and removed by the bank; or, (d) more than 50 percent of the voting rights on the board of directors and similar decision-making bodies are held by the bank.

While the following financial institutions are not included in consolidated capital adequacy ratio:<sup>250</sup>

- (1) a financial institution that has been closed or declared bankrupt; (2) a financial institution that goes into a liquidation process due to its termination;
- (3) a financial institution, more than 50 percent of whose interest capital is held temporarily by the bank and will be sold in a year; and, (4) an overseas financial institution subsidiary whose fund allocation is affected by the host country's exchange restrictions and unexpected events.

Information disclosure regarding capital adequacy in the Capital Adequacy Measures includes objectives and policies of risk management, scope of consolidated accounts, capital, capital adequacy, credit risks and market risks.<sup>251</sup> Appendix 5 of the Capital Adequacy Measures specifically set forth items that must be disclosed. The board of

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<sup>250</sup> *ibid.*

<sup>251</sup> *ibid* art 43.

directors is responsible for information disclosure, and the board must approve the contents of information disclosure in advance.<sup>252</sup>

To comply with Basel II, the Capital Adequacy Measures also focus on the importance of the banking regulator's supervisory review of the capital adequacy of banks.<sup>253</sup> The board of directors undertakes the ultimate responsibility for capital adequacy management, while senior management is responsible for implementing capital adequacy policies.<sup>254</sup> Under the Capital Adequacy Measures, a bank is required to report to the CBRC its consolidated capital adequacy ratio semi-yearly and unconsolidated capital adequacy ratio on a quarterly basis.<sup>255</sup> The CBRC should conduct an on- and off- site examination of capital adequacy, emphasizing on:<sup>256</sup>

(1) policies and procedures with regard to capital adequacy; (2) credit planning for maintaining adequacy capital levels and capabilities and instruments to monitor capital levels; (3) credit risks and market risk levels; and, (4) compliance with the Capital Measures relating to the trading book and item valuation.

The *Guidance on the Disclosure of Capital Adequacy Ratio of Commercial Banks* was (hereinafter referred to the Guidance) released on December 16 2009 and came into force on January 1 2011.<sup>257</sup> According to the Guidance, a bank is required to publish, in good time, the changes in paid-in or common equity and other capital instruments, to disclose

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<sup>252</sup> *ibid* art 42.

<sup>253</sup> Zhou (n 193) 124.

<sup>254</sup> Capital Adequacy Measures, arts 33 and 34.

<sup>255</sup> *ibid* art 35.

<sup>256</sup> *ibid* art 36.

<sup>257</sup> Guidance on the Disclosure of Capital Adequacy Ratio of Commercial Banks, <<http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=20091216826F7C3783BCBBAAFF98666191E7FD00>> accessed 20 August 2010.

quarterly information about core capital ratio, supplementary ratio and capital adequacy ratio, and to publish semi-annually information about consolidation scope, credit risk exposure, and non-performing loan information, changes of loan loss provisions, risks in asset-backed-securities, and information about market risks and operational risks.<sup>258</sup>

#### **4.5.3.2.2      *Large exposure and connected lending limits***

The excessive concentration of risks has been well documented as a cause of bank failure; therefore many banking laws stipulate formal limits for risk concentration.<sup>259</sup> The Basel Committee's Core Principles Methodology also requires supervisors to set prudential limits to restrict a bank's exposure to single counterparties or groups of connected counterparties.<sup>260</sup> In China, the Commercial Banking Law of 2003 provides that the ratio of the balance of loans to a single borrower and the bank's capital may not exceed 10 percent.<sup>261</sup>

However, there are several weaknesses related to the lending limit in the Commercial Banking Law of 2003.<sup>262</sup> First, the Commercial Banking Law of 2003 restricts risk-concentration control only to loans, excluding other on- and off- balance sheet activities.<sup>263</sup> Second, the Commercial Banking Law of 2003 does not define a single borrower. It leaves it unclear as to whether two or more borrowers who constitute a single risk can be treated as a single borrower.<sup>264</sup> Third, differing from large exposure regulations in other countries, which provide some exemptions from large exposure

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<sup>258</sup> *ibid* art 46.

<sup>259</sup> Zhou (n 193) 90.

<sup>260</sup> Basle Committee, *2006 Core Principles Methodology*, 20.

<sup>261</sup> Commercial Banking Law 2003, art 39 para 4 .

<sup>262</sup> Zhou (n 192) 62 and Zhou (n 193) 90.

<sup>263</sup> *ibid*.

<sup>264</sup> *ibid*.

controls according to borrowers and types of transactions, the Commercial Banking Law of 2003 brings all loans under the lending limit.<sup>265</sup> Fourth, the Commercial Banking Law of 2003 does not set up a mechanism for reporting large exposures.<sup>266</sup> Finally, the Commercial Banking Law of 2003 does not set the limits on the aggregate of all large exposures.<sup>267</sup>

In April 2004, the CBRC released the Measures on the Administration of Insider and Shareholder Connected Transactions of Commercial banks (hereinafter referred to as Connected Transaction Measures). The Connected Transaction Measures make several modifications to the Commercial Banking Law of 2003 related to risk concentration control. Pursuant to the Connected Transaction Measures, a connected transaction refers to a transfer of resources or obligations between a bank and its connected parties, including all on- and off- balance sheet activities.<sup>268</sup> Under the Connected Transaction Measures, the connected party is broadly defined to include connected natural persons, connected legal persons and other connected organizations.<sup>269</sup>

A connected natural person is defined to include:<sup>270</sup> (1) a person inside the bank;<sup>271</sup> (2) a bank's major natural person shareholder;<sup>272</sup> (3) close relatives of an insider person and major natural person shareholder; (4) a controlling natural person shareholder, director,

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<sup>265</sup> *ibid.*

<sup>266</sup> Zhou (n 192) 62.

<sup>267</sup> Zhou (n 193) 91.

<sup>268</sup> Those activities include credit extensions, asset transfers, provision of services and connected transactions prescribed by the CBRC. See Connected Transaction Measures, art 18.

<sup>269</sup> *ibid* art 6.

<sup>270</sup> *ibid* art 7.

<sup>271</sup> An insider person refers to a bank's director, senior management of the head office and branches, and other staff who have the power to choose or participate in granting credit and transferring assets. See *ibid*

<sup>272</sup> A major natural person shareholder is defined as a shareholder who holds or controls 5 percent or more of a bank's shares or voting rights. See *ibid*.

key management personnel of a connected legal person or other organization of a bank;<sup>273</sup> or, (5) other natural persons having material influence on a bank.

Connected legal persons or other organizations refer to:<sup>274</sup> (1) a bank's major non-natural person shareholders; (2) legal persons or other organizations controlled directly or indirectly by enterprise that also controls the bank;<sup>275</sup> (3) legal persons or other organizations controlled directly, indirectly or jointly or materially influenced by a bank's insider persons, major natural shareholders and their close relatives; and, (4) other legal persons or organizations directly, indirectly or jointly controlling or having material influence on a bank.

Under the Connected Transaction Measure, the granting of credit by a bank to a connected party shall not exceed 10 percent of the bank's capital, while granting credit to a group customer to which a connected legal person or organization belongs shall not exceed 15 percent of the bank's capital.<sup>276</sup> In Chinese banking Laws, some related borrowers who constitute a single risk are not regarded as a single borrower.<sup>277</sup> Therefore, granting credit to a group borrower, under which there are connected parties constituting a single risk, should be subject to the 10 percent risk concentration limit.<sup>278</sup>

The internal auditing department of a bank is required to conduct a special auditing of connected transactions every year and to report the auditing result to the board of

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<sup>273</sup> Connected legal persons or other organizations in this article do not include a bank's insider persons, major natural person shareholders, and legal persons or other organizations directly, indirectly or jointly controlled by or on which material influence may be exerted by their close relatives. See *ibid.* In the Connected Transaction Measures, legal person and other organizations do not include a commercial bank. See *ibid* art 8.

<sup>274</sup> *ibid* art 8.

<sup>275</sup> The term 'enterprise' does not include a state-owned asset management company. See *ibid.*

<sup>276</sup> Connected Transaction Measures, art 32.

<sup>277</sup> Zhou (n 193) 98.

<sup>278</sup> *ibid.*

directors and the supervisory board of the bank.<sup>279</sup> The board of directors must report matters of connected transactions to the general shareholders' meeting annually and to the CBRC on a quarterly basis.<sup>280</sup> According to the Connected Transaction Measures, a bank should disclose matters with regard to connected transactions in the notes of its accounting statements, including the relationship between a connected party and the bank itself, the basic information about a connected natural person and connected legal person, the bank's shares held by a connected party, the type and amount of connected transactions, and the pricing policies on connected transactions.<sup>281</sup> The CBRC especially requires a bank to individually disclose major connected transactions.<sup>282</sup>

#### **4.5.3.2.3      *Provisioning***

The Commercial Banking Law of 2003 prescribes a general rule on provisioning that a bank shall, in accordance with relevant State regulations set up adequate loan loss provisions in order to write off bad debts.<sup>283</sup> In April 2002, to help the implementation of the Guidelines of Risk-based Classification of Loans, the PBOC issued the Guidance on Provisioning for Loan Losses (hereinafter referred to as the Provisioning Guidance), which the CBRC still applies in assessing the provisioning level of banks.

Pursuant to the Provisioning Guidance, provisions for loan losses include general, special and specific provisions.<sup>284</sup> General reserves are set aside based on a certain percentage of the balance of the total loans and used for covering unidentified possible loan loss.<sup>285</sup> The

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<sup>279</sup> Connected Transaction Measures, art 35.

<sup>280</sup> *ibid* arts 36 and 37.

<sup>281</sup> *ibid* art 38.

<sup>282</sup> *ibid*.

<sup>283</sup> Commercial Banking Law 2003, art 57.

<sup>284</sup> Provisioning Guidance, art 2.

<sup>285</sup> *ibid*.

Guidance stipulates that a bank shall set aside the general provisions on a quarterly basis, and the general provisions may not be less than 1 percent of the year-end balance of total loans.<sup>286</sup>

Special provisions are set aside based on the ratio of the loss to the amount after the risk-based classification in line with the Guidelines of Risk-based Classification of Loans and used for covering special losses.<sup>287</sup> Banks may set aside special provisions on a quarterly basis according to the following criteria: the provision is set aside for loans to be watched by two percent, that for substandard loans by 25 percent, that for doubtful loans by 50 percent, and that for loss loans by 100 percent. Among them, provisions for losses of substandard and doubtful loans may be set aside with a range of 20 percent.<sup>288</sup>

Specific provisions are set aside covering losses out of risks of a state, region, an industry or a type of loans.<sup>289</sup> Specific provisions may be set aside by banks in their discretion on a quarterly basis by a percentage determined according to the specific risk scenario of loans of various types, probability of losses and historical experience.<sup>290</sup>

According to China's traditional practice, banks must comply with the regulation of the Ministry of Finance on loan loss provisions.<sup>291</sup> In February 2006, the Ministry of Finance formally announced the issuance of the Accounting Standards for Business Enterprises

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<sup>286</sup> *ibid.*

<sup>287</sup> *ibid.*

<sup>288</sup> *ibid* art 5.

<sup>289</sup> *ibid* art 2.

<sup>290</sup> *ibid* art 6.

<sup>291</sup> 'The Ministry of Finance issued the Accounting System of Financial Enterprises in 1993 and 2001 respectively. Different banks were permitted to apply the two different versions of the accounting system. The main difference between the 1993 and 2001 version was that, under the 1993 version, a bank did not need to set aside sufficient loan loss provisions even if the amount of NPLs was carried on the balance sheet, while the 2001 version required a bank to set aside sufficient loan loss provisions and to write off its profit or capital in the event of a deficiency in provisions. For example, four biggest state-owned banks used the 1993 version of the accounting system before 2003.' See Zhou (n 137) 66.

(ASBEs), which consists of a new Basic Standard and 38 specific ASBEs. These standards are substantially in line with the International Financial Reporting Standards and became mandatory for listed Chinese companies from 1 January 2007. The CBRC required the usage of the new standard with fair value accounting for all listed Chinese banks in 2007 and granted a one year transition period for other commercial banks, trusts, finance, leasing and money brokerage companies and a two year transition for rural banks and credit cooperatives.

#### **4.5.3.3 Supervisory and enforcement approach**

The CBRC monitors the operations of commercial banks and their branches through on-site inspections and off-site surveillance. If a banking institution is not in compliance with a regulation, the CBRC has the power to issue corrective and punitive measures, including imposition of fines, suspension of certain business activities, restrictions on distributions of dividends and other income and asset transfers, closure of the institution and other penalties.

##### **4.5.3.3.1 *On- and off-site examinations***

The CBRC is authorized to conduct on-site examinations of banks by the Commercial Banking Law of 2003 and the Banking Supervision Law.<sup>292</sup> Under the Commercial Banking Law of 2003, the CBRC has the power at any time to carry out inspection of and exercise supervision over the deposits, loans, settlements, and non-performing loans of

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<sup>292</sup> The PBOC shall have the power to inspect and supervise the commercial banks in accordance with the provisions of Articles 32 and 34 of the PBOC Law. See Commercial Banking Law, art 62.

banks.<sup>293</sup> Under the Banking Supervision Law, the CBRC shall conduct on-site examinations of the business activities and risk profiles of a commercial bank.<sup>294</sup>

The CBRC is authorised by the Banking Supervision Law to take the following measures to conduct on-site examinations: (1) to enter a bank for on-site examinations; (2) to interview staff members of a bank and require them to provide explanations about the matters under inspection; (3) to check and make copies of a bank's documents and materials related to the matters under inspection, and to seal up documents and materials that are likely to be removed, concealed or destroyed; and, (4) to examine the computer systems with which a bank controls its business data.<sup>295</sup>

The Banking Supervision Law also prescribes that on-site examination shall be subject to approval by the person in charge in the CBRC. For on-site examinations, there shall be no less than two examiners, who shall show their legal certificates and the written notification of examination.<sup>296</sup>

The CBRC shall conduct off-site supervision of the business activities and risk profiles of a bank, for which it shall establish an information system, and analyse and assess a bank's risk profiles.<sup>297</sup> Meanwhile, the CBRC has the power to require a bank to submit a balance sheet, profit statements, other financial accounting statements, statistical reports and information concerning business activities and management, as well as the audit reports prepared by certified public accountants.<sup>298</sup>

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<sup>293</sup> Commercial Banking Law 2003, art 62.

<sup>294</sup> Banking Supervision Law, art 24.

<sup>295</sup> Banking Supervision Law, art 34.

<sup>296</sup> *ibid.*

<sup>297</sup> Banking Supervision Law, art 23.

<sup>298</sup> *ibid* art 33.

Pursuant to the Banking Supervision Law, the CBRC shall establish a rating system and an early-warning mechanism for supervision over a bank in order to determine, on the basis of the rating and risk profile of a bank, the frequency and scope of on-site examinations as well as other measures to be taken.<sup>299</sup> In December 2005, the CBRC released the Internal Guidelines on Supervisory Ratings of Commercial Banks (Trial) (hereinafter referred to as the Guidelines on Supervisory Ratings) which came into force on 1 January 2006. The Guidelines on Supervisory Ratings apply to all commercial banks including Chinese commercial banks, foreign-owned banks and Chinese-foreign joint venture banks.<sup>300</sup> Under the Guidelines on Supervisory Ratings, the CAMELS are introduced. The components of capital adequacy, asset quality, earnings, and sensitivity to market risk except management consist of quantitative and qualitative factors. Pursuant to the Guidelines on Supervisory Ratings, composite and component ratings are assigned a rating scale ranging from 1 to 6. A rating of 1 is the highest rating signifies best performance, while a rating of 6 is the lowest rating and indicates worst performance.

Each component rating is the arithmetically-weighted sum of the rating of quantitative factors and qualitative factors, which carry a weight of 60 percent and 40 percent respectively.<sup>301</sup> A component score over 90 points inclusive is rated 1, 75 inclusive to 90 points rated 2, 60 inclusive to 75 points rated 3, 45 inclusive to 60 points rated 4, 30 inclusive to 45 points rated 5, and below 30 points rated 6.<sup>302</sup>

The composite score is the sum of the weighted scores of six components, in which the weighted score of each component is first gained by multiplying each component score

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<sup>299</sup> *ibid* art 27.

<sup>300</sup> Guidelines on Supervisory Ratings, ch1, para 2.

<sup>301</sup> *ibid* ch 2, para 7(1).

<sup>302</sup> *ibid*.

by its corresponding weight.<sup>303</sup> The six components have different weights so as to assign a composite rating. Capital adequacy has a weight of 20 percent, asset quality 20 percent, management 25 percent, earnings 10 percent, liquidity 15 percent, and sensitivity to market risk 10 percent.<sup>304</sup> When the capital adequacy of a bank is below 8 percent, its composite rating should not be more than 3. When the capital adequacy of a bank is declining and is below 8 percent, its composite rating should not be more than 4.<sup>305</sup> A composite score of 90 inclusive to 100 points is rated 1, 75 inclusive to 90 points rated 2, 60 inclusive to 75 points rated 3, 45 inclusive to 60 rated 4, 30 inclusive to 45 points rated 5, and below 30 points rated 6.<sup>306</sup>

In addition to the six components, examiners shall consider other factors to give an overall assessment of a bank.<sup>307</sup> Other factors include the external environment of the bank, controlling shareholders of the bank, clientele base and market share of the bank, administrative investigations, lawsuits and legal penalties in which the bank and its connected parties are involved, ratings given by international and domestic rating agencies, and news reports about the bank.<sup>308</sup> To increase the accuracy of supervisory ratings, examiners shall make a positive or negative adjustment to a composite rating according to the nature of these factors and their effects on the bank's risk profile.<sup>309</sup> However, other factors do not change the composite rating of the bank.

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<sup>303</sup> *ibid* ch 2, para 7(2).

<sup>304</sup> *ibid*.

<sup>305</sup> *ibid*.

<sup>306</sup> *ibid*.

<sup>307</sup> Zhou (n 193) 151.

<sup>308</sup> Guidelines on Supervisory Ratings, ch 2, para 8.

<sup>309</sup> Guidelines on Supervisory Ratings, ch 2, para 8(2) .

#### **4.5.3.3.2      *Prompt corrective action***

The PCA system is incorporated into the Chinese banking regulatory and supervisory process by the Capital Adequacy Measures.<sup>310</sup> According to the Capital Adequacy Measures, banks are classified into three categories based on their capital adequacy levels, including adequately capitalized banks whose total capital adequacy ratio is not lower than 8 percent and core capital adequacy is not lower than 4 percent, under-capitalized banks whose total capital adequacy ratio is lower than 8 percent and core capital adequacy is lower than 4 percent, and significantly undercapitalized banks whose total capital adequacy ratio is lower than 4 percent and core capital adequacy is lower than 2 percent.<sup>311</sup>

To prevent the capital of an adequacy capitalized bank from falling below the minimum level, the CBRC shall take the following intervening measures:<sup>312</sup> (1) require the bank to improve its rules and systems of risk management; (2) require the bank to improve its ability to control risks; (3) require the bank to strengthen analysis and forecast of capital adequacy; and, (4) require the bank to make a feasible and practical capital maintenance plan and restrict the bank from engaging in particular high-risk activities.

For undercapitalized banks, the CBRC shall take the following corrective measures:<sup>313</sup> (1) issue a supervisory letter, specifying the description of capital adequacy situation of the bank, corrective measures to be taken and detailed plan for carrying out the corrective measures; (2) require the bank to make a feasible and practical capital restoration plan within two months of receiving the CBRC's supervisory letter; (3) require the bank to

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<sup>310</sup> Zhou (n 192) 60.

<sup>311</sup> Capital Adequacy Measures, art 38.

<sup>312</sup> *ibid* art 39.

<sup>313</sup> *ibid* art 40.

restrict its asset growth; (4) require the bank to reduce the size of risky assets; (5) require the bank to restrict the purchase of fixed assets; and, (6) impose more stringent requirements or limitations on a bank's expansion of institutions and activities.

In addition to the measures above, the CBRC has the power to impose limitations on distribution of dividends and other returns, suspend all but low-risk activities, and refuse the bank's application to establish new institutions and activities according to the bank's risk levels and implementation of the bank's capital restoration plan.<sup>314</sup>

For significantly undercapitalized banks, the CBRC can impose two additional measures in addition to the corrective measures taken against an undercapitalized bank: (1) require the bank to reshuffle its senior management; and, (2) appoint a conservator for the bank, whose task is facilitating the bank's reorganization or even closing the bank.<sup>315</sup>

Other enforcement measures in China can consist of two categories including sanctions against banking institutions and bank officers and employees. Where banking institutions appoint directors or senior managers without subjecting their qualifications for the position to examination; refuse to accept or obstruct off-site supervision or on-site examination; provide statements, reports, documents or materials that are false or conceal important facts; fail to disclose information to the public; violate the rules of prudent operation to a serious extent; refuse to enforce the measures required by the Banking Supervision Law or the CBRC; violate the provisions of laws, administrative regulation on banking regulation and supervision, the CBRC may issue fines in different amounts depending on the seriousness of circumstances; impose disciplinary sanctions on or

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<sup>314</sup> *ibid.*

<sup>315</sup> *ibid* art 41.

disqualify directors and senior managers according to the performance of their duties; and suspend or revoke the institution's banking license.<sup>316</sup>

If bank's officers or employees act in an unlawful manner, such as taking advantage of their duties to demand, receive or accept bribes, embezzle, misappropriate or take into their possession money belonging to the bank or any client, neglect their duties in violation of the provisions of the Commercial Banking Law, violate regulations by practicing favouritism towards their relatives or friends in granting loans or providing guaranty, they shall be responsible for administrative penalties or criminal charges.<sup>317</sup>

The CBRC shall terminate the measures against the bank within three days after the CBRC accepts it as conforming to the rules of prudential operation.<sup>318</sup>

However, the law does not stipulate the period during which a bank can rectify its problems. Nor does the law provide how the CBRC shall deal with a bank that does not satisfy the prudential rules after taking corrective measures.<sup>319</sup>

## 4.6 Conclusions

Soon after China's accession to the WTO, SOCBs went through a period of substantial reform. In this chapter, I focused on the reform of the corporate governance regime and also examined major pieces of legislation and other institutional changes pertaining to the SOCBs. First, a comprehensive legal framework for bank regulation and supervision has

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<sup>316</sup> See Banking Supervision Law, arts 45, 46 and 47; Commercial Banking Law 2003, arts 77, 78 and 80

<sup>317</sup> Commercial Banking Law 2003, arts 84-9.

<sup>318</sup> Banking Supervision Law, art 37.

<sup>319</sup> Zhou (n 192) 73.

been set up, which has moved from an administrative regulatory framework to an increasingly transparent legal framework. This is part of the liberalization process of the normative approach to banking regulation, which, for example, includes structural regulation and conduct regulation alleviation. It is of great significance for the focus of the prudential regulation and supervision to move from rule compliance to risk control. The banking regulatory and supervisory system, which was established in 2003, has made an important progress in upgrading China's banking supervisory standards and norms in order to improve the efficiency of the banking supervisory. Secondly, four state-owned commercial banks have been transformed into shareholding companies and have become listed companies. Compared with the previous banking system under the close control of the authorities without the influence of the global financial market, the efforts made, in which the boards and management of the banks have to respond to the interests of their owners rather than act as agents of state policy under ownership and governance changes, represent a significant narrowing of the differences between the Chinese banking system and the world banking system. Thirdly, the 'Big four' now have a system more closely modelled on modern banking operations, with institutional structures and practices increasingly in accordance with international norms.

The current banking regulatory and supervisory regime reflects the role of the government in Chinese society. In other words, the government may exert its control over the Chinese financial institutions, especially the SOCBs after the shareholding reform. However, the Chinese government has changed its direct control over banks to a system that utilises prudential regulation.

## **CHAPTER FIVE**

### **ISSUES IN THE SOCBs AFTER CORPORATIZATION AND THE INSTITUTIONAL STRUCTURE OF BANKING REGULATION IN CHINA**

#### **5.1 Introduction**

The preceding two chapters presented the evolution of corporate governance in China's SOCBs. Despite all the great efforts made and their seemingly successful corporatization and listing, problems still exist in the SOCBs' corporate governance.

This chapter makes an in-depth analysis on specific areas that are crucial to the development of sound corporate governance in the Chinese SOCBs, including ownership structure, Party Committee and the institutional structure of banking regulation. This chapter first analyses the characteristics of the ownership of the SOCBs. It then analyses the existing problems and feasible alternatives to future ownership reform. The next part discusses the special committee, namely the Party Committee, which exercises decisive influence over the governance of the banks and the directors. Following this will be discussion of the current Chinese banking regulatory framework in detail. A more detailed discussion of the problems facing Chinese banking regulatory framework will then be presented; according to China's local conditions, it then sets forward an appropriate agenda for reform of China's banking regulatory structures. Finally, conclusions are presented.

## 5.2 Ownership reform in SOCBs: Chinese approach

The entire SOCB ownership reform process was carried out in accordance with three steps. First, to further reform the SOCBs as well as to secure the financial stability and the economic growth, the Chinese government embarked on financial restructuring in the SOCBs. This included balance sheet restructuring through recapitalization and the disposal of NPLs.<sup>1</sup> Second, in the mid-2000s, the Chinese government fundamentally changed the ownership structure of SOCBs from solely state-owned to a diversified basis through the introduction of strategic investors and Huijin, which represents the Chinese state in order to achieve a sound corporate governance mechanism.<sup>2</sup> Third, since 2005, the Chinese government has pushed the SOCBs to go public in order to strengthen the market controls for banks.<sup>3</sup>

The main purpose of the scheme was to change the ownership structure of the SOCBs fundamentally, from solely state-owned one to a diversified position including the state, domestic and international strategic investors, and the public.<sup>4</sup>

### 5.2.1 Characteristics of the ownership reform

There are two particular characteristics that can be observed in the ownership reform of the SOCBs.<sup>5</sup>

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<sup>1</sup> See details in ch 4. See also Berry F.C. Hsu, Douglas Arner and Qun Wan, 'Financial Restructuring and China's Asset Management Companies' in James R Barth, Zhongfei Zhou, Douglas W Arner, Berry F.C. Hsu and Wei Wang (eds), *Financial Restructuring and Reform in Post-WTO China* (Kluwer Law International 2007) 124.

<sup>2</sup> See details in ch 4.

<sup>3</sup> Violaine Cousin, *Banking in China* (Palgrave Macmillan 2011) 13.

<sup>4</sup> Sun (n 5) 154.

<sup>5</sup> This part is based on the research by Wei Sun, 'China's Banking Reform: A Corporate Governance Perspective' (DPhil thesis, University of Leeds 2007) 154.

The first characteristic is that the nature of ownership has not changed dramatically. Although the overwhelming state ownership of the SOCBs has been broken through partial privatisation, the state nevertheless continues to play multiple roles: investor, manager and supervisor.<sup>6</sup> Notwithstanding recapitalisation, corporatization and listing, state shareholders remain dominant in ownership and have absolute control in the SOCBs.<sup>7</sup> Moreover, China imposes an upper ceiling on foreign shareholders in domestic banks; specifically, foreign ownership of each bank must be less than 20 percent with each investor less than 10 percent. Only a small portion of the equity in the banks has been sold to private investors after listing.<sup>8</sup> Therefore, the state maintains control in the SOCBs while non-state investors are permitted to contribute to the SOCBs through minority shareholding.<sup>9</sup> Consequently, it is possible for the state to control more social assets with relatively less state assets.<sup>10</sup>

For state-owned banks, the state acts simultaneously as both a principal and an agent. With such large ownership stakes, the state can appoint and withdraw managers.<sup>11</sup> The state also affects daily operations and strategic decisions because of the loyalty of managers to the Party.<sup>12</sup> Furthermore, the state is assured in its ability to control management and operations at all times due to the strong involvement of shareholders

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<sup>6</sup> Cousin (n 3) 205.

<sup>7</sup> Nicholas Calcina Howson, 'China's Restructured Commercial Banks: Nomenkla Accountability Serving Corporate Governance Reform' in Min Zhu, Jinqing Cai and Avery Martha (eds), *China's Emerging Financial Markets: Challenges and Global Impact* (John Wiley & Sons 2009) 136.

<sup>8</sup> Sun (n 5) 154.

<sup>9</sup> *ibid.*

<sup>10</sup> *ibid.*

<sup>11</sup> Cousin (n 3) 209.

<sup>12</sup> *ibid.*

required by Chinese regulations.<sup>13</sup> The state is both an outsider and insider at the same time.<sup>14</sup>

The listed SOCBs have incorporated strategic investors that are all leading global financial institutions.<sup>15</sup> The apparent purpose of introducing foreign strategic investors into the SOCBs is not financial, but rather to help the banks strengthen internal controls and develop modern management systems.<sup>16</sup> However, the minority shareholders in practice have little ability to determine the behaviour and strategy of the controlling shareholder, and this is even more the case for insiders as the controlling shareholder formally appoints them.<sup>17</sup> Under the state-dominated capital structure of the SOCBs, it is true that minority shareholders effectively have no power to monitor or change director fiduciaries.<sup>18</sup> Thus, it is doubtful whether the foreign strategic investors could effectively act in their original roles and functions because of their low ownership shares and limited management involvement.<sup>19</sup> This situation is hard to change in the short term due to China's current economic and political environment.

The second characteristic is that top-down administrative directives, rather than market rules, have played a dominant role in the ownership restructuring of the SOCBs.<sup>20</sup> The Chinese authorities, such as the State Council, the National Development and Reform

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<sup>13</sup> *ibid.*

<sup>14</sup> Jinwen Lu, 'The Structure of Corporate Governance in SOCBs and Preventing Moral Hazard' (2004) 124(16) *Journal of Sun Yatsen University* 219.

<sup>15</sup> Wai-chung Lo and Michael C.M.NG, 'Banking Reform and Corporate Governance' (2009) 42 *The Chinese Economy* 27.

<sup>16</sup> *ibid.*

<sup>17</sup> Howson (n 7) 137.

<sup>18</sup> *ibid.*

<sup>19</sup> Lamin Leigh and Richard Podpiera 'The Rise of Foreign Investment in China's Banks—Taking Stock' (2006) IMF Working Paper WP.06/292, 7 <<http://www.imf.org/external/pubs/ft/wp/2006/wp06292.pdf>> accessed 10 May 2008.

<sup>20</sup> Sun (n 5) 155 Administrative directives mean regulations issued by Chinese central authorities such as the State Council, the NDRC and the CBRC.

Commission (NDRC) and the CBRC, have imposed a fixed timetable for the reform processes in order to ensure the success of the reform.<sup>21</sup> For example, the CBRC released the *Guidelines on Reform and Supervision of Corporate Governance for Bank of China and China Construction Bank* in 2004, which included both qualitative and quantitative targets, transforming two pilot banks into modern and internationally competitive shareholding commercial banks.<sup>22</sup>

### 5.2.2 Existing problems in the model of Huijin

The creation of Huijin was originally designated as a conduit to recapitalize the Bank of China and China Construction Bank with foreign reserves. It has now graduated into a solely state-owned investment arm of China's sovereign wealth fund, the China Investment Corporation. Following its investments in BOC and CCB, Huijin has acquired large strategic stakes in ICBC, ABC and other financial institutions.<sup>23</sup> The creation of Huijin has made a significant difference in terms of the governance of the SOCBs because it has become the legitimate residual claimant, which has been deemed as a solution in addressing the longstanding issue of the state ownership.<sup>24</sup> In addition, Huijin, as a commercially oriented shareholder, should play a larger role than the government agencies in disciplining and monitoring the SOCBs. It has a clear mandate to represent

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<sup>21</sup> *ibid.*

<sup>22</sup> *ibid.*

<sup>23</sup> Huijin has also acquired large strategic stakes in other banks (for example, Bank of Communications, Everbright, China Development Bank) and insurers (for example, China Reinsurance, New China Life and Sinosure).

<sup>24</sup> Sun (n 5) 84.

the owners of the SOCBs in exercising its rights and responsibilities, which seems a large step towards clarifying the property rights of the SOCBs.<sup>25</sup>

However, the model of Huijin has certain congenital defects. To begin with, Huijin was established rapidly without careful discussion or deliberation. It also has not received legal authorisation from the National People's Congress to manage the state assets.<sup>26</sup> Moreover, the status and nature of Huijin is confusing.<sup>27</sup> Although Huijin holds the majority of the shares in the SOCBs, it is unable to appoint staff to the SOCBs; instead, the right to appoint SOCB staff belongs to the Central Organization Department of the CPC.<sup>28</sup> In addition, the directors and supervisors at Huijin are appointed by and are accountable to the State Council.<sup>29</sup> As a result, civil servants from the PBOC, the State Administration of Foreign Exchange (SAFE) and the Ministry of Finance (MOF) assume the majority of the executives and directorial roles in the Huijin even though it is registered as an investment company.<sup>30</sup> However, the government-appointed board can lead to an institutional dilemma.<sup>31</sup> The government is the owner of the wholly state-

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<sup>25</sup> Yuanyuan Peng, *The Chinese Banking Industry: Lessons from History for Today's Challenges* (Routledge 2007) 11.

<sup>26</sup> *ibid.*

<sup>27</sup> *ibid.*

<sup>28</sup> *ibid.* Generally, Huijin recommends names of candidates to the Central Organization Department of the Communist Party of China for approval.

<sup>29</sup> See the website of Huijin, <[http://www.huijin-inv.cn/hjen/governance/governance\\_bod.html](http://www.huijin-inv.cn/hjen/governance/governance_bod.html)> accessed 11 May 2011.

<sup>30</sup> Peng Xi, 'On Capital Injection and Perfecting the Role of Huijin' (2006) 4 *Time Finance* (Chinese edition). The Board of Directors of Huijin consists of five people. Other than one Executive Board member who is from senior management, the others come from the PBOC, MOF and SAFE. The Supervisory Board is composed of three members who also from the above government institutions. See the website of Huijin, <[http://www.huijin-inv.cn/hjen/governance/governance\\_bod.html](http://www.huijin-inv.cn/hjen/governance/governance_bod.html)> accessed 11 May 2011. Directors and supervisors in Huijin coming from the PBOC, MOF and SAFE are in breach of Article 58 of Company Law, which provides that civil servants must not hold a concurrent post in any company. In addition, government officials from the PBOC undertake the roles of directors and supervisors in Huijin, violating Article 14 of PBOC Law that the governor, the vice governor and the employees in the PBOC must not hold a concurrent post in any financial institution, enterprise or foundation.

<sup>31</sup> Zhongfei Zhou and Jingwei Li, 'In Search of Approaches to Improving Corporate Governance in China's State-Owned Commercial Banks' (2002) 36 *International Lawyer* 215, 226.

owned Huijin, and therefore has the legal power to appoint the board. The board should be accountable to the government/owner and act in the best interest of the government/owner. Thus the government's administrative orders continue to be carried out by its appointed board and the board-appointed management.<sup>32</sup> The dilemma is that the supervisory board, acting in the interests of the government/owner, is authorised to supervise the government-appointed board and management. So when the board and management of Huijin carry out the government's will, the supervisory board must respect the bank's activity because this activity is in accordance with the interests of the government/owner.<sup>33</sup> As the real owner of the SOCBs, Huijin is unable to exercise its ownership rights while the government continues to carry out de facto ownership rights without bearing any residual risks. Due to its ambiguous status and insufficient power, it is difficult for Huijin to fully implement its function to effectively manage state assets.<sup>34</sup>

### **5.2.3 Further reform**

The dominance of state ownership is one of the strongest impediments to the sustainable establishment of corporate governance structures in SOCBs. One obvious long-term option is the accelerated privatisation of SOCBs. However, due to huge social costs and uncertainties, the SOCBs are not currently suitable for privatisation. A more politically realistic and commercially viable option is an increased proportion in the stakes of domestic and international strategic investors. Most importantly, it is imperative to strengthen the management capacity of state assets of Huijin.

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<sup>32</sup> *ibid.*

<sup>33</sup> *ibid.*

<sup>34</sup> Peng (n 25).

The main problem is that Huijin is a wholly state-owned investment company and has not become a true modern company. The management of Huijin is in fact composed of government officials. Government bureaucracy still inherently exists.

Future reform would make Huijin a pure financial holding company with clear corporate objectives, strong economic incentives, and delineated lines of responsibility.<sup>35</sup> Huijin is a long-term investor in SOCBs. Its main business activity would be to monitor management of the state assets of the SOCBs.<sup>36</sup> Its main income would be the dividends related to the investments in the SOCBs.<sup>37</sup> Thus, its economic interests would be closely in accordance with the performance of the SOCBs, which would provide strong incentives to actively monitor the SOCBs.<sup>38</sup>

Huijin would ‘specialise in asset management with possession of time, expertise and monitoring skills.’<sup>39</sup> As the major shareholder of the SOCBs, Huijin would enjoy the shareholders’ rights stipulated in the company law. It would ‘delegate day to day monitoring to the supervisory board.’<sup>40</sup> It could appoint ‘executive directors and non-executive directors to undertake bank specific monitoring on its behalf.’<sup>41</sup> It could place its own representatives who are accountable to Huijin on the supervisory board.<sup>42</sup> The supervisory board would exercise day-to-day monitoring activities on behalf of Huijin.

Huijin would owe duty of care, duty of loyalty and duty of good faith to the government due to the state-owned assets in the SOCBs. Monitoring the banks’ management of state-

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<sup>35</sup> This part is on the basis of the research by Zhou and Li. See Zhou and Li (n 31) 231-34.

<sup>36</sup> Zhou and Li (n 31) 232-34.

<sup>37</sup> *ibid.*

<sup>38</sup> *ibid.*

<sup>39</sup> *ibid.*

<sup>40</sup> Zhou and Li (n 31) 233.

<sup>41</sup> *ibid.*

<sup>42</sup> *ibid.*

owned assets, the duties owed to the government and the benefits produced to the company are all interrelated and therefore, the issue concerning who will monitor the monitor in the case of Huijin is less serious.<sup>43</sup> Its successful monitoring, thereby leading to good performance of a bank, would directly increase its economic income and vice versa. In addition, the government would have the power to withdraw its assets from the problematic Huijin. Therefore, Huijin would have limited incentives to breach fiduciary duties.

### 5.3 Party committee

Article 19, which is an often-ignored provision in the Company Law, provides that:

[A]n organisation of the Chinese Communist Party (CCP) shall be set up in a company to carry out party activities according to the Charter of the Chinese Communist Party and the company shall provide necessary conditions for the activities of the CCP organisation.<sup>44</sup>

Three committees exist in SOCBs, including senior management, the board of directors and the supervisory board, as well as another undisclosed committee, namely the Committee of CCP, which is the crucial decision-making organ within SOCBs.<sup>45</sup> The majority of the executives at SOCBs are members of the Party Committee.<sup>46</sup> The Party

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<sup>43</sup> *ibid.*

<sup>44</sup> Company Law 2005, art 19. The constitutionality of Article 19 is questionable because the PRC Constitution does not offer such special rights to CCP organisations and members. In essence, no individual or organisation, including any political party and its members, is privileged to be beyond the Constitution or other laws. See PRC Constitution, art 5.

<sup>45</sup> The Party Committee is widely discussed in Chinese writings and journalism about the corporatized commercial banks, but rarely referred to in foreign language writings and journalism.

<sup>46</sup> Richard He Huang and Gordon Orr, 'China's State-Owned Enterprises: Board Governance and the Communist Party' (2007) 1 McKinsey Quarterly.

Committee is headed by the Chairman of the Board, and the head of the Supervisory Board and the President serve as vice-secretaries of the Party Committee. The Party Committee is in charge of strategy, personnel appointments and corporate social responsibility.<sup>47</sup> The board of directors therefore has no more than the ability to rubber stamp the big decisions of the Party Committee in SOCBs.<sup>48</sup>

Howson cites an interview with the chairman of the Bank of Communications, who states that the Party Committee represents the interest of shareholders and submits certain proposals to the Board of Directors.<sup>49</sup> Furthermore, independent directors, acting in the interests of the bank, are also mainly named by the Party or the Organisation Department and they do not have a right to veto.<sup>50</sup> Thus, it is clear that all directors are accountable to the Party rather than the shareholders. The primary power of corporate law and the governance regime is in the hands of the Party Committee, which is quite different from the corporate form of international best practice. First, the controlling shareholder's interest is communicated through the company-level Party Committee, not via the shareholders' meeting. The Party Committee's proposals are communicated directly to the board of directors.<sup>51</sup> Moreover, the Party Committee recommends senior management candidates to the board of directors, who then approve candidates. Finally, the Party Committee causes the company to act in accordance with "satiability", "lawfulness", and

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<sup>47</sup> Howson (n 7) 141.

<sup>48</sup> Huang and Orr (n 46). See also Richard McGregor, *The Party: the Secret World of China's Communist Party* (Harper 2010).

<sup>49</sup> Howson (n 7) 142.

<sup>50</sup> Howson (n 7) 141.

<sup>51</sup> *ibid.*

national “macroeconomic measures” instead of the profit-making interest of the shareholders.<sup>52</sup>

However, the reality is that China is ruled by the CCP. Political control is one of the most important factors in shaping Chinese companies’ corporate governance practice. Therefore, the existence of the Party Committee in a company is an unavoidable issue that will continue to play an important role in companies for a long time. For SOCBs, the ideal option is to find a reasonable solution that does not affect the efficiency of corporate governance in assuming accountability by the Party Committee in corporate governance. The priority thus is to have a clear line of accountability and responsibility for the Party Committee in the corporate governance mechanism. It would be necessary for SOCBs to formulate the guidance of the Party Committee, have a clear line of accountability and responsibilities to the Party Committee and in relation with the board of directors, supervisory board and senior management, gradually set up a coordinative mechanism and a checks and balances mechanism between them with a positively interactive working mechanism. In brief, the boundary of the activities of the Party Committee would ensure that it does not damage the decision-making status of the board of directors in the company, which should be placed in a reasonable legal framework.

## **5.4 Institutional structure of banking regulation in China**

The healthy development and stability of the banking system is crucial to the success of China’s further economic and social transformation.<sup>53</sup> Therefore, it is imperative for

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<sup>52</sup> Howson (n 7) 142.

<sup>53</sup> Hui Huang, ‘Institutional Structure of Financial Regulation in China: Lessons from the Global Financial Crisis’ (2010) 1 *Journal of Corporate Law Studies* 220.

China's banking regulatory regime to be improved so as to meet the need of developing a more efficient banking system.<sup>54</sup> The banking regulatory framework is one of the most important external forces in shaping the behaviour of banks. One of Chinese banking restructuring programme is to institute a bank regulatory and supervisory framework.

#### **5.4.1 Regulatory authorities**

The PBOC and the CBRC are the two main supervisors of the banking sector in China.

##### **5.4.1.1 People's Bank of China**

The PBOC was established on December 1, 1948. In September 1983, the State Council decided to have the PBOC function as a central bank.<sup>55</sup> The 1995 PBOC Law legally confirmed the PBOC's central bank status.<sup>56</sup>

The PBOC is working under the leadership of the State Council. This means that the State Council has power over the final decisions of the PBOC and matters of approval rather than the central bank itself.<sup>57</sup> The PBOC needs to report its decisions concerning annual money supply, interest rates, exchange and other important issues to the State Council for approval.<sup>58</sup> The top management of the PBOC is composed of the governor and a certain number of deputy governors; the governor of the PBOC is appointed and removed from office by the President of the PRC.<sup>59</sup>

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<sup>54</sup> *ibid.*

<sup>55</sup> State Council, *Decision Regarding the Limiting of the People's Bank of China to the Function of Central Bank* 1983.

<sup>56</sup> PBOC Law 2003, art 2.

<sup>57</sup> See PBOC Law 2003, art 5.

<sup>58</sup> *ibid.*

<sup>59</sup> *ibid* art 10.

The PBOC is responsible for formulating and implementing monetary policy, preventing and resolving financial risks, and safeguarding financial stability.<sup>60</sup> The PBOC Law provides that the PBOC performs the following major functions: issuing and enforcing relevant orders and regulations; formulating and implementing monetary policy; issuing Renmibi and administering its circulation; regulating the inter-bank lending market and inter-bank bond market; administering foreign exchanges and regulating the inter-bank foreign exchange market; regulating the gold market; holding and managing the official foreign exchange and gold reserves; managing the State treasury; maintaining normal operation of the payment and settlement system; guiding and organizing the anti-money laundering work of the financial sector and monitoring relevant fund flows; conducting financial statistics, surveys, analysis and forecasts; participating in international financial activities in the capacity of the central bank; performing other functions specified by the State Council.<sup>61</sup> Until 1992, the PBOC was the sole supervisor for banking, securities and insurance. In October 1992, the China Securities Regulatory Commission (CSRC) was established and in April 1998, CSRC became the sole regulatory and supervisory authority for securities companies and markets. On November 18<sup>th</sup> 1998, the China Insurance Regulatory Commission was founded as the insurance supervisor.

The CBRC was set up in 2003 to take over the banking supervisory tasks of the PBOC, but it would be wrong to assert that the PBOC would no longer perform banking regulatory functions.<sup>62</sup> If financial institutions, entities and individuals engage in activities concerning deposit reserves, special loans, Renminbi, inter-bank loans, foreign

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<sup>60</sup> PBOC Law 2003, art 2.

<sup>61</sup> PBOC Law 2003, art 4.

<sup>62</sup> Zhoufei Zhou, 'Banking Regulatory Law Reforms in China: A Long Way to Go Towards International Standards' in James R. Barth, Zhongfei Zhou, Douglas Arner, Berry F.C. Hsu and Wei Wang (eds), *Financial Restructuring and Reform in Post-WTO China* (Kluwer Law International 2006) .

exchanges, bullion, exchequer, settlement and anti-money laundering, they are subject to regulation and supervision by the PBOC.<sup>63</sup> Under the leadership of the State Council, the PBOC has the power to conduct an overall examination of a banking financial institution if the banking financial institution runs into payment difficulty that would thereby cause financial risks.<sup>64</sup> The PBOC can recommend to the CBRC that it conducts examinations of banking financial institutions, based on the needs of the implementation of monetary policy and the maintenance of financial stability.<sup>65</sup>

#### **5.4.1.2 China Banking Regulatory Commission**

According to the *Decision on the Exercise of Regulatory and Supervisory Functions by the China Banking Regulatory Commission in Place of the People's Bank of China* adopted at the Second Session of the Standing Committee of the Tenth National People's Congress on April 26, 2003, the CBRC formally took over from the PBOC the function of regulation and supervision of banks, asset management companies, trust and investment companies, as well as other deposit-taking financial institutions under the leadership of the State Council.

The regulatory goals of the CBRC are to facilitate the lawful and sound operations of the banking industry and to maintain public confidence in the banking industry.<sup>66</sup> The main responsibilities of the CBRC include formulating supervisory rules and regulations governing the banking institutions; authorizing the establishment, changes, termination and business scope of the banking institutions; conducting on-site examination and off-site surveillance of the banking institutions and taking enforcement actions against rule-

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<sup>63</sup> *ibid.*

<sup>64</sup> PBOC Law 2003, art 32.

<sup>65</sup> *ibid* art 30.

<sup>66</sup> Banking Supervision Law 2006, art 3.

breaking behaviours; conducting fit-and-proper tests on the senior managerial personnel of the banking institutions; compiling and publishing statistics and reports of the overall banking industry in accordance with relevant regulations; providing proposals on the resolution of problematic deposit-taking institutions in consultation with relevant regulatory authorities; being responsible for the administration of the supervisory boards of the major state-owned banking institutions; and other functions delegated by the State Council.<sup>67</sup>

The CBRC focuses on narrowing the gap between Chinese and international banking practices, which involves addressing issues with regard to non-performing loans, credit risk management, capital adequacy, corporate governance and effective financial intermediation.<sup>68</sup> The most effective way to enhance its capacity is to liberalize and gradually open up the banking system.<sup>69</sup>

The CBRC comprises 15 departments, including the General Office, the Supervisory Rule and Regulations Department (Research Bureau), the Banking Supervision Department I which is responsible for the supervision of state-owned commercial banks and asset management companies, the Banking Supervision Department II which is responsible for the supervision of equity-holding commercial banks and city commercial banks, the Banking Supervision Department III which is responsible for the supervision of policy banks, postal savings institutions and foreign banks, the Non-Bank Financial Institutions Supervision Department which is responsible for the supervision of nonbank financial institutions excluding those conducting securities, futures and insurance

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<sup>67</sup> *ibid.*

<sup>68</sup> Cousin (n 3) 23.

<sup>69</sup> *ibid.*

businesses, the Co-operative Finance Supervision Department which is responsible for the supervision of rural and urban credit co-operatives, the Statistics Department, the Human Resources Department, the Publicity Department, the Staff Union Department and the Supervisory Boards Office.<sup>70</sup> In addition, it has three functional centres, namely, the information Centres, Training Centre and Internal Service Centre.<sup>71</sup>

The establishment of the CBRC, which marks the separation of the banking regulatory function from the PBOC, has had a positive effect on reforms of the Chinese banking system.<sup>72</sup> It is believed that the separation can raise the professional level of monetary policy and banking regulation and reduce conflicts of interests arising from multiple goals in supervision and monetary policy.<sup>73</sup>

One oft-repeated concern before the separation was that the PBOC would face a conflict of interest in performing both jobs. It has in the past been willing to use public money to save insolvent financial institutions. It is not appropriate for the PBOC, as China's central bank, to set interest rates in such a way as to protect a few major financial institutions, rather than to prevent inflation.<sup>74</sup>

Moreover,

The separation increased the focus on asset quality and risk management and on more technical matters. This could be witnessed clearly in recent years and

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<sup>70</sup> CBRC website, < <http://www.cbrc.gov.cn/english/info/yjhjj/index.jsp> > accessed 20 November 2011.

<sup>71</sup> *ibid.*

<sup>72</sup> Charles C.C. Chau, 'The New Watchdog for the Banking and Financial Industry in China: the China Banking Regulatory Commission' (2003) 18 *Journal of International Banking Law and Regulation* 335.

<sup>73</sup> *ibid* 337.

<sup>74</sup> *ibid.*

has been underlined by the healthy financial indicators in the overall banking system.<sup>75</sup>

#### **5.4.1.3 Other Regulatory Authorities**

In addition to the CBRC and the PBOC, banks are also subject to supervision and regulation by other regulatory authorities, including the State Administration of Foreign Exchange (SAFE), the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC). For example, in conducting foreign exchange business, banks are subject to the regulation of SAFE; in conducting fund custodian business, banks are subject to the regulation of CSRC; in conducting bank assurance business, banks are subject to the regulation of CIRC.<sup>76</sup>

In addition, other ministries have an influence on the banks' operating environment, including the Ministry of Finance which is responsible for enacting accounting and tax rules and the NDRC which is in charge of enterprises finance issues and industry policies.<sup>77</sup> Both departments are very powerful and have a paramount role in terms of defining future policies.<sup>78</sup>

#### **5.4.1.4 Multiplicity of regulators**

Along with the rising number of regulators involved, however, coordination costs and risks increase for the banking system.<sup>79</sup> 'There exists even the danger of unclear task-sharing between agencies and the missing responsibility for systemic important sectors

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<sup>75</sup> Cousin (n 3) 23.

<sup>76</sup> *ibid.*

<sup>77</sup> *ibid* 24.

<sup>78</sup> *ibid.*

<sup>79</sup> *ibid* 27.

uncovered in the regulatory scope.’<sup>80</sup> Differentiated supervision even acts as a barrier to development and innovation.<sup>81</sup>

The lesson is learned from the recent crisis that ‘the pure micro-level supervision and the pure focus on price stability cannot automatically guarantee financial system stability.’<sup>82</sup> In addition, it is necessary to unify the sectoral supervision of banking, securities and insurance to better close the loopholes in financial regulation and better supervise large sized and complex financial conglomerates.<sup>83</sup>

Caijing Magazine asserts that:

Cross-industry supervision has already been discussed in 2008. However, the outcome was only a superficial compromise to work at two regulatory levels: the first one including the Ministry of Finance, PBOC and NDRC, and the second one comprising the three commissions. The anchor coordinator is the PBOC. The agreed loose coordinating mechanisms (with no systematic format or defined responsibilities) and exchange of information cannot, however, close the loopholes in the financial regulation.<sup>84</sup>

Currently, the proposal for the establishment of a Financial Supervision Coordination Commission, which would unify the supervision of banking, securities and insurance, is under discussion by the top leadership. It would play a more active role in supervisory

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<sup>80</sup> *ibid* 22.

<sup>81</sup> Cousin (n 3) 24.

<sup>82</sup> Horst Leochel, Natalie Packham, and Helena Xiang Li, ‘International Banking Regulation and Supervision after the Crisis: Implications for China’ (EU-China BMT Working Paper Series No.013 December 2010).

<sup>83</sup> *ibid*.

<sup>84</sup> Caijing, ‘Macro-prudential Supervision “China policy”’ (28 September 2009) Caijing Magazine.

coordination, better close the loopholes in the financial regulation and improve supervision of large and complex financial conglomerates.<sup>85</sup>

### **5.4.2 Structural problems**

The following discussion focuses on the structural issues of Chinese banking regulation and supervision. As Huang points out, ‘the regulatory framework has a significant impact on the extent to which regulatory regimes are successful in achieving their objectives. Indeed, the current financial crisis has brought to the fore the importance of the financial supervisory structure.’<sup>86</sup>

It is necessary to create an effective regulatory structure. However, the effectiveness of a regulatory regime fundamentally relies on good laws and rules, and their enforcement.<sup>87</sup> Nevertheless, more appropriate structures may help regulators make and enforce substantive regulatory rules and consequently, the effectiveness of the regulatory regime would improve.

#### **5.4.2.1 Lack of regulators’ independence**

The banking regulators must be independent. They must be free from political interference as well as from regulatory capture by interest groups to ensure the institutional, personal and functional independence of supervisors.<sup>88</sup>

However, the lack of regulatory independence is a long-standing issue in China’s banking regulation. Although the relevant regulations and laws prescribe de jure independence,

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<sup>85</sup> Leochel, Packham and Li (n 82) 27.

<sup>86</sup> Huang (n 53) 231.

<sup>87</sup> *ibid.*

<sup>88</sup> Cousin (n 3) 25.

they do not guarantee de facto independence.<sup>89</sup> The PBOC Law and the Banking Supervision Law explicitly prohibit local governments, governmental departments at various levels, public organizations and individuals from interfering with the PBOC's and CBRC's discharge of functions.<sup>90</sup> However, both regulators, namely the PBOC and CBRC, which are established under the State Council and are subordinated to it, can never be entirely cut off their close relationship with the government.<sup>91</sup>

Although the PBOC Law attempts to preserve some measure of independence for the PBOC, it is in essence an administration with ministerial rank that works under the leadership of the State Council.<sup>92</sup> The PBOC has one governor and a certain number of deputy governors. Article 10 of the PBOC Law provides that the candidate for the governor of the PBOC shall be nominated by the Premier of the State Council and decided on by the National People's Congress; when the National People's Congress is not in session, the governor shall be decided by the Standing Committee of the National People's Congress and appointed or removed by the President of the PRC.<sup>93</sup> The Premier of the State Council directly appoints or removes the deputy governors of the PBOC.<sup>94</sup>

Under the PBOC Law, the PBOC shall, under the leadership of the State Council, independently implement monetary policies and perform its functions.<sup>95</sup> For some significant decisions, the PBOC is required to obtain approval from the State Council.

Article 5 of the PBOC Law prescribes that the People's Bank of China shall report its

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<sup>89</sup> *ibid* 26.

<sup>90</sup> PBOC Law 2003, art 7 and Banking Supervision Law 2006, art 5.

<sup>91</sup> Zhoufei Zhou, 'Banking Regulatory Law Reforms in China: A Long Way to Go Towards International Standards' in James R. Barth, Zhongfei Zhou, Douglas Arner, Berry F.C. Hsu and Wei Wang (eds), *Financial Restructuring and Reform in Post-WTO China* (Kluwer Law International 2006) 49.

<sup>92</sup> Huang (n 53) 234.

<sup>93</sup> PBOC Law 2003, art 10.

<sup>94</sup> *ibid*.

<sup>95</sup> PBOC Law 2003, art 7.

decisions to the State Council for approval concerning annual money supply, interest rate, foreign exchange rates and other important matters specified by the State Council before they are implemented.<sup>96</sup>

The CBRC, which is subject to the direct leadership of the State Council, may have less independence from the government. The State Council appoints all the chairpersons of the CBRC and they are accountable to the Premier.<sup>97</sup>

The authority of the CBRC is further dented by the state ownership taking the dominant position in the financial markets.<sup>98</sup> The presidents and other senior officers of the SOCBs, who are appointed by the State Council, have a dual role:

On the one hand, they are business persons in the sense that they work in the industry; on the other hand, they are government staff in the sense that they still have relevant administrative ranks and are subject to the administrative system.<sup>99</sup>

In other words, they are quasi-governmental officials. In the hierarchy of China's administrative system, they may even rank equally with the Chairman of the CBRC.<sup>100</sup> This feature has not much changed, even though the SOCBs are now public.<sup>101</sup> This has affected the authority of the CBRC.

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<sup>96</sup> PBOC Law 2003, art 5.

<sup>97</sup> Huang (n 53) 234.

<sup>98</sup> *ibid* 235.

<sup>99</sup> *ibid*.

<sup>100</sup> *ibid*.

<sup>101</sup> As the controlling shareholder, the state still has the power of appointment.

The PBOC and CBRC cannot be made fully accountable for their policies and actions, as a consequence of the strong influence exerted by the State Council.<sup>102</sup> Therefore, there is no doubt that China needs to tackle the issue of lack of regulatory independence. As Huang states, the lack of independence:

[M]akes it possible for the government to interfere with the financial regulatory system to the effect that decisions are made for political gain rather than in the interest of the nation. However, it is of little value to simply suggest that the various financial regulators be restructured and become fully independent in line with international norms-this is a prime example of something easier said than done. Consistently with China's economic reform policy itself, it is necessary to take a gradualist approach and make sure that the responses to the issue are measured. This will take time, as it involves not only standard legal and economic considerations, but also super-complex social and political factors, which will evolve as the economic reform progresses.<sup>103</sup>

#### **5.4.2.2 Challenges of mixed operation**

The Chinese regulatory structure is characterized by segregation in compliance with the current separation of banking from securities and insurance services.<sup>104</sup> Three different agencies perform regulation and supervision of banking, securities and insurance under the leadership of the State Council.<sup>105</sup>

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<sup>102</sup> Cousin (n 3) 27.

<sup>103</sup> Huang (n 53) 236.

<sup>104</sup> Loechel, Packham and Li (n 82) 27.

<sup>105</sup> *ibid.*

Over recent years, Chinese banks have grown increasingly complex. They have expanded their business scope to include areas such as leasing, trusts and the acquisition of other banks.<sup>106</sup> Moreover, financial conglomerates have emerged through shareholding structures, such as the China Everbright Group, CITIC Group and China PingAn Group, which involve a diversity of institutions operating in a range of different sectors, including banking, securities, insurance, trusts and asset investment.<sup>107</sup>

With the emergence of large multi-service financial conglomerates and complex cross-sector financial products, China's current regulatory structure has shown significant inadequacies in response to the changing financial landscape.<sup>108</sup>

First, China's current regulatory model is designed to meet the needs of the traditionally segmented financial markets. Each regulator emphasizes on its designated part of the financial system. This means that no single regulator has all of the information and authority necessary to monitor systemic risk.<sup>109</sup> With the development of financial modernization and innovation, this model of sectors-based with separate regulators for banking, securities and insurance is not suitable for the new financial landscape.

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<sup>106</sup> Cousin (n 3) 24. The *Administrative Rules for Pilot Incorporation of Fund Management Companies by Commercial Banks* 2005 marked the first trial of moving toward the integrating of other financial services like asset management with banking (on a trial basis on large SOCBs and then other strong joint-stock commercial banks). With the release of the *Pilot Administrative Measures for Commercial Banks to Make Equity Investment in Insurance Companies* in 2009, banks were further allowed to hold stocks in insurance, trust, financial leasing or consumer finance companies.

<sup>107</sup> See *ibid.* Article 43 of the Commercial Banking Law 2003 adds the clause 'unless the State Council provides otherwise' to the traditional prohibition on banks engaging in securities business activities. Article 6 of the Securities Law 2005 provides a similar clause 'unless the State Council provides otherwise'. Article 8 of the Insurance Law prescribes that insurance shall be segregated from banking, securities and trust sectors, unless it is otherwise provided for by the state.

<sup>108</sup> Huang (n 53) 239.

<sup>109</sup> Jing Bai, 'Research on China's Financial Regulatory Model' (April 2011) *Oriental Enterprise Culture* 6 (in Chinese).

Second, as Huang writes:

The mismatch between China's regulatory structure and the underlying market it regulates has increased the regulatory costs and more importantly, has led to overlaps and gaps in regulatory coverage.<sup>110</sup>

### **5.4.3 Recommendations for supervisory structure reforms**

In response to the problems with China's financial regulation, some have suggested that China should transfer immediately to the UK model by merging the CSRC, the CBRC and the CIRC into a single financial regulator.<sup>111</sup> But this suggestion does not adequately consider local Chinese conditions. China's financial sector is currently in the primary stage. China's financial markets are still largely segmented along the traditional banking, securities and insurance lines. An immediate and wholesale shift for China to the UK model would involve large costs and bring in financial chaos.<sup>112</sup>

Therefore, in the short term, China may maintain the regulatory model of one bank (the central bank or PBOC) and three commissions (regulatory commissions for banking, securities and insurance) but strengthen their coordination led by the PBOC and meanwhile improve financial regulation.<sup>113</sup> The Financial Supervisory Coordination Commission (FSCC) could be established to bring together regulators from across

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<sup>110</sup> Huang (n 53) 239.

<sup>111</sup> Bai (n 109) and Bo Jiang, 'Analysis on Financial Regulatory Models from the Perspective of Consolidated Operations' (2011) 7 Reform and Strategy (in Chinese).

<sup>112</sup> Bai (n 109) 7. The UK system of financial regulation is currently under radical reform. The new institutional structure is expected to be formalized by 2012. The FSA is to be abolished. The prudential supervisor, the Prudential Regulation Authority, will conduct the prudential regulation of deposit takers, insurers and some investment firms. The other authority, the Financial Conduct Authority, will be responsible for consumer protection in financial services and the regulation of business conduct and market regulation; it will also assume the responsibility for consumer credit regulation that is currently exercised by the Office of Fair Trading. See Eilís Ferran, 'The Break-up of the Financial Services Authority' (2011) 31 Oxford Journal of Legal Studies 455, 456.

<sup>113</sup> Wang Z, Luo Y, and Yang J, 'Comparative Research on Financial Mixed Operation Regulatory Model' (June 2011) Caikuai Yuekan 42 (in Chinese).

markets and other relevant agencies to coordinate and share information, and to identify gaps in regulation.<sup>114</sup> A standing committee within the Commission could be created, including the PBOC and three commissions, in order to promote efficiency and continuity. The FSCC could be authorized to supervise the consolidated operations of large financial groups.<sup>115</sup>

In the long term, China needs to create a unified financial supervisory agency so as to face the challenges of the ongoing process of financial innovation and modernization. A unified regulator is able to approach financial regulation based on a holistic perspective, avoid regulatory duplication and reduce costs.<sup>116</sup> However, the UK single regulator model has its own problems.<sup>117</sup> More importantly, as mentioned above, the UK system of financial regulation is currently under radical reform towards an “objectives-based regulation” model.<sup>118</sup> Therefore, the future development of China’s financial regulation should pay close attention to the latest international developments.

## 5.5 Conclusions

The state still has ultimate control over the SOCBs even though international strategic investors have been introduced. Due to their low ownership shares and limited management involvement, it is very hard for international strategic investors to effectively play their original roles and functions. The establishment of Huijin seemed to

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<sup>114</sup> Huang (n 53) 249.

<sup>115</sup> Bai (n 109) 7.

<sup>116</sup> Jiang (n 111) 73.

<sup>117</sup> See James Sassoon, ‘The Tripartite Review: A Review of the UK’s Tripartite System of Financial Regulation in Relation to Financial Stability (Preliminary Report)’, (March 2009) <[http://www.conservatives.com/News/News\\_stories/2009/03/Osborne\\_welcomes\\_Sassoon\\_report\\_into\\_tripartite\\_financial\\_regulation.aspx](http://www.conservatives.com/News/News_stories/2009/03/Osborne_welcomes_Sassoon_report_into_tripartite_financial_regulation.aspx)> accessed 20 November 2009

<sup>118</sup> See note 112.

be a big step towards clarifying the property rights of the SOCBs. However, the ambiguous status and insufficient power of Huijin have enormously affected the management of state assets in SOCBs. Therefore, it is imperative for Huijin to become a truly modern company with clear corporate objectives, strong economic incentives, and delineated lines of responsibility. In addition, it should enjoy shareholder's rights that are stipulated in the Company Law.

Notwithstanding the corporatization of SOCBs, the public listing of SOCBs and the implementation of formal corporate governance mechanisms, the real power of SOCBs is still in the hands of the Party Committee in regards to overall strategic direction and personnel appointments. Due to China's unique political environment, the Party Committee will continue to play a role in the company for a long time. But the boundary of activities of the Party Committee should be placed in a reasonable legal framework.

The current Chinese regulatory regime adopts a traditional sectoral regulatory structure, including the central bank and three commissions. With the latest developments in China's financial markets, such as the emergence of financial conglomerates, financial innovation and financial modernization, there are several significant problems in this regulatory regime. In response to these challenges, in the short term, China needs to strengthen coordination, led by the PBOC, and create the Financial Supervisory Coordination Commission, which would unify the supervision of banking, securities and insurance for a more active role of supervisory coordination, to better close loopholes in financial regulation and better supervise large sized and complex financial conglomerates. In the long term, the future development of China's financial regulation should pay close attention to the latest international developments. With the further development of

China's financial markets, the "objectives-based regulation" model will provide the direction for reform.

## **CHAPTER SIX**

### **CONCLUSIONS AND RECOMMENDATIONS**

#### **6.1 Research Summary and Findings**

The specific theme of this study is the development of corporate governance in the context of reforms of the SOCBs since the 1980s. This thesis has performed systematic and comprehensive research of these issues. The research questions addressed are how the evolution in systems of corporate governance in SOCBs takes place, and why China is engaged in such a process. It is necessary to point out that any conclusions about this dramatic reform are tentative because the system of corporate governance in SOCBs is still in a process of evolution.

The study demonstrates that the SOCBs have undergone a wide-ranging reform since the early 1980s. This study divides the whole process of reform of SOCBs into two stages: before entry into the WTO and after entry into the WTO.

The discussion of corporate governance reform of SOCBs before entry into the WTO in chapter three reveals that China had a highly centralised banking system; this began to change with economic reforms that began to decentralise and liberalise China's economy since China initiated the transition from a planned economy to a market economy. With the economic reforms, the mono-banking system under the planned economy could no longer satisfy the demands of the expanding economic activities in the changing economic environment. Reforms to the banking system thus began to be gradually carried out. China underwent a profound transformation. One part of that reform programme

involved the introduction of a two-tier banking system, which established the framework of China's banking sector. The PBOC was established only to exercise the functions of a central bank. Four state banks were formally set up as specialised banks at first, including ABC, BOC, CCB and ICBC, and later they were allowed to run as commercial businesses. The promulgation of the Resolution on Financial System Reform by the State Council in 1993 was regarded as the legal foundation for the establishment of the modern commercial banking system in China.<sup>1</sup> It confirmed that the framework of China's banking system included an independent central bank and state-owned commercial banks as well as a variety of other financial institutions. To curb intervention from local government, the new structural system of the PBOC came into existence with nine regional branches, instead of the old organisational structure with 32 branches, by the end of 1998.<sup>2</sup>

To take over the policy lending business from the specialised banks, three policy banks were established in 1994, providing finance for government projects of national priority. But under pressure from the government, the SOCBs generally continued to assume policy burdens, such as lending policy loans to finance investment projects and to keep the loss-making SOEs alive. As a result, the SOCBs were heavily burdened with NPLs. The NPLs threatened the stability of the SOCBs and the Chinese economy. Therefore, four state asset management companies were established in 1999 to deal with the NPLs of the SOCBs. In March 1998, the equivalent of USD 32.6 billion was injected into the four SOCBs by issuing special treasury bonds and, meanwhile, the equivalent of USD

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<sup>1</sup> See ch 3, 3.2.2.

<sup>2</sup> See ch 3, 3.2.3.

170 billion of NPLs was stripped away.<sup>3</sup> SOCBs then began to introduce risk management mechanisms.

Another significant outcome of the reforms during this period was that a basic legal framework for bank regulation and supervision began to take shape. The Commercial Banking Law of PRC, which was promulgated in 1995, set out the principles of profitability, security and liquidity for commercial banks, and required state banks to be responsible for their own operations and be free from external interference. The PBOC Law of 1995 gave the PBOC broader power to supervise and control the entire financial industry. The focus of regulation and supervision began to shift to prudential regulation and supervision against irregularities of financial institutions. This was reflected in regulatory improvements, especially the adoption of loan classification and provision, capital adequacy and internal control systems.

The study also shows that despite the great progress made before 2001, SOCBs still had many problems. First, since the SOCBs were the wholly state owned, there were no shareholders' meetings, leading to a weak check and balance system in the SOCBs' organisational structure and consequently poor corporate governance. In addition, SOCBs were endowed with two main functions, which were the profit maximisation and financial support, so as to accelerate capital accumulation in key state-owned sectors and to adjust the economic structure during the period of economic transition.<sup>4</sup> Moreover, the SOCBs had few opportunities to develop their risk-management capacities because of

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<sup>3</sup> Alicia Garc á-Herrero, Sergio Gavilá and Daniel Santabábara, 'China's Banking Reform: An Assessment of its Evolution and Possible Impact' (Bank of Spain 2005) 16  
<<http://www.bde.es/webbde/Secciones/Publicaciones/PublicacionesSeriadas/DocumentosOcasionales/05/Fic/do0502e.pdf>> accessed 10 December 2006.

<sup>4</sup> See ch 3, 3.3.2.

heavy administrative intervention and controls.<sup>5</sup> The existence of ambiguous property rights may have resulted in a lack of incentives to monitor the SOCBs by the government on fully commercial principles. Last but not the least, there were problems with banking regulation and supervision in China. Due to its limited independence and autonomy, the PBOC's regulation and supervision of banks and other financial institutions was vulnerable to administrative intervention from the State Council, local governments or party leaders.<sup>6</sup> Administrative restrictions over commercial banks had not been lifted completely, such as interest rate control and credit plans.<sup>7</sup> The licensing and structural change approval procedures were not transparent enough. Monitoring measures needed to be improved as well, including clearer rules for on-site examinations, making good use of external independent auditors, and developing a more efficient early warning system.<sup>8</sup>

The analysis in chapter four reveals that the Chinese government has sped up banking reforms in order to improve the competitiveness of SOCBs after entry into the WTO in 2001, because foreign banks had to be treated in the exact same manner as Chinese banks by the end of 2006 according to China's commitments to the WTO.<sup>9</sup> This phase of the banking reforms involved reducing the governmental administrative control over the banks' operations, setting up a new corporate governance mechanism, and improving the regulatory and supervisory system.

In freeing SOCBs from direct government intervention, liberalisation efforts progressed in three steps. First, in 1998, the PBOC replaced the direct credit quotas for the SOCBs

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<sup>5</sup> See ch 3, 3.3.3.

<sup>6</sup> Jianbo Lou, *China's Troubled Bank Loans Workout and Prevention* (Kluwer Law International 2001) 230.

<sup>7</sup> *ibid.*

<sup>8</sup> Lou (n 6) 230-31.

<sup>9</sup> See ch 4, 4.2.

with the credit guidance of non-binding targets. SOCBs have been given more responsibility for their lending decisions and no longer have any obligation to lend loans to state-owned enterprises.<sup>10</sup> Second, the interest rate has been gradually liberalised. In October 2004, the upper limit on the interest rate of loans and the lower limit on the interest rate of deposits were removed.<sup>11</sup> This was a critical step in increasing the competitiveness of and improving the risk management skills of SOCBs. Third, the PBOC has reformed its institutional structure in order to avoid interventions from local government. It abolished its branches at provincial and municipal levels, under which banks were vulnerable to local government intervention. Therefore, it is possible for the PBOC to improve the efficiency and integration of financial regulation and supervision.<sup>12</sup>

The Chinese government simultaneously launched a radical programme that seeks to establish an effective corporate governance mechanism in the SOCBs. The subsequent reform to China's banks has been based upon two main aspects. The first is bank restructuring through the cleaning up of NPLs; this is done by the creation of four AMCs and recapitalisation by pumping additional funds in order to improve asset quality.<sup>13</sup> The second is the establishment of an internal governance mechanism in the SOCBs. The key elements have been placed on a reform of SOCB ownership structures in order to find owners capable of monitoring bank performance effectively, shareholding restructuring in order to improve checks and balances regimes, and the establishment of internal

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<sup>10</sup> *ibid.*

<sup>11</sup> Garc ía-Herrero, Gavil á and Santab ábara (n 3) 19.

<sup>12</sup> Jianbo Lou, 'China's Bank Non-Performing Loan Problem; Seriousness and Causes' (2000) *International Lawyer* 1147, 1169.

<sup>13</sup> Garc ía-Herrero, Gavil á and Santab ábara (n 3) 16.

controls and risk management systems.<sup>14</sup> In particular, the creation of Huijin, which is wholly owned by the state, is a breakthrough in reforming the governance of the SOCBs, because the company has exercised its rights and performed its responsibilities as the major shareholder instead of government agencies. The significant role of Huijin is to remove the state from direct ownership of the SOCBs.<sup>15</sup>

As an integrated component of the Chinese banking restructuring programme, the legal, regulatory and supervisory framework for bank governance has been strengthened. Many laws, regulations, codes and standards have been amended and promulgated after entry into the WTO in order to set up a complete system of governance.<sup>16</sup> The legal framework for bank regulation and supervision has moved from an administrative regulatory framework to an increasingly transparent legal framework. This is a part of the liberalisation process in which the normative approach to banking regulation, such as structural regulation and conduct regulation has been alleviated. It is great significant for the focus of the prudential regulation and supervision to move from rule compliance to risk control. The establishment of the CBRC has made important progress in upgrading the banking supervisory practices in line with international norms so as to improve the efficiency of the banking supervisio.

The current banking regulatory and supervisory regime reflects the role of the government in Chinese society. In other words, the government may exert control over the Chinese financial institutions, especially the SOCBs after the shareholding reform.

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<sup>14</sup> See Jing Leng, 'China's Banking Reform in the Context of Globalisation and Transition' (2006) 17 *European Business Law Review* 1286, 1289.

<sup>15</sup> Leng (n 14) 1287

<sup>16</sup> OECD, *Governance in China* (OECD 2005) 390.

However, the Chinese government has changed from direct control over the banks to the use of prudential regulation.

The study demonstrates that the new round of reform has the clear goals and has been implemented gradually. Financial restructuring is initially changing the financial conditions in the SOCBs, which allows them to have adequate capital; this is a necessary condition for the establishment of modern corporate governance structures. Moreover, corporatization and the bringing in of strategic investors can set up a corporate governance framework, with shareholders' meetings, board of directors and supervisors. This is the basis of proper decision-making, and a check and balance mechanism. It is also a necessary prerequisite for carrying out effective oversight, implementing risk controls, and improving asset quality. In addition, a strict supervisory and regulatory framework can help standardise the behaviour of banks in the manners of efficiency, safety and liquidity, and thereby guarantee the interests of shareholders, depositors, and legal persons of the banks.<sup>17</sup>

The analysis in chapter five has revealed that the reform programme has not changed the fundamental problems in Chinese banking. The government still retains dominance in ownership and the appointment of key personnel. Party control, unclear rights and obligations, agency problems, and the unclear status of the bank owners still exist.

The state has ultimate control over the SOCBs, although international strategic investors have been introduced. Due to their low ownership shares and limited management involvement, it is very hard for foreign strategic investors to effectively play their

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<sup>17</sup> Jiangxi Wang, 'Commercial Banking Reform' in Min Zhu, Jinqing Cai and Avery Martha (eds), *China's Emerging Financial Markets: Challenges and Global Impact* (John Wiley & Sons 2009) 110-12.

original roles and functions. The establishment of Huijin seemed to be a large step towards clarifying the property rights of the SOCBs. However, the ambiguous status and insufficient power of Huijin have enormously affected the management of state assets in SOCBs.<sup>18</sup> The findings suggest that the future reform of Huijin should guide it to become a pure financial holding company with clear corporate objectives, strong economic incentives, and delineated lines of responsibility.<sup>19</sup> As the major shareholder of the SOCBs, Huijin would enjoy shareholders' rights stipulated in company law.<sup>20</sup> Meanwhile, the findings assert that bank managerial monitoring of state-owned assets, the duties owed to the government and benefits produced to the company are interrelated and therefore, the issue concerning who will monitor the monitor in the case of Huijin is less serious.<sup>21</sup>

In contrast to the corporate governance practiced in the western banks, the Party Committee actually plays a decisive role in appointing personnel and submitting strategic proposals. Due to the reality that China is ruled by the Communist Party, the Party Committee will continue to play an important role in the company for the foreseeable future.<sup>22</sup> Therefore, the boundary of activities of the Party Committee should be placed in a reasonable legal framework.

Furthermore, chapter five indicates that lack of regulatory independence is a long-standing issue in China's banking regulation. The creation of the CBRC does not remove the government control over the banking system, even though the Banking Supervision

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<sup>18</sup> See ch 5, 5.2.2.

<sup>19</sup> See ch 5, 5.2.3.

<sup>20</sup> *ibid.*

<sup>21</sup> *ibid.*

<sup>22</sup> See ch 5, 5.3.

Law explicitly prohibits local governments, governmental departments at various levels, public organizations and individuals from interfering with the discharge of the CBRC's functions.<sup>23</sup> The CBRC, which is established under the State Council and is subordinated to it, can never be entirely cut loose from its close relationship with the government.<sup>24</sup> Thus it is not completely clear that the CBRC can ensure that Chinese banks are "sound and safe" because of issues of enforcement and the lack of a level playing field.<sup>25</sup> For the former, the Chinese society is still plagued with the problems of the weak rule of law and therefore, it is hard to enforce laws and regulations.<sup>26</sup> For the latter, the CBRC should be sufficiently freed from political influence so as to ensure a level playing field to all banks.<sup>27</sup>

In addition, the current Chinese regulatory regime adopts a traditional sectoral regulatory structure, including the central bank and three commissions. With the latest developments in China's financial markets, such as the emergence of financial conglomerates, financial innovation and financial modernisation, there are several significant problems in this regulatory regime. First, China's current regulatory model is designed for traditional segmented financial markets. Each regulator emphasizes on its own designated part of the financial system. This means that no single regulator has all of the information and authority necessary to monitor systemic risk.<sup>28</sup> Second, China's current regulatory mode

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<sup>23</sup> Banking Supervision Law 2006, art 5.

<sup>24</sup> Zhoufei Zhou, 'Banking Regulatory Law Reforms in China: A Long Way to Go Towards International Standards' in James R. Barth, Zhongfei Zhou, Douglas Arner, Berry F.C. Hsu and Wei Wang (eds), *Financial Restructuring and Reform in Post-WTO China* (Kluwer Law International 2006) 49.

<sup>25</sup> Wei Sun, 'China's Banking Reform: A Corporate Governance Perspective' (DPhil thesis, University of Leeds 2007) 142.

<sup>26</sup> *ibid.*

<sup>27</sup> *ibid.*

<sup>28</sup> Jing Bai, 'Research on China's Financial Regulatory Model' (April 2011) *Oriental Enterprise Culture* 6 (in Chinese).

has increased regulatory costs and more importantly, has led to overlaps and gaps in regulatory coverage.<sup>29</sup> In response to these challenges, in the short term, China needs to strengthen coordination led by the PBOC and create the Financial Supervisory Coordination Commission, which would unify supervision of banking, securities and insurance for a more active role of supervisory coordination, to better close the loopholes in financial regulation and better supervise large sized and complex financial conglomerates. In the long term, the future development of China's financial regulation should focus on the latest international developments. With the further development of China's financial markets, the "objectives-based regulation" model will provide the direction for reform.

## **6.2 Limitations and Suggestions for Further Research**

This thesis has concentrated on the most dramatic and significant transformations in Chinese banking, and has made limited references to the bank governance role played by the capital market. It has not addressed the issue of the role of market competition on bank governance. With respect to the capital market and market competition, which are essential components of the external governance mechanisms of companies, what role they play and how much influence they have on the governance of SOCBs in China are interesting and important questions. Further research could examine whether the capital market and the market competition assist good governance of SOCBs in China. In addition, section 5.2.2 in chapter five only referred to the role of directors but did not mention the bank governance roles played by creditors and employees. Under a two-tier

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<sup>29</sup> Hui Huang, 'Institutional Structure of Financial Regulation in China: Lessons from the Global Financial Crisis' (2010) 1 *Journal of Corporate Law Studies* 239.

board structure in China, further research could particularly focus on particularly whether the involvement of employees under the current system helps good governance and whether employees feel that they participate in the governance of the SOCBs. Finally, the CBRC has recently enacted many new rules regarding bank governance. Further research could focus on the implementation of new regulations in the SOCBs and also the effectiveness of the means of enforcement of such regulations in China.

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