

Australian
Leadership
Awards
– Fellowships

Executive Roundtable and Professional Placements

2–10 October 2008 • Melbourne, Canberra and Sydney

Session 7, Part 1

Emerging Best Governance Practices in Commercial Financial Institutions:
Corporate Governance in Chinese Banks

Prof On Kit Tam

Faculty of Business and Economics, Monash University

Introduction

China's financial system is dominated by its state owned commercial banks but for years these banks were not able to operate in a truly commercial manner because of the many institutional constraints derived from the legacy of the centrally planned command economy. With the rising level of marketisation in the economy, the Chinese Government has in recent years initiated a series of major policy moves to tackle the issues of making the four state-owned banks more efficient and capable of successfully operating in the increasingly competitive market place.

China's predominantly state-owned banking system has been made to serve the state industrial sector, resulting in a whole range of attendant problems that are well known. One of the most conspicuous features of the malaise of China's banking system was the huge proportion of non-performing loans in the four major state banks. The banking sector's preoccupation with serving the state-owned sector has also meant that their corporate governance has been weak and ineffectual.

Measures taken by the Chinese government in the 1990s to transform the state owned commercial banks included the setting up of special policy banks for the four state owned commercial banks to separate out policy lending, the establishment of asset management companies to take over their non-performing loans, equity injection for recapitalisation, and more significantly in terms of structural change the offering of shareholdings via overseas and domestic public listing and the participation of foreign strategic investors in three of the state owned commercial banks – Bank of China, China Construction Bank and the Industrial and Commercial Bank of China.

During 2004 and 2005, the Bank of China, China Construction Banks and the Industrial and Commercial Bank of China were transformed into shareholding limited liabilities companies. Modern corporate governance practices were introduced. These included the

constitution of shareholders meeting, board of directors, supervisory board, independent directors, the separation of board chairman and bank president, special board committees and the cessation of linking bank employment conditions to the government administrative structure.

Chinese Banks - Board Composition 2006

Bank	Size of Board of Directors	Number of Independent Directors	Executive Directors	Proportion of Independent Directors (%)
Construction Bank of China	15	4	4	26.7
Bank of China	16	4	4	25.0
Industrial and Commercial Bank of China	13	3	4	23.1
Minsheng Bank	15	5	2	33.3
Huaxia Bank	17	7	2	41.2
Bank of Communication	19	5	4	26.3
Shanghai Pudong Development Bank	17	6	2	35.3
China Merchants Bank	17	6	2	35.3

Source: Annual Reports

Corporate Governance Issues

While a range of modern corporate governance mechanisms have been introduced, the predominance of state ownerships in the major Chinese banks, the capacity for enforcement, and the banks' decentralised mode of operations still present serious challenges.

China Banking Regulatory Commission (CBRC) has prescribed to the banking sector requirements for effective corporate governance and several performance indicators which are benchmarked against major global banks. They are:

- (1) A sound corporate governance structure comprising the general shareholders meeting, a board of directors, a supervisory board and an executive management team with all the necessary checks and balances in place;
- (2) Introducing domestic and foreign strategic investors to form synergy;
- (3) Setting out clearly defined business strategies;
- (4) Improving decision-making process, internal controls and risk management system;
- (5) Reducing layers of hierarchy and streamlining business process and procedures;
- (6) Adopting a market-oriented human resource management system with built in accountability and motivation;
- (7) Establishing policies and procedures for prudent accounting practices and sound information disclosure;

- (8) Establishing an up-to-date information technology system to ensure quality management and services;
- (9) Underpinning staff training and talents recruitment; and
- (10) Utilising fully the services of professional and financial intermediaries in joint-stock restructuring.

The CBRC also set performance benchmarks which include: net Return on Assets (ROA) ratio, the net Return on Equity (ROE) ratio, cost/income ratio, non-performing assets ratio, capital adequacy ratio, the largest exposure, and the NPL provisioning coverage ratio. In addition, the CBRC has designated responsibility and accountability for the bank reforms and put into place a target-driven evaluation system, in which the reforming banks are required to conduct periodical performance evaluation and submit the evaluation reports to the CBRC.

However, it has been reported that the China Banking Regulatory Commission uncovered fraud and other irregularities in China's financial institutions for the year 2005 amounting to US\$95.9 billion, a 31 percent increase over 2004. The government disciplined 6,826 people, including 325 senior executives. Some 1,205 institutions were punished for fraud and other illegal activities.

The series of high profile major financial crimes involving top leaders as well as local managers in China's state owned commercial banks in recent years shows that having formal rules and regulations is not a sufficient condition for ensuring effective corporate governance. Development of China's legal and regulatory environment is very much still in a work in progress state with uneven enforcement, and the unrelenting spate of bank scandals have demonstrated a need for better risk management in Chinese banks.

The multi-layered agency problems in the majority state-owned banks, coupled with the provincial centred business operations have provided fertile opportunities for behaviours that are detrimental to the interests not only of minority shareholders but also the majority shareholder due to the power of insiders. The reported corporate scandals and misdemeanours clearly attest to such issues.

References

Almanac of China Finance (Beijing), various issues.

Annual Report of various Chinese banks.

Boyreau-Debray, Genevieve, and Shang-Jin Wei, 2005, "Pitfalls of a State-Dominated Financial System: The Case of China" , *NBER Working Paper No. 11214* (Cambridge, Massachusetts: National Bureau of Economic Research).

China Banking Regulatory Commission, 2004. "Guidelines on Corporate Governance Reforms and Supervision of Bank of China and Construction Bank of China" (Beijing).

Claessens, S., & Laeven, L. (2004). "What drives bank competition? Some international evidence", *Journal of Money, Credit, and Banking*, 36, 563–583.

Cull, Robert, and Lixin Colin Xu, 2003, "Who Gets Credit? The Behavior of Bureaucrats and State Banks in Allocating Credit to Chinese State-Owned Enterprises," *Journal of Development Economics*, Vol. 71, pp. 533–59.

Yang, Li (ed), *Blue Book of Finance – China: Banking and Financial Development No.2, 2007*. Beijing: Social Science Academic Press.

Karacadag, Cem, 2003. "Financial System Soundness and Reform," in Wanda Tseng and Marcus Rodlauer (eds), *China: Competing in the Global Economy* .Washington: International Monetary Fund).

Ling, Jianghuai, 2006 *On Commercial Bank Risk* (in Chinese), Beijing: Renmin Chubanshe

Oldfield, G. and A. Santomero, "The Place of Risk Management in Financial Institutions," *Sloan Management Review*, Summer 1997.

Podpiera, Richard, " Progress in China's Banking Sector Reform: Has Bank Behavior Changed?", *IMF Working Paper* , WP/06/71, March 2006