



CORPORATE GOVERNANCE

and Financial Reform

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Preface

This book provides a comprehensive and up to date review of corporate governance reforms and related financial reforms in China during the country's transition to a market economy. The discussions in this book cover China's enterprise, banking and securities sectors and take China's participation in economic globalization as a critical background to its domestic reform agenda.

By exploring the dynamics of China's evolving corporate governance regime, this book presents an important country study of corporate governance reforms in developing and post-communist transition economies to show the possibility of alternative paths to the market. As revealed in this book, China's experience illustrates the benefits of a gradualist transition strategy which emphasizes proper sequencing and pacing of reforms at different stages of economic development and the merits of transitional corporate governance institutions. Set as a counter-example is the radical privatization approach adopted by Russia, known as "shock therapy," which this book regards as a less successful case of building a vibrant corporate sector and a well functioning corporate governance system in a transition economy.

Drawing on the comparison between China and Russia, this book argues that for transition economies there is no universal path to a market economy; alternative approaches are possible. In moving toward the market, distinct social, political and cultural contexts that are peculiar to individual economies can create path dependence phenomena in country-specific reforms and should be carefully digested in reformers' policy making and strategy design processes.

International best practices may not work at a particular stage of development in a particular economy, often due to a lack of supporting and complementary institutions.

The book emphasizes that corporate governance reforms in China have proceeded under various constraints imposed by the country's limited political liberalization, underdeveloped legal environment and inadequate institutional, regulatory and human capital. These practical constraints have themselves been undergoing changes and adjustments over the course of China's economic development. These factors illustrate that in building a market-oriented corporate governance regime, it is sensible economics, as well as politics, for China to adopt a gradualist strategy in initiating and stepping up reforms to corporate ownership, control and financing mechanisms in both state and non-state sectors. Under this gradualist strategy, what has played a key role in discovering a better road to the market is a number of institutional innovations suitable to the particular social, political, economic and institutional conditions at a given stage of China's transition. These institutional innovations have generated sustained outcomes of economic efficiency, which in turn have created stimuli for the further expansion and deepening of reforms at later stages. While such innovative yet transitional institutions have shown the benefits of sequencing and pacing in corporate governance reforms in China, they have not fully complied with a full market economy — they instead have served as “stepping stones” to it.

Three features of the book

At a more specific and technical level, this book has three features in its coverage and analysis.

Firstly, the book articulates a dynamic theory of corporate governance and applies it to China's transition. This theory brings together two burgeoning fields of studies in legal scholarship: corporate governance and law and development. The book draws on the rapidly growing literature in these two fields to analyze the specific question of the evolution of corporate governance in China as the country is moving from central planning to a market economy. The analysis and reasoning in this book are grounded in legal, economic and political theories, in an effort to make a fresh cross-disciplinary contribution to contemporary research on post-communist transition.

Secondly, the book presents abundant empirical evidence reported in a vast volume of previous studies on both the Chinese and international experiences in corporate governance reforms — especially, evidence from other transition economies, particularly Russia — and makes necessary comparisons. The empirical and comparative perspectives of this book make it an informative and useful source of reference to those interested in not only the progress made in

China's transition, but also the broader dimensions of post-communist transition in a global context.

Thirdly, to relate academic inquiries to practical policy concerns on the part of national governments, especially of China's reformers, the topics discussed in this book display a wide range of issues that have received serious attention from the Chinese government at its various attempts to reform the country's enterprise and financial sectors. Corporate governance reforms in China have in recent years closely targeted two goals: improving the efficiency and global competitiveness of domestic enterprises; repairing and upgrading the financial system which funds the enterprises. Accordingly, the following topics are closely addressed in this book:

- History and development of China's corporate governance reforms at state-owned enterprises (SOEs), township and village enterprises (TVEs), private enterprises and listed companies
- Interactions between capital market development and corporate governance reforms in China
- Role of banking reform in China's corporate governance reform agenda
- Constraints of China's underdeveloped legal and institutional environments on corporate governance improvements
- Broad implications of China's experience for international debates on comparative corporate governance

Structural framework of the book

By way of introduction, Chapter 1 discusses the relevance of corporate governance to China as an economy in transition to the market and the impact of economic globalization on China's corporate governance reforms. Meanwhile, a dynamic theory of corporate governance is proposed as an analytical tool to interpret China's corporate governance reforms.

Chapter 2 locates the Chinese corporate governance regime in international and historical contexts. Section I introduces basic concepts of corporate governance and important mechanisms impacting on corporate governance. Section II reviews the new waves of global corporate governance reforms, particularly in the wake of a series of corporate scandals in both the U.S. and Europe. Section III discusses the latest trends in contemporary corporate governance research.

Chapter 3 reviews the history of China's enterprise reforms and the emergence of corporate governance issues since the country started to pursue market-oriented reforms and an "open door" policy for trade and investment in the late 1970's and early 1980's.

Chapter 4 provides a general review of corporate governance practices of major types of Chinese enterprises during the transition, including large

state-owned enterprises (SOEs), small and medium enterprises (SMEs), listed companies, township and village enterprises (TVEs), and private enterprises. Chapter 4 also points out the constraints of China's underdeveloped legal and institutional environments on corporate governance improvements.

Chapter 5 analyzes the interaction between capital markets and corporate governance of Chinese listed companies and proposes future reform strategies for enhancing China's capital markets.

Chapter 6 addresses the issue of China's banking reform as both a necessary complement to the SOE reform and a critical component of the overall agenda of corporate governance reforms in China.

Chapter 7 explores the potential of China's experience to inform major debates in contemporary corporate governance literature.

Chapter 8 concludes by highlighting the merits of China's gradualist strategy for corporate governance reforms and suggests broad implications of China's experience for other developing and transition economies in their pursuit of market-building and economic development.

Acknowledgments

The completion of this book marked a milestone in my academic career. This is my first monograph, which is heavily built upon research done during the four years of my doctoral studies at the University of Toronto Faculty of Law from 2001 to 2005. My years in Toronto had been incredibly rewarding. In this intellectually enriching, emotionally engaging, and at times physically overcharging process, I had been transformed from a curious young student from China with a preliminary exposure to academic training, to a fully committed academic.

It is fair to say that when I look back, I realized that the path that I have followed to reach today's destination has been filled with many surprises. These surprises, with their strong effects on me both professionally and personally, not only have made my life in Toronto by far the most exciting experience in my still unfolding journey of searching for individual fulfillment, but also have permanently changed my character and my perspective on thinking about the world.

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Jing Leng
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Contents

Preface	ix
Acknowledgments	xiii
Chapter 1	
Introduction	1
1.1 The Relevance of Corporate Governance to China	2
1.2 The Impact of Economic Globalization on China's Corporate Governance Reform	7
1.3 China and a Dynamic Theory of Corporate Governance	14
1.4 Subjects of Investigation	21
Chapter 2	
Basic Concepts of Corporate Governance and Global Movements in Corporate Governance Reforms	25
2.1 Basic Concepts of Corporate Governance	25
2.2 Recent Corporate Governance Failures in the West and New Waves of Global Corporate Governance Reforms	30
2.3 New Trends in Contemporary Corporate Governance Research	34

Chapter 3	
The History of China's Enterprise Reform and Emerging Corporate Governance Issues	39
3.1 The First Stage of SOE Reform: Autonomy, Incentives, and Competition (1978–1992)	41
3.2 The Second Stage of SOE Reform: Restructuring, Corporatization, and Ownership Diversification (1993–1997)	44
3.3 The Third Stage of SOE Reform: Decentralized Privatization and the Need for Complementary Financial Reform (1997 to Present)	47
3.4 Summary	60
Chapter 4	
Corporate Governance Practices of Major Types of Chinese Enterprises and Institutional Constraints on Corporate Governance Improvements during Transition	63
4.1 The Enterprise Landscape in China	67
4.2 Corporate Governance of SOEs	70
4.3 Corporate Governance of Listed Companies	90
4.4 Corporate Governance of Township and Village Enterprises (TVEs)	91
4.5 Corporate Governance of Private Enterprises	98
4.6 Important Questions Arising from Corporate Governance Reform in China	110
Chapter 5	
The Interaction between Capital Markets and Corporate Governance of Chinese Listed Companies	117
5.1 An Overview of Important Aspects of China's Stockmarket	121
5.2 Corporate Governance and Performance of Listed Companies in Domestic Market	134
5.3 Overseas Listings and Corporate Governance of Chinese Companies	146
5.4 Legal and Regulatory Reforms to Improve China's Stockmarket and Corporate Governance of Listed Companies	161
5.5 Summary	176
Chapter 6	
Corporate Governance Reform of China's Banking System	183
6.1 The NPL Problem and the Urgency of China's Banking Reform	185
6.2 AMCs and NPL Disposal	188
6.3 Recapitalizing the "Big Four"	194
6.4 Shareholding Restructuring and Corporate Governance Improvements	199
6.5 Egregious Corporate Governance Failures at the "Big Four" and Their Repercussions	205
6.6 Overseas Listings of Chinese Banks	211
6.7 Summary	215

Chapter 7	
The Chinese Experience in International Corporate Governance Debates	221
7.1 China and Alternative Approaches to Corporate Governance	222
7.2 China and the Debate on Global Convergence in Corporate Governance	237
7.3 Corporate Governance Failures in Transition Economies: Lessons from Russian Privatization and Its Discontents	244
7.4 Summary	256
Chapter 8	259
Conclusion	259
8.1 The Central Argument of This Book	260
8.2 Re-interpreting “Gradualism” with Respect to Corporate Governance Reform and Related Financial Reform in a Transition Economy	261
8.3 A Summary of Major Findings in This Book	266
8.4 The Broad Implications of China’s Gradualist Strategy for Corporate Governance Reforms and Related Financial Reforms for Developing and Transition Economies	
Appendix 1 Abbreviations	271
Appendix 2 Chinese Government and Regulatory Agencies	273
Appendix 3 Chinese Terms	274
Appendix 4 Chinese Language Financial Newspapers and Journals	275
Appendix 5 Glossary	276
Index	291

1

Introduction

Chapter 1 presents an introduction to the domestic and international backgrounds to China's corporate governance reform. Section 1.1 discusses the relevance of corporate governance to China as an economy in transition from central planning to the market in an age of rapid integration of the world economy.¹ Section 1.2 briefly examines China's motivation in joining the World Trade Organization (WTO) as well as the implications of China's accession to this multinational trading system for the country's corporate governance reform. In particular, Section 1.2 reviews China's commitments to financial liberalization under the WTO agreements and highlights their impact on China's enterprise and financial sectors, most importantly the banking and securities industries, both of which are closely associated with China's ongoing corporate governance reform. Section 1.3 proposes a dynamic theory of corporate governance as an analytical tool adopted in this book to interpret China's experience. Finally, Section 1.4 clarifies the major subjects of investigation in this book and explains the reasons for their selection.

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1. There are competing definitions and understandings of "corporate governance," which are generally reviewed in Chapter 2. This book adopts a relatively broad understanding of corporate governance when applying this concept to China. In China, the state (as both the owner and regulator of enterprises), managers and employees of state enterprises, banks (as the primary creditors to state enterprises), private entrepreneurs and their employees, and public investors of listed companies are all relevant parties or stakeholders in the context of corporate governance reform in China.

1.1 The Relevance of Corporate Governance to China

1.1.1 Corporate governance reform as part of a broader agenda for China's economic liberalization and structural reforms at a new stage of transition

In recent years, the topic of enterprise and corporate governance reforms in China has attracted extensive attention from academics in contemporary research on transition economies. This is primarily because corporate governance has significant relevance to China's transition to a market economy at the new stage of economic development since the late-1990s, especially after China's accession to the WTO in 2001.

As China's transition from a command economy to a market economy proceeds, corporate governance has been identified as the core element of a "modern enterprise system" (*xiandai qiye zhidu*) toward which China's lagging state sector has been striving. To the extent that China's corporate governance reform is aimed at transforming its traditional state-owned enterprises (SOEs) to modern competitive firms operating on market basics, they can be seen as part of a broader agenda for China's continuing economic liberalization and structural reforms.

Since China joined the WTO, structural reforms of the SOE and financial sectors have increasingly proved a bottleneck to the country's transition to a full market economy. While China's growth has been driven by the non-state sector in which collectively owned township and village enterprises (TVEs), foreign-invested enterprises (FIEs) and private enterprises dominate and outperform SOEs, the state sector, still of a considerable size, remains an inefficient component of the national economy. In the meantime, China's banking sector has increased its exposure to the likelihood of a potential systemic financial risk due to years of policy lending to loss-making SOEs, embodying the dangerous consequence of an accumulation of massive non-performing loans (NPLs).

Early attempts at state enterprise reforms had obtained limited results in solving the persistent problem of SOE inefficiency, largely because these programs had only focused on managerial incentive building and autonomy expansion without seriously addressing the ownership issue. Having realized the limitations of previous reform programs, the Chinese government started to implement a shareholding experiment in the early 1990s as an alternative approach to SOE reform, which marked the first serious attempt by the government at tackling ownership reform in the SOE sector. The shareholding reform has been aimed at diversifying the ownership structure of SOEs and transforming them into shareholding companies with a set of Western-style corporate governance structures spelled out in the Company Law. It was expected that good corporate governance practices would change

managerial behavior and provide effective solutions to the agency problem of SOEs. Increasingly, the importance of corporate governance reform has been recognized by Chinese policy makers.

Scholars interested in emerging markets and transition economies often find China's corporate governance reform a fascinating topic because the reform has been conducted in a weak legal and institutional environment. This unfavorable condition raises the need for developing necessary complementary market-supporting institutions, such as a strong securities market and an efficient banking system that would ensure the success of corporate governance reform in a transition economy. In addition, legal and judicial reforms that provide investors with better protections are also widely considered an important condition for the establishment of a functioning corporate governance regime in a transition economy like China. It is now widely shared by researchers that to better understand the overall dynamics of China's transition to a market economy under legal and institutional constraints, it is highly necessary to investigate corporate governance reform in China.

1.1.2 Corporate governance matters for firm performance and financial stability in emerging markets

On the relationship between corporate governance and firm performance, empirical findings seem to diverge. A number of studies on corporate governance in developed market economies have suggested that a positive link usually exists between good corporate governance and superior firm performance.² However, other less positive studies have pointed out that firm-specific corporate governance initiatives have little or no effect on market value in developed countries.³ By comparison, for transition economies and emerging markets the correlation between corporate governance and firm performance seems unequivocally significant: a number of empirical studies have demonstrated that corporate governance does matter in these less

2. These studies are discussed in more detail in Chapter 2.

3. See, for example, Bernard Black, "Does Corporate Governance Matter? A Crude Test Using Russian Data," 149 *U. Pa. L. Rev.* 2131 (2001); Bernard Black, "The Non-Correlation between Board Independence and Long-Term Firm Performance," 27 *J. Corp. L.* 231 (2002); Sanjai Bhagat & Bernard Black, "Board Composition and Firm Performance: the Uneasy Case for Majority-Independent Boards," 1053 *PLI/Corp* 95 (1998); Benjamin E. Hermalin & Michael S. Weisbach, "Boards of Directors as An Endogenously Determined Institution: A Survey of the Economic Literature," 9:1 *FRBNY Economic Policy Review* 20 (2003); Anup Agrawal & Charles R. Knoeber, "Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders," 31:3 *Journal of Financial and Quantitative Analysis* 377 (1996), p. 394; Anup Agrawal & Charles R. Knoeber, "Do Some Outside Directors Play A Political Role?," XLIV *Journal of Law and Economics* 179 (2001).

developed economies, in the sense that a firm's corporate governance practices can have a huge effect on its market value in a country where other constraints on corporate behavior are weak.⁴

For example, two recent empirical studies confirm that in China, there does exist a positive correlation between corporate governance quality and firm performance. One study finds that better-governed companies are associated with (a) higher profitability as measured by ROA (return on assets) and ROE (return on equity), (b) higher stock market valuation as measured by the ratio of market value and book value of the net assets, and (c) lower market turnover ratio.⁵ The results indicate that good corporate governance matters greatly in China's emerging stockmarket. The other study constructs a corporate governance index for Chinese listed companies and finds that the index has a statistically and economically significant effect on firms' market valuation, indicating that investors indeed pay a considerable premium for well-governed firms in China.⁶

As international institutional investors have started to realize the growing importance of portfolio equity flows to emerging markets, including the Chinese market, corporate governance in these economies has attracted growing attention from the global equity investing community. For example, the Institute of International Finance (IIF), a financial organization of a group of international portfolio management firms, recently released a Code of Corporate Governance that it hoped to promote in major emerging markets, such as China, Brazil, Mexico, Poland, Russia, South Africa and South Korea.⁷ No doubt, from the perspective of attracting international investors, China needs to improve its corporate governance regime.

Despite the increasing awareness of the importance of good corporate governance among domestic companies, the general business environment in China does not look encouraging, and has raised concerns among international investors. A 2001 PricewaterhouseCoopers survey on global business opacity in 35 countries ranked China the lowest (Russia the second lowest), pointing to corruption and lagging legal, tax, banking, property rights and accounting reforms as major problems.⁸ Moreover, according to a 2001 Credit Lyonnais

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4. See, for example, Leora F. Klapper & Inessa Love, "Corporate Governance, Investor Protection, and Performance in Emerging Markets," World Bank Research Working Paper, No. WPS 2818 (2002).
 5. Chong-En Bai *et al.*, "Corporate Governance and Protection of the Rights of Minority Shareholders in China," Working Paper, Centre for China Financial Research (CCFR) at the University of Hong Kong (2002).
 6. Chong-En Bai *et al.*, "Corporate Governance and Market Valuation in China," 32 *Journal of Comparative Economics* 599 (2004).
 7. The Institute of International Finance, Inc. (IIF), "Corporate Governance in China: An Investor Perspective" (April 2004), p. 1.
 8. Art Haigh, "We Look into Russia's Future with Optimism," *Kommerstant-Daily* (January 26, 2001), online <http://www.pwcglobal.com/ru/eng/ins-sol/issues/01-02-26_ah>.