

## Zhou Xiaochuan: Improve corporate governance and develop capital market

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the Euromoney "China Forum: Capital Market and Corporate Governance", Beijing, 1 December 2004.

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Distinguished guests, ladies and gentleman,

Good morning,

First of all, on behalf of the People's Bank of China, I would like to congratulate on the convening of the "China Forum" sponsored by Euromoney and the exciting topic, namely "capital market and corporate governance", you have selected for discussion. I also appreciate the support given by the Industrial and Commercial Bank of China, HSBC, Anst & Young, Hong Kong Stock Exchange and Moody Asia to this conference.

Corporate governance is crucial to China's development. It involves broad contents and has profound implications. Hence, I wish to take the opportunity to share with you my observations on this exciting topic. While the concept of corporate governance was relatively new in China, we have encountered many difficulties in this process. At the very beginning, we even disagreed and argued about some of the very fundamental issues like primary school students. However, as we moved forward, encouraging progress has been made in establishing sound corporate governance in the country. Of course, many issues remain to be addressed in this regard and more in-depth research will have to be done. On today's occasion, I would like to raise 12 issues for discussion and wish the discussion could have a constructive input to corporate governance development in China.

### 1. Twelve issues for discussion

(1) The role of government in promoting corporate governance. The concept of corporate governance was introduced from abroad and there has been a process for us to understand and apply corporate governance in China. The Third Plenary Session of the Fourteenth National Congress of CPC in 1993 attempted to include the concept of corporate governance in its communiqué, calling for a clarified relationship among "shareholders, Board of Directors, management and employees". However, it was not until 1999 when the concept was formally cited in the major documents published by the Fourth Plenary Session of the Fifteenth National Congress of CPC. On the basis of international experiences, it might be helpful for the government to clarify its attitude towards the Five Principles on Corporate Governance issued by the OECD in 1999 and its role in establishing the institutional and legal framework for corporate governance. The *Revised Principles on Corporate Governance* issued by the OECD in 2004 also attached great importance to this issue. In recent years, some government agencies, including the China Securities Regulatory Commission and China Banking Regulatory Commission, have issued some very helpful guidelines on corporate governance. However, what the government should do to further improve corporate governance remains to be studied.

(2) The selection of corporate governance model. International practices have been characterized in this regard by different selections. For example, there are Anglo-Saxons model, Lain River model, Japan-Korea model, and so on. Experiences in the past ten years have shown a trend of convergence among these patterns, despite differences remaining in many other aspects. In this consideration, the selection of a corporate governance model suitable to the Chinese situation remains to be further explored.

(3) The problem of insider control and ownership ambiguity. In early 1990s, China began to introduce the concept of corporate governance mainly because many enterprises faced serious problems of insider control and ambiguity in ownership. So far, the problem remains not fully solved and thus deserves further discussion.

(4) The remaining issues of "debt-equity" swap. A problem closely linked with insider control was the distortion and irregular transactions created in the process of massive "debt-equity" swap that took place in 1999, despising the principles of corporate governance. Leaders of the State Council have also been highly concerned with this issue. Given the mistakes, what should be done to clean up legacies left over by the debt-equity swap?

(5) Feasible ways to promote corporate governance. In China, companies with the best corporate governance are generally those listed in the market as they are subject to the guidelines of corporate governance issued by regulatory authorities and to the supervision of investors, general public and the market. The practice of listed companies also indicates that joint-stock reform is an important way out and thus to have large and medium-sized enterprises listed is a crucial and effective measure to foster corporate governance. Without joint-stock reform and public listing, are there any other feasible ways to make substantial progress in corporate governance in the enterprises? In my view, the answer might not be so encouraging.

(6) The role of Party Committee in corporate governance. In China, the Communist Party Committee, in addition to investors, Board of Directors, management and stakeholders, also plays a role in corporate governance. The related issues need further study.

(7) The role of stakeholders in corporate governance. We have benefited from many good experiences in corporate governance from abroad. However, relevant authorities in China have always been shy from clearly stating their attitudes towards the stakeholders' role in corporate governance. Compared with the Principles on Corporate Governance issued by the OECD in 1999, the revised version issued in 2004 stresses more the role of stakeholders in corporate governance. Now, it is an important topic as to how to accurately define and make people understand the role played by stakeholders and have them positively contribute to corporate governance.

(8) The protection of stockholders' interests. One of the major weaknesses of China's corporate governance lies in its negligence over the shareholders' interests. For example, in some old state-owned enterprises, shareholders have still been barred from dividend distribution. Hence, it remains an important topic in corporate governance as to how to protect shareholders' interests.

(9) The role of independent directors in corporate governance. An encouraging development in recent years is the introduction of independent directors in corporate governance. Despite the worries and skepticism of many people about the introduction of independent directors at the very beginning, fearing they might not be able to perform their duties properly and such an arrangement is an artificial system at best, many independent directors have begun to play an increasingly important role in corporate governance after receiving training and field education. It remains to be studied as to how to have them better fulfill their duty in the future.

(10) The role of institutional investors in corporate governance. Many new institutional investors have emerged in China's capital market, such as close-ended funds, open-ended funds, venture capital funds, industrial investment funds and social securities funds. Given the ambiguity in business ownership and the prevalence of insider control, should these institutional investors take a passive approach to corporate governance like those in the United States or involve themselves more actively in promoting corporate governance?

(11) The role of banks as creditors in corporate governance. Many Chinese enterprises are highly leveraged. That is, they borrow hugely from the banks and have little capital of their own. In this context, banks are major creditors. The Principles on Corporate Governance issued by the OECD attach great importance to the role played by creditors in corporate governance, the mechanism protecting the creditors' rights and the effective framework of liquidation. It is very important for China's banking sector to think carefully of their role as creditors in corporate governance.

(12) Corporate governance in non-state enterprises. Last but not least, an important step forward in China's corporate governance is that it is no longer deemed an issue solely for the restructuring of state-owned enterprises, but also an equally important topic for other non-state enterprises. In the past, policy documents usually focused only on corporate governance in the state-owned enterprises as if it were not an issue for non-state enterprises. Recently, more people have come to realize it needs to be introduced in the non-state sectors as well. Enterprise reforms actually have much in common.

These are the twelve issues about corporate governance on which I wish to hear your views. I also hope the participants, in particular those from China, could take notice of the major achievements of the *Revised Principles on Corporate Governance* issued by the OECD in 2004.

## 2. Major achievements of *the Revised Principles on Corporate Governance* issued by the OECD in 2004

The *Five Principles on Corporate Governance* issued by the OECD in 1999 has attracted widespread attention from policy makers, investors, companies and stakeholders. With the development of the macro environment and emergence of new events associated with corporate governance, new challenges have arisen to the *Principles*. In this case, the OECD has since 2002 conducted survey and consultations worldwide on how to guarantee an effective implementation of the principles of corporate governance such as the strengthening of the independence of the Board in decision making, enhancing the information rights of the shareholders, improving the independence of auditing and the transparency of ownership structure, etc. Finally, the *Revised Principles on Corporate Governance* was issued in April 2004.

Compared with the version of 1999, the revised *principles* of 2004 is advanced in the following five aspects:

First, a new chapter titled “The foundation for an effective framework of corporate governance” was introduced. The chapter elaborates the role of government in establishing the overall institutional and legal framework for corporate governance. It lays out the principles the government should follow in advocating and establishing the framework of corporate governance, including the enforcement mechanism of formulating corporate governance principles, the protection mechanism for the parties involved in corporate governance, and the approach to avoiding rising cost incurred by excess supervision, etc. Hence, the *Principles* of 2004 was expanded to six chapters.

Second, the 2004 version strengthened protection for shareholders’ rights. The voice of shareholders is raised in four aspects: (1) Salaries of the executives are determined by the Board on the basis of their long-term performance. Shareholders have rights to get access to information on the compensation policy of executives and Board members. All equity remuneration must be approved by shareholders. (2) Shareholders have rights to change members of the Board and participate in the nomination and vote. (3) Institutional investors as fiduciaries shall publish their own corporate governance policy, procedures of voting and the way to fulfill voting rights in case of interest conflicts. (4) All the barriers impeding cross-border voting shall be removed.

Third, more emphasis is put on the resolution of interest conflicts. Based on the 1999 version that stresses disclosure of interest conflicts, the 2004 version requires the interest parties involved to disclose the way of resolving interest conflicts. In addition, it also takes note of the conflict of interests existing between the big and small shareholders in the emerging markets. It (1) adds a new principle that requires rating and research agencies to reasonably handle conflicts of interest when disclosing information about the company; (2) clarifies auditing responsibility by stating that the auditors shall be responsible to the Board; (3) strengthens the independence of auditing and defines the steps that should be taken by the auditors to manage and alleviate potential interest conflicts; and (4) pays more attention to the protection of small shareholders’ interests and states that “the interests of small shareholders shall be protected and they shall be effectively compensated for any direct or indirect impairment caused by the controlling shareholders”.

Fourth, it puts more emphasis on the protection of stakeholders and whistle blowers. It, to a larger extent, stresses the rights and role of employees and creditors. (1) It clearly states to establish a mechanism that “enhances the participation of employees”. Stakeholders, including individual employees and their representatives, shall be able to freely express their views to the Board with respect to any illegal or immoral activities. Employees’ views and their rights to express the views shall be respected and protected. It shall be ensured that information can flow safely and confidentially to the Board. (2) Corporate governance shall ensure the enhanced participation of employees, through which the information of employees’ special skills can flow to the management, benefiting the company directly or indirectly. The examples of employees’ participation include increasing representatives of employees in the Board, adopting the plan of employees holding of stocks and establishing a profit sharing mechanism such as pension contribution. For instance, pension contributions can be pooled into an independent fund and the fund manager shall be independent from the company’s management in terms of business operation. (3) It stresses the important role of creditors in corporate governance and external supervision. It also states that effective and efficient liquidation framework and credit rights enforcement mechanism are important supplement to effective corporate governance, ensuring effective protection for the rights of the shareholders. The importance of employees and creditors is raised in the new version.

Fifth, it further stresses the responsibility of the Board. (1) It stresses the role of the Board in establishing a high ethical standard, complying with laws and regulations, exercising internal control and disclosing financial information. (2) It stresses the independence of the Board, which shall not only be independent from the executive management, but also be independent from controlling shareholders. (3) It stresses the importance of information disclosure with respect to connected transactions, resolutions adopted by committees under the Board, procedures of meetings and their structure, etc.

The revised *Principles of Corporate Governance* issued by the OECD in 2004 further expanded the concept of corporate governance. In the process of transition to a market economy, China has primarily introduced the concept of corporate governance and its principles. In this regard, further studies of international experiences in corporate governance need to be conducted to follow any new development and strengthen relevant perceptions and practices.

The development of China's capital market is, to a large extent, determined by the quality of listed companies, which is closely linked with corporate governance. With the enrichment of our understanding and experiences in corporate governance, I am confident of China's capital market development in the future. Since we have discussed most issues associated with corporate governance, our understanding of this important issue is very much improved. As we gradually move to consensus on the residual issues, rules and practices will be definitely improved as well. The strengthening of corporate governance will lay a solid foundation for the development of China's capital market, and thus will play an important role in helping transform the relationship between banks and enterprises.