

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

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the High-level Forum on China's Reform, Beijing, 13 July 2005.

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Dear friends, ladies and gentlemen,

Good morning. It's my pleasure to attend this High-level Forum on China's Reform.

The theme of this forum, which is "Promoting Institutional Innovation by Emphasizing the Reform of Government Administration System", implies that discussions will be made on the performance of the government and the steps it needs to take in the future. Having a well-established tradition of criticism and self-criticism, the Chinese government has always attached importance to promoting the reforms by deepening its understanding of various issues. In this context, I would like to speak on the roles of the government in promoting the reform of the financial institutions.

First, the government needs to further clarify the objectives of the reform and restructuring of the financial institutions. Why should we spend resources on financial sector reform and restructuring? There are two answers to this question. Some people think that financial sector reform aims at preventing risks, crisis and instability, thereby avoiding causing trouble on the government. People holding such a view believe that since risks are concentrated in the financial sector, some risky financial institutions should be closed to eliminate the risks. While some people think that the sustainable, steady and healthy development of the national economy depends on a robust financial sector that provides good financial services. Therefore, we need to carry out the reforms to make most financial institutions strong and healthy, so that they will be able to operate with lower risks and at the same time provide good services, thus contributing to the development of the national economy.

The first view is somewhat narrow and short-term based. Risk is not the only factor we need to consider. Inadequate financial services will hamper economic development. One example is related to the rural financial institutions. After we closed some financial institutions because of their unhealthy development, financial services in the rural area became insufficient, hindering the development of the rural economy. The second view emphasizes the role of the financial sector in the allocation of resources. With inadequate financial services, the savings will not be effectively allocated, resulting in a waste of resources and significant negative impact on the long-term growth efficiency. Although the financial sector will give rise to risks, it can also absorb risks. In fact, the financial sector absorbs some of the risks produced by the real sector, and plays the role of price-discovery for the real economy. If performing well, the financial market can serve to absorb, buffer and resolve risks.

If we hold the view that the objective of financial sector reform is to make the financial institutions stronger and healthier, measures need to be taken in many areas. First, the government should properly handle the burden of non-performing assets of the financial institutions left over from the past or during the transition period. Second, sound financial, accounting, loss provisioning and tax systems need to be set up to create a favorable institutional environment to enable the financial institutions to develop soundly and provide good financial services. Third, the government should remove unwarranted controls and establish effective incentives to encourage the financial institutions to improve their services and contribute to better allocation of resources. Fourth, steps need to be taken to promote competition-based market mechanisms and eliminate unnecessary price control to enable prices to play a larger role in the economy. Fifth, measures should be taken to help the financial institutions to improve their ability to properly set the prices, including on the money market and capital market. Sixth, we also need to take active and steady steps to develop various instruments including the financial derivatives that can help form an effective pricing mechanism in the market. Seventh, clear strategies on the intermediate services, including accounting, evaluation and credit rating, need to be formulated taking into account both the current need and long term development of the market.

Second, principles and guidelines of corporate governance need to be further clarified. Many people have realized that improving corporate governance is of crucial importance to the entire reform. Nevertheless, the concept and content of corporate governance have yet to be clarified.

The basic requirements of corporate governance are set in the Company Law, which needs further improvement in China. On the other hand, the Company Law does not encompass every aspect of corporate governance. Corporate governance involves the agreements or practices outside the

stipulations of laws and regulations and those of the self-disciplinary organizations as well as the cultural traditions. In China, different departments or institutions have different understanding for the requirements of corporate governance. We can see that these requirements have major omissions, and no guidelines have been given to resolve the main practical issues. No official view has been clearly expressed regarding the OECD Principles of Corporate Governance (both the 1999 version and the 2004 revised version). Therefore, the reform of corporate governance is likely to be a reform without clear definitions. I'm going to give several examples in this regard. First, preserving shareholders' rights is one of the core elements of corporate governance. Nevertheless, violating the rights of the shareholders is not a rare phenomenon in China, and there is explicit solution to this problem. For instance, in the debt-equity-swaps, no effective measures are in place to safeguard the rights and interests of the shareholders, and in many cases, the assets they were holding turned out to be neither a loan nor an equity. Second, the OECD Principles of Corporate Governance emphasizes the role of stakeholders. So far, there has not been an accurate and widely accepted translation in Chinese for the word "stakeholder", nor do we have principles or guidelines concerning the role of stakeholders in corporate governance. Third, the respective roles of the Party organizations and of the board of directors and the management need to be clarified. This is an issue unique in China. In most cases, the Party organizations play a positive role in supporting the operation of the board of directors and the management. However, there are some occasions where the Party organizations and the board of directors or management hold different opinions on certain issues, calling for principles and guidelines to resolve such issues. Fourth, the relationship between corporate governance and the authority's regulation and supervision need to be properly handled. In the planned economy and during the early transition period, government acted as both the owner and the supervisory authority of the enterprises. Despite the fact that enterprise management and government supervision have been basically separated, there are often cases where these two become mixed together. Clear principles and guidelines are needed in this area.

Improving corporate governance is a reform on which the public has placed great hopes. We must not let the public disappointed because of unclear principles and guidelines in pursuing the reform. The government should play an important role in setting up clear principles and guidelines on corporate governance by drawing upon the international and historical experiences as well as taking into account China's current specific situation.

Third, the operations and policies of asset management companies need to be improved. During the several years of development since they were established in 1999, some problems have emerged, which are reflected in the prices at which the non-performing assets are disposed, the abuse of power for personal gains, and the undue transfer of benefits. Several issues are yet to be clarified. First, if and only if the objective of the reforms is to make the financial institutions stronger so that they can provide better financial services does it make sense to dispose the non-performing assets left over from the past, particularly during the period when the management of the enterprises were not separated from government administration. Otherwise the disposal of non-performing assets would be nothing but transferring the risks from the "left pocket" to the "right pocket" of the government, which will invite criticism from the public. Second, the asset management companies have been established to handle the non-performing assets in a professional way. It should be noted that the assets they are dealing with are not good assets, but those classified as doubtful or loss. In terms of value preservation and enhancement, different methods are required for handling the non-performing assets and the good assets. When seeking to recover the bad assets, we need to strike a proper balance between quantity and speed. Although the value of some assets will go up after they have been held for a considerable period of time, in most cases, the longer the assets have been held, the less their value will become. In this sense, the so-called "ice cream effect" does exist. On the other hand, the asset management companies seeking to dispose the non-performing assets very rapidly will likely face criticism, since people think that more will be recovered if the assets are disposed less rapidly. Third, against the background of market-oriented reform, the disposal of non-performing assets will be done through the market. Therefore, measures should be taken to develop the market and enable the assets to be disposed at the prices formed through market competition. This requires that market participants be under hard budget constraints, having sound financial system, clearly defined ownership and well established incentive structure. Regarding incentives, the government should set a clear baseline for the recovery of the non-performing assets, and establish an effective incentives system that will encourage the asset management companies to make the greatest efforts in recovering the assets. Problems will occur in the market-based disposal of non-performing assets if any of the above-mentioned measures are not taken properly.

What can the government do? First, steps should be taken to improve the legal framework. Although we have in place a regulation on asset management companies, there are weaknesses in the formulation, administration and enforcement of laws and regulations governing the disposal of non-performing assets. International comparison shows that China needs to make improvement in this area. Second, apart from the four state-owned asset management companies, private and foreign participants should be encouraged to enter this market to promote competition. Third, internal reforms should be carried out in the four state-owned asset management companies to enable them to operate on real commercial basis with hard budget constraints. Fourth, when the market has not been fully developed, it is desirable to let the institutions with rich market experiences to make price evaluation so as to avoid soft constraints and set up internal incentives. Fifth, efforts should be made to establish proper incentives. Without incentives or with very weak incentives, it is not possible to preserve and enhance the value of the assets and make maximum recovery. Without effective incentives, people may also tend to seek personal gains from the disposal of assets. Sixth, it is important to have appropriate procedures and prevent any improper practices so that the assets are disposed through market competition. However, if the market is not strong enough – for example, market participants are under soft constraints or there are adverse internal incentives, improper behaviors may arise even with sound procedures, and the procedures themselves may become a shelter disguising those improper activities. Seventh, it is crucial to develop market intermediaries, since the disposal of assets relies importantly on the integrity and services of the intermediaries. Eighth, the objectives of setting up asset management companies are not only to dispose the non-performing assets in a professional way, but also to make the commercial banks stronger so that they will be able to provide better financial services. So the government needs to consider how to handle the relationship between the asset management companies and the commercial banks.

The asset management companies will not operate satisfactorily and there will be much criticism from the public if the above are not handled properly.

The State Council attaches great importance to the issues concerning the asset management companies. Premier Wen Jiabao has said that “the asset management companies have had five years’ experiences in disposing the non-performing assets, and it is time for them to carefully review the experiences and lessons and try to resolve the long-term problems”. Apart from promoting more effective internal management of the asset management companies and strengthening external regulation and supervision on them, the government has much more to do. From the longer-term point of view, China will need a well-functioning capital market to enable its economy to develop soundly.