

## Zhou Xiaochuan: Take care of the stakeholders and improve corporate governance

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the China Economic Summit, Beijing, 23 May 2006.

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Ladies and Gentlemen,

Good morning! It is an honor to have been invited to attend this meeting and I would like to talk about the issue of stakeholders in corporate governance. I choose this topic because of three reasons. One is that this summit is on developing high technology industries and my topic shall reflect this main theme. As Mr. Kim mentioned just now, this industry is knowledge-based and needs a lot of talented people. Therefore, we shall say that the corporate governance in this field is notably different from that in the traditional industries. Second, the issue of stakeholders also relates to harmonized growth; and third, in the new economic environment, the development of present companies may be different in terms of investor-employee relationship.

The Government has reiterated that the main direction of state-owned enterprise reform is shareholding reform. At present, significant progress has been achieved in share-holding reform of the state financial enterprises in the banking, insurance and securities sectors with the most noticeable results in state-owned commercial banks. In the process, many enterprises have expressed the wish to introduce employee share-holding plans, which lie in the heart of the stakeholder concept of corporate governance.

The reason why enterprises bring forth employee share-holding plan is that successful experiences of international businesses have shown the advantages of right incentives. Many international companies, especially high-tech companies, have adopted employee share-holding plans. Other non-high-tech companies, such as the United Airlines, have also adopted such plans. There are three major underlying reasons. First, the plan can promote employees' enthusiasm for work; second, it encourages employees to be involved in management of their companies; and it also gives incentives to employees to be vigilant and keen on compliance and preventing frauds and illegal activities.

In recent years, progress on establishing good corporate governance has not been smooth as we have neither had a clear vision on how to proceed nor thoroughly reviewed past mistakes. So far there is no employee shareholding plan in place though some companies have made their proposals. The reform is still going forward.

Corporate governance is the core of shareholding reform. In the reform of financial enterprises, corporate governance is the most emphasized by the state-leaders. The concept of corporate governance is very clear and has been spelled out in the Company Law. In the content of corporate governance, a substantial part is about philosophy, principles and guidelines, which is not to be explicitly defined by laws or regulations. One of the important issues is about coverage of stake-holders. In terms of definition, stakeholders in a broad sense should include investors, whose rights and interests are covered by the Company Law. Generally speaking, stakeholders as we speak of refer to employees, businesses with which a company has a stable relationship, and creditors. For enterprises with environmental impacts, the concept extends to the neighboring communities.

Corporate governance is a new concept for the Chinese. Our first attempt to include corporate governance in important government documents in 1993 failed because the concept was not widely accepted. It was not until 1999 was it included in the documents of the Fourth Plenary Session of the 15th National Congress of CPC. We still have a lot to learn on this subject. Initially, the emphasis was on guarding the owners' interests, making profit for owners, as well as setting up a good check and balance relationship and structure. Then, corporate governance was translated as corporate governance structure in Chinese, emphasizing the importance of a good structure.

Even though each country has its country-specific corporate governance stemming from its cultural tradition and legal system, some common elements are the most important and most basic. These common elements are included in two very important OECD documents that are worth our attention and research. One is the *Five Principles on Corporate Governance* released in 1999. The other is *Revised Principles on Corporate Governance* issued in 2004. The 1999 version listed the role of stakeholders in corporate governance as a separate principle, and stated that the legitimate rights

should be established in the corporate governance framework, to encourage companies and stakeholders to work together to create wealth and employment and ensure the company's financial soundness and sustainability. The document included the following four parts. First, the corporate governance framework make sure that stakeholders' legitimate rights are respected; second, when their legitimate rights are violated, the stake-holders should be compensated; third, the corporate governance framework should provide a mechanism for stakeholders to participate in enhancing a company's performance; especially, it should allow different stakeholders to play different roles. However, the extent to which stakeholders are involved in managing the company should vary according to the laws and regulations and to different companies. For example, employee shall be represented at the Board; employee share-holding plan or other profit sharing mechanism shall be put into place; views of stakeholders shall be considered in some important decisions. It was especially emphasized that stakeholders should be involved in the insolvency process. Fourth, the stakeholders should have access to necessary information on managing the company.

The OECD again revised the five principles in 2004. In this revision, the protection of stakeholders and whistle blowers is emphasized. It, to a larger extent, stresses the rights of employees and creditors. There are three main aspects. First, 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 in the company. 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. Second, corporate governance shall ensure the enhanced participation of employees, so that the employees' special skills can be put to use in the company, benefiting the company directly or indirectly. The examples of employees' participation include increasing representatives of employees in the board, adopting the plan of employee stocks holding 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. Third, 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 further stressed in the new version.

China wishes to learn from international experiences and practices in the process of building a socialist market economy with Chinese characteristics. It can be said from the point of view of a socialist market economy, China should do better in terms of employees' status and their involvement in managing companies. However, we do not have any established principles or framework related to stakeholders. We will learn by doing and reviewing experiences.

Why have we not done better compared with many traditional western economies in this aspect? It has to do with the mistakes in the past. For any country learning from the history and past experiences is a very important, though not an easy task, and one that is liable to misunderstanding. An example at hand is the Americans' review of the Great Recession in 1929. The reviews generated different conclusions right after the recession and in the 30's and 40's. And a number of people became Nobel laureates because they found the true causes of the recession through their studies. I am not saying that all that need to be found have been found. New findings may emerge as the studies go.

Let me come back to employee share-holding in China. This had something to do with practices and mistakes in the 1990s. Due to the lack of proper legal procedures, insider control was rampant. Chaos occurred in employee share-holding in the 1990s. The so called original shares or employees shares were issued when insiders controlled the company and distributed the employees' shares without any necessary legal procedures nor services from law firms. This resulted in serious frauds and bribery so every time employees' share was mentioned it stirred negative responses. The other reason is that the administratively set prices were usually too low due to procedural shortcomings. In the early 1990s, once a stock was listed, its market price jumped sharply to much higher than the administratively determined price. The big jump in prices resulted in a huge profit margin and a channel for interests transfer.

However, now things have changed and the Company Law is very clear. It is no longer possible for any insiders to launch employee shares without going through an established procedure, or without a true name-list of employees. The market is becoming mature too. Not every listing on the stock market will create an opportunity for the price of original share to rise sharply. It is fair to say that the market is more and more rational in pricing. For stocks that are priced too high as original stocks, the prices do

not even go up much. Compared to past, many of the old concerns no longer exist. We need to study our history carefully, cool-headedly, in a fresh perspective, and learn our lessons.

In sum, I would like to take this opportunity to emphasize that the direction of state enterprise reform is share-holding reform with corporate governance at its core. In this core one important component is the treatment of stakeholders, i.e. their rights, their roles and their protection. We need to further study and combine international experiences with China's own situation and come up with our own solutions for stakeholder protection. This will contribute to harmonized growth, and the sustainable development of high-tech companies, human-resource intensive and knowledge based companies, which will in turn create wealth for our society.

The above are my thoughts. Your comments are welcome.

Thank you.