

Wu Xiaoling: Conditions and environment for improving corporate governance structure of China's financial enterprises

Speech by Ms Wu Xiaoling, Deputy Governor of the People's Bank of China, at the 2005 China International Finance Development Forum, Shanghai, 23 April 2005.

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I. Financial enterprises are playing special and important roles in the performance of the national economy. Reform of commercial banks takes a significant niche in that of financial enterprises.

A financial enterprise, in particular, a commercial bank, is a special enterprise that shoulders formidable social responsibility. A commercial bank is characterized by absorption of savings, extension of loans and funds settlement for the general public. The profitability of commercial banks and their ability to provide services will have impacts in many respects. First, they are vital to welfare of the public, safety of savings of depositors and capital safety and profitability of investors. Second, they affect efficiency of funds allocation and in turn indirectly influence that of resource allocation in the whole economy. Third, they entail transaction costs and efficiency of commodity trades and investment in the economy. It is the sole and specific role played by commercial banks that puts their reform in a particularly important niche in the whole reform of all financial enterprises.

II. Perfecting governance structure of commercial banks is vital to success of the reform of commercial banks.

(I) The government decides that reform be implemented in state-owned commercial banks in line with the mode of "one policy for one bank". The move is aimed at the target that the big four commercial banks enhance the returns of capital management, upgrade efficiency of resource allocation in the whole economy and safeguard safety of and preserve valuation of state-owned assets to the greatest extent, in a bid to mitigate risks in operation of commercial banks and to reduce negative impacts on the whole society.

The share-holding reform of state-owned commercial banks only represents one means of attaining the reform target. It is aimed at forming effective corporate governance structure, strengthening restraints in the capital market and improving performance of banks.

(II) The linchpin of improving corporate governance structure of commercial banks lies in proper handling of the relationship between commercial banks on one side, and investors, top Management, employees and other stake-holders on the other, enabling all the parties to restrain one another according to laws, rules, regulations and contracts.

Good corporate governance structure will help commercial banks set targets for their operation, determine the approaches to attaining the targets, facilitate implementation of decisions and put in place effective oversight. It will earn trust of investors and the public, winning more room for better development. Reversely, poor governance structure will result in failure of operation of commercial banks as well as the reform itself. Tod Minton (2000) studied 399 companies in Korea, Malaysia, the Philippines and Thailand and found out that during the Southeastern Asian Crisis the difference in corporate governance from company to company produced immense impacts. Mckinsey Investor Opinion Survey (2000) also indicated that most investors were willing to invest large sum of funds in companies with good corporate governance.

(III) Improvement of corporate governance of commercial banks calls for not only the efforts of the banks themselves but also favorable environment. During economic transition, favorable environment has bigger significance. To some extent, favorable environment will directly influence the establishment and betterment of corporate governance structure in every commercial bank.

The People's Bank of China (PBC), as the agency for implementation of the reform scheme of state-owned commercial banks, pays particular attention to cultivation of favorable institutional environment for reform of commercial banks, and is committed to advocating for a favorable legal environment.

III. Conditions and environment for improvement of corporate governance structure of commercial banks

(I) The aspects of corporate governance structure of commercial banks

The definition varies for corporate governance. To some, it means all the control system of guidance and control in corporate finance and other aspects (The Cadbury Committee, Financial Aspects of Corporate Governance). To some, it encompasses an array of relations among corporate management, Board of Directors, shareholders and other stake-holders (The OECD Principles of Corporate Governance); Some view that corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer & Vishny). The Basle Committee on Banking Supervision used the one of the OECD in its Enhancing Corporate Governance of Banking Organizations in September 1999 and pointed out that it is of vital importance for a bank to possess strong corporate governance. Central to good corporate governance structure of commercial banks are: clearly definition of relationships between the Board of Directors, top Management, the Supervisory Committee, shareholders and other interest parties, establishment of effective incentive and restraint mechanism and open and transparent disclosure mechanism, in a bid to safeguard conformity of operation and top Management of banks with the interests of shareholders and other interest parties.

We believe that corporate governance encompasses internally the relationship between shareholders and the Board of Directors (Directors), between the Board and top Management, between the Board and top Management and the Supervisors and between Management and employees. Externally, it includes the relationship between banks and financial supervisory authorities (e.g. the People's Bank of China (PBC), the State Administration of Foreign Exchange (SAFE), China Banking Regulatory Commission (CBRC) and China Securities Regulatory Commission (CSRC)), between banks and administrative departments of the government and the Party (e.g. the Organization Department of the CPC Central Committee, the State Council, the Ministry of Finance, State Development and Reform Commission, National Audit Office and local governments etc.), between banks and industrial associations and intermediary agents (e.g. self-discipline industrial organizations, accountants, auditors and legal counsels), between banks and clients and between banks and suppliers of finance (share-holders and creditors) etc.

In constructing internal and external relationships, banks will deal with the cadres and personnel system, the employment system, the fiscal and tax system, the financial supervisory system, the ownership system, the arrangement for protection of consumers' rights, the system of fair competition and anti-monopoly and the system of service standardization for intermediary organizations etc. The outside legal environment will greatly influence establishment and effectiveness of internal corporate governance structure of commercial banks.

The core of corporate governance structure lies in the solution to the principal-agent problem. With expansion of a company, equity will become ever more diversified and decentralized. The power of the general meeting of shareholders passes into the hands of the Board and there is severe conflict of interest between big shareholders and small and medium-sized ones. Operation of companies has more minute division of responsibilities, enhanced specialization raises the status of professional managers. Thus, the Board cannot bring its role of restraint into full play. The separation of ownership leads to the severe problem of insider control. The issue worthy of extensive attention remains how to choose directors, supervisors and top Management with integrity, loyalty and diligence and how to institute mutual oversight and restraint among themselves through effective incentive and restraint mechanism, in a bid to safeguard the interests of owners of the company. In handling the relationship between the principal and the agent, the personnel system and the ownership system are of vital importance regarding the external institutional buildup.

(II) We shall reform the personnel system in a bid to select excellent directors, to form a diligent and responsible board and to appoint outstanding top Management for banks.

1. The key to establishment of adequate corporate governance structure rests with handling well the relationship between the principle of the Party's supervision over cadres and respecting the rights of investors.

The Party's supervision over cadres is one of the basic principles of the Communist Party of China (CPC). The core of the principle is to safeguard implementation of the Party's general and specific policies through organizational construction. As the ruling party, CPC can recommend party members and non-party people with both ability and integrity for holding positions in leading groups at various

levels by directly relying on leadership and cohesion of the Party organization. Our party has been making efforts in strengthening inner-party democratic construction and we shall have the Party committees play bigger role in choice and hiring of competent personnel in a bid to eradicate corruption in hiring of personnel due to minority decisions. In such public opinion organizations as the NPC and the CPPCC and their local subordinates, and in enterprises and social organizations, there is an issue of the relationship between the ruling party and interest parties in the above entities. In the new era, the organization and personnel system is confronted with a new issue of how the competent personnel from viewpoint of the Party organization receive public acceptance and legally hold the proper positions.

The relationship between shareholders and top Management is a principal-agent relationship. If we'd like to choose the Board of Directors and the Chairman thereof and to let the Board to have its say in establishing favorable incentive and restraint mechanism for Top Management, then we shall grant to investors the right of personnel choice and hiring. As such, the agent will serve the owner in a loyal manner, so as to eradicate intrusion through insider control into the interest of shareholders.

China's financial enterprises, in particular, the state-owned commercial banks, have continued to use the administrative system for the Party organizations and government agencies as their personnel system. There is a strong sense of officialdom and yet to form the ideology of restraint of ownership. When commercial banks are still wholly state-owned or state-controlled, there is still no intense contradiction. While the equity is diversified, there could be conflicts between the power by the shareholders in choice of agents and the existing personnel system. Therefore, the key to improving corporate governance in financial enterprises lies in dealing well with the relationship between the principle of the Party's supervision over cadres and the power of shareholders.

2. "Recommendation by the Party organization and acceptance by the public" shall be concrete reflection of the principle of Party's supervision over cadres.

Today, the country is ruled by law. Persons in charge of enterprises, in particular, members of the Board and top Management of share-holding enterprises shall go through legal procedures and then hold relevant posts. First and foremost, the principle of Party's supervision over cadres shall be reflected in proper choice by the Party of representatives of state-owned equity. We shall recommend to the Board as representatives of state-owned equity those honest and clean Party members that have a grasp of the business and those professionals that will carry out in a loyal way the responsibility of representatives of state-owned assets. Through their work, we shall implement the Party's general and specific policies. Second, within financial enterprises, the Party organization shall strengthen cultivation and training of Party members. They will in turn become persons with high ideals and moral integrity, proficient in professional work and conscientious in carrying out general and specific policies of the Party. Through the Party-wide education to maintain the progressiveness of Party members, we shall render Party members in financial enterprises to have adequate competitiveness in professional work and charismatic character. By expanding admission of party membership, we shall attract those outstanding talents into the Party that accept Party Constitution so that candidates recommended by the Party organization will be accepted by internal departments and staff of the enterprises in election of members of the Board and appointment of top management. Third, we shall reinforce the Party's work of united front within financial enterprises. We shall carry out well publicity to the masses of enterprises, in particular, outstanding personage of democratic parties or without party affiliation, and educate them to conscientiously implement the policies of the government at their posts. We shall bring into full play the supervisory roles of non-Party democrats on the work of the Party organization as well as enterprises.

"Recommendation by the Party organization and acceptance by the public" is a practice for which we have strove as a target for the personnel system since its reform. In other words, it is a system of competing for posts. As such, we can recommend truly outstanding talents to hold relevant posts. And only by doing so can we get over the long-standing bad habits of courting promotion through personal relationships and eradicate corruption in the personnel system.

3. We shall strengthen the reform of the system of hiring financial practitioners, in a bid to ensure that financial enterprises are governed by qualified Board and that qualified talents provide financial services to the public.

An enterprise is a social entity that weaves various social relationships. It comes into being in order to reduce transaction costs and to increase social wealth. Financial enterprises connect with the public with even stronger social feature and bigger social responsibility. It is of vital importance for them to select qualified shareholder representatives and qualified managers.

Of the outside conditions for perfecting corporate governance structure of financial enterprises, one is imperative that supervisory authorities and self-discipline industrial associations shall propose qualifications for practitioners of the financial industry, in particular, senior officers of financial enterprises-Chairman of the Board, Directors and top Management. The qualifications are not "license" requirements. They are, however, standards only attainable with adequate training.

In view of China's practices in mitigating financial risks, it is not the case that he who has funds shall become Chairman of financial enterprises. The Board will decide as to operational policies, strategies and the incentive and restraint mechanism. Members of the Board shall possess adequate expertise. Their expertise may not necessarily be confined to the financial industry, it shall at least cover adequate business management. To increase efficiency of the Board, there has formed an association of Directors. The association proposed the qualifications for the Board and compiled guidance for directors. Many international organizations also proposed the advice of training directors. China's supervisory authorities have also required of directors to participate in adequate training. All the above concludes that training of directors constitutes an important aspect of improving corporate governance structure.

In the early period of instituting corporate governance structure of financial enterprises, the biggest lesson is, taking the Board as a rubber stamp. As a result, some directors did not have adequate expertise, without bringing into play the role of the Board in corporate governance. It is encouraging, however, the situation has been improving. In the recent reform of state-owned commercial banks, the government has appointed such young, energetic professionals as Mr. Xiao Gang, Mr. Jiang Chaoliang and Mr. Guo Shuqing as Chairmen of Bank of China (BOC), Bank of Communications (BoCom) and China Construction Bank (CCB) respectively. The move indicated that we have paid much attention to organizational ability, expertise and creativity of Directors. The Central Huijin Investment Corporation sent for 6 Directors to BOC and CCB. They are also selected from the People's Bank of China (PBC), the Ministry of Finance, China Securities Regulatory Commission (CSRC), the State Administration of Foreign Exchange (SAFE) and other agencies. They are professional executives, enthusiastic with the financial industry, full of administrative experience and proficient in operation of financial enterprises.

Strengthening and improving training arrangement and rules of procedure for members of the Board of Directors, shall be the focus of the next stage of reform and the gist of the principle of separation of the functions of enterprises from those of government. We shall grant the managerial power to investors and their representatives in the real sense. Only by doing so can we have the micro basis for operation of the market economy.

When China is running short of financial talents, we could as well hire talents abroad or from all walks of life, thus accelerating growth of China's financial talents.

(III) We shall improve the system of labor safety and set up the personnel system in which one can be transferred to other jobs or be given a higher or a lower position as required.

Handling well the relationship between the Board and top Management and between the Board and employees, represents one very important component of corporate governance structure of financial enterprises. The above calls for establishment of the adequate system of safeguarding labor rights and interests. Concretely speaking, it entails the employment system and social safety net. In terms of the reform of China's state-owned enterprises and banks, the success is hinged on instituting the personnel system in which one can be transferred to other jobs or be given a higher or a lower position as required.

The sense of security, ownership and enthusiasm of employees of financial enterprises come from the adequate law of labor safety and social security net. Guanzi once said, he who has immovable property will have immovable perseverance. When enterprises have clearly established ownership and when employees have the sense of physical safety, the reform shall proceed smoothly. The Labor Law prescribes that establishment of employment calls for employment contracts. The contract is the fundamental basis for safeguarding legal interests of employees during employment. Employment contracts shall be entered into in conformity with the principle of equality, voluntary participation, consultation and consensus, which represents complete contractual freedom enjoyed by employees. Employees of financial enterprises may participate in the management of the enterprise in a democratic manner and discuss on equal footing with the employer about protection of legal interests of labor through the General Meeting of employees, trade unions or other means.

Career development program, training program, compensation scheme and Employee Stock Ownership Plan (ESOP) can create the sense of honor and ownership among employees, arouse their definite expectation about the future and thus can mobilize their working enthusiasm. The survey conducted by Mercer Human Resource Consulting on 40 multi-national companies (MNCs) in Shanghai in November 2003 indicated employee development program (78%), reward and acknowledgement (60%), compensation and welfare (56%) and training program (40%) were among the top 4 appealing factors. The economist, Mr. Liang Xiaomin, in his recent presentation about culture in the Shanxi Merchants, also pointed out that draft banks by Shanxi Merchants in the 19th century designed the arrangement of "career stock" according to each employee's position, tenure and performance. The stock could share dividends. The arrangement played apparent incentive role in that period.

Since 1920s, there were more and more mergers and acquisitions in a horizontal, vertical and mixed manner and even across borders, bringing about several times the super-banks. After China institutes its exit mechanism for financial institutions, acquisitions, restructuring and bankruptcy will surface as well. Under such circumstances, it is of high necessity to establish social safety net for employees and to make proper arrangements for employees' medical and unemployment and pension insurance.

We shall establish effective incentive and restraint mechanism. We shall gradually establish the market of professional managers. The situation shall be changed where some operational performance and reputation mechanism are the important determinants for compensation of top management in the market and within the enterprises. Government agencies are after all government agencies, and enterprises are after all enterprises. There shall no longer be an incentive mode based on "administrative hierarchy". In no event shall executives of top Management with poor performance be transferred to posts at the same administrative levels or back to posts in administrative agencies. Professional managers shall cherish their own reputation and get over the complex of "administrative hierarchy".

For top Management of banks, we shall have incentive compensation. More important, we shall cultivate expectation linked with future operational earnings, e.g. stock option, long-term incentives like big pension plan for long tenure, practice practical protection of property safety and personal dignity for top Management for their hard-working after retirement.

Strong incentives shall be accompanied by strict restraint. We shall form the responsibility mechanism, by means of supervisor inquiry, proposal for recall, establishment of track records of top Management and investigation and affixation of responsibility. In the recent revision of the Corporate Law, lessons have been drawn from the practice of "lifting the veil of the corporations" and constructive proposal has been put forward regarding "supervisor proceedings" and "shareholder proceedings". For damaging behavior by directors and top Management, shareholders may ask the supervisory committee or supervisors to lodge proceedings. In case of emergency, shareholders may lodge proceedings on their own behalf.

(IV) We shall set up limited government, safeguard ownership in real earnest, create level playing ground and cultivate the sense of serving the public by financial enterprises.

A real market economy shall be one based on ruling by law. The concept of limited government is the cream of the principle of ruling by law. Financial enterprises shall be regulated due to its special nature of public products, externality and information asymmetry. The regulation, however, shall be moderate. Regulation shall focus on compliance and internal risk controls. The financial industry is an industry that manages risks. All financial products have inherent risks. The issue herein lies in acknowledgement of risks, presentation of risks to clients, measures to mitigate and control risks to the extent capital and reserves of financial enterprises could sustain. Regulation shall be confined to the extent creativity of financial enterprises will not be stifled and risks shall be fully disclosed to clients. Reliance solely on regulation will be costly and ineffective. In terms of the financial safety net, the first priority is self-restraint of financial institutions. Industrial self-discipline and public oversight ensue with it, while financial regulation comes the fourth.

We shall protect ownership of financial enterprises in real earnest. We shall emphasize prior claim of banks for their creditor's rights with collateral, and shall establish gradually the basic credit database fully covering enterprises and individuals, in a bid to improve the social credit environment and to create favorable environment for banks' operation. Financial institutions are inflicted with costs in providing services to the public and shall be paid off to be viable enterprises. Many clients, who used to enjoy free services for some financial products for a long period, are still not used to the practice. Financial enterprises shall make efforts for explanation and publicity when charging the relevant fees.

Meanwhile, financial enterprises shall in turn sharpen their sense of social responsibility and shall cherish a sense of accountability to repay the public by providing prime and prompt financial services for residents in their community and other enterprises as well. As such, banks may charge fees for their services while clients feel the services are worthwhile of the charges. The Board and top Management of financial enterprises shall take serving the public as the sole purpose of development of their enterprises, and earn their room for viability and growth in serving the public.