Bank Reform in China

The reform of state-owned banks in mainland China has not yet tackled their fundamental corporate governance problem: the need for genuine checks and balances on those in control

Recent reforms of financial institutions in mainland China focus on the incorporation, share-ownership restructuring and overseas listing of the 'big four' state-owned banks, namely the:

1. Bank of China
2. Construction Bank of China
3. Industrial and Commercial Bank of China, and
4. Agricultural Bank of China.

Two of these banks are solely owned by the state, namely the Bank of China and the Construction Bank of China. Along with another bank – the Communication Bank which is a state-owned stock-holding bank – these banks adopt the principle of 'emphasising the prominent points and progressing steadily'. Under the direction of the State Council of the Central Government, the People's Bank of China, which is the central bank of China, is responsible for the reform measures to be taken by state-owned banks. The reform measures to be taken by all of the state-owned banks are almost identical, with only minor differences in details tailored to suit the specific conditions of each bank.

Being solely owned by the state, the Bank of China and the Construction Bank of China receive capital from the central government's foreign exchange reserves. The two banks each share half of a capital injection totalling US$45 billion. A shell company – the Central Huijin Company – was founded as a holding company for the investment. The Bank of China and the Construction Bank of China, using their own capital, took steps to write off their non-performing loans in order to clear the way for the legal procedures required for the banks to become stock companies, and for eventual listing. The boards of directors of the two banks were reformed, reshuffling the top officials. As the Communication Bank is a listed company already, this company reorganisation was not required. HSBC has become a international strategic investor in the Communication Bank.

> the reform of state-owned banks will only be an extension of SOE reform, which should certainly limit our expectations of success

The Dominant Shareholder Problem

Fundamentally, the state-owned banks are state-owned enterprises (SOEs) by nature. In a sense, they are stereotypical SOEs, bearing all their characteristics and shortcomings. Since the government agencies spearheading bank reform have no fresh ideas beyond those already devised for SOE reform, the reform of state-owned banks will only be an extension of SOE reform, which should certainly limit our expectations of success.

Take, for example, the dominant shareholder problem which is even more acute in China's state-owned banks than it is in the SOEs. As the sole founding shareholder, the Central Huijin Company holds 100% of the shares of the Bank of China. Its shareholding will be diluted to 70% after the bank's IPO. As one of the five founding shareholders of the Construction Bank of China, the Central Huijin Company holds 85% of shares in the bank directly. Additionally, the Central Huijin Company is a major shareholder in the Communication Bank. So as the majority shareholder of the Bank of China and the Construction Bank of China, the Central Huijin Company has eliminated the checks and balances which a diverse shareholding might provide, thereby seriously undermining the groundwork of effective corporate governance.

Since it was specifically established as a shareholding company for the reform of China's state-owned banks, the Central

Huijin Company neither has business of its own, nor its own management team. Its board of directors and its top management comprises officials from a number of government financial agencies. It is also run by the government officials sitting on the boards of directors of the state-owned banks. It is unknown whether they have sufficient knowledge of the corporate operation and management of those banks.

There are other corporate governance problems in the reform of China's state-owned banks similar to those of the other large SOEs. Since the SOEs' initial listings many corporate governance problems have emerged, such as the hasty sale of assets and the creation of specialised committees. The reforms designed to win these companies overseas listings have often been of form rather than substance. There is rarely any change to the fundamental issues, such as the shareholding structure, board composition, management team selection and management philosophy.

The Role of the Financial Bureaucracy Group

The highly concentrated shareholding structure of the banks makes the role played by Financial Bureaucracy Group (FBG) critical in their management and reform. The FBG is a common-interest group composed of senior officials from several main government agencies in charge of finance, banking and securities and some other state-owned financial institutions. These agencies and institutions include the People's Bank of China, the 'big four' state-owned banks, the China Bank Regulation Commission (CBRC), the China Securities Regulation Commission (CSRC) and the Ministry of Finance. These senior officials are mostly well-educated in their related fields, and have held positions in these agencies or institutions for a long time, sometimes even for their entire careers, swapping jobs amongst themselves frequently.

A typical representative of the FBG is the current president of the People's Bank of China and the chairman of the Committee of the Monetary Policy, Xiaochuan Zhou, who has also occupied the posts of assistant minister of the MOFEC (Ministry of Foreign Economic Cooperation), the vice-president of the Bank of China, the vice-president of People's Bank of China, the president of the Construction Bank of China, and chairman of the CSRC. The current chairman of the CBRC, Mingkang Liu, likewise, has held a series of key posts in the agencies and institutions mentioned above. The core-management officials of the three state-owned banks all come from the FBG, for example, the current chairman of the board of the Bank of China, Gang Xiao, has held the post of vice-president of People's Bank of China before he joined the Bank of China.

> the Central Huijin Company has eliminated the checks and balances which a diverse shareholding might provide

It is a well-known characteristic of financial bureaucracies that a small personnel network often results in a group of insiders gaining control of almost all financial areas. The FBG plays a leading role in China's current financial reforms, including reform of the state-owned banks, but the tendency to protect personal interests can become an obstacle to the establishment of effective corporate governance mechanisms.

Those in control of the FBG share certain values and attitudes, they clearly believe in government by the elite and toeing the line of the bureaucracy. They are political veterans rather than believers in the free market and modern management skills. The FBG officials may appear to be both government officials and businessmen, wearing different hats as shareholder representatives, directors, senior executives, and supervisors of the state-owned banks. However, their political interests work against the core values of good corporate governance, such as the division of power, creating mechanisms of checks and balances, fairness, transparency and accountability.

It is doubtful then that the current reform of China's state-owned banks can really solve their deep-rooted institutional and governance problems. There is a wide gap between the goals of the reforms and the goals of good corporate governance, which cannot be achieved only through changes in form. Stakeholder theory shows that modern financial institutions, including banks, are sensitive to external forces and need special corporate governance measures to cope with them. The banks in mainland China need to strive hard to meet the basic requirements of good corporate governance, only then will they be able to achieve modern international best practices in the future.

Simon Ho and Annie Li
School of Business, Hong Kong Baptist University

Simon Ho is Dean & Professor and Annie Li is a PhD student, both at the School of Business, Hong Kong Baptist University.
More information on state-owned bank reform can be found on the website of China Banking Regulatory Commission (www.cbrc.gov.cn), and the State-Owned Assets Supervision and Administration Commission (www.sasac.gov.cn).