China's Corporate Governance Challenges

by

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Outline

- Introduction: Transition and Governance
- Minority Shareholder Protection and Corporate Governance
- Need for further reform of SOEs
- Privatization or Corporatization of SOEs
- The State as Shareholder
- Commercialization of Banks
- Conclusion

Transition and Corporate Governance

Policy Agenda on CG in China:

Driven by the transition process from state ownership and central planning towards…

a market economy based on some form of private ownership!

Transition and Corporate Governance (2)

- Chinese model of transition process:
  - Led and managed by the Chinese Communist Party
  - Development of market infrastructure together with reform of Government
  - Gradualism
  - Experimentation
  - Partial reform and pragmatism

Minority Shareholder Protection (MSP) in Emerging Market Countries

The Law & Finance view:

- Main problem of development is how to transfer capital from rich to poor countries

- Main obstacles to development are:

1. Lack of protection of capital income (property rights protection – rule of law)
2. Trade barriers

MSP in Emerging Market Countries (2)

Based on evidence: China' s problem is not that it attracts too little capital for investment!

Formal MSP and financial development (LLSV and others): on both

- *quality of law on the books*
- *law enforcement* indicators

China has below average performance relative to other transition countries (Pistor & Xu, 2005)

MSP in Emerging Market Countries (3)

China is not just an *outlier*.....

...its GDP is larger than the sum of GDPs of all Eastern European countries, the former SU, and all African countries....

....Poland is smaller than Guangdong province, and Hungary smaller than Shanghai (Pistor & Xu, 2005)

Further reform of SOEs

- World Bank Report 2005: SOEs absorb *2/3* of all credit even though SOE share in industrial GDP is only *1/5*.

- Wen Jiabao Report 2005:
  - Improve mechanism for allocation of funds
  - Improve corporate governance
    - Annual reports
    - Performance-based incentives for CEOs

Further reform of SOEs

- Closures of inefficient firms
- Liberalization and market access
- Institute competitive mechanisms
- Improve oversight

Large-scale Privatization of SOEs is not an option

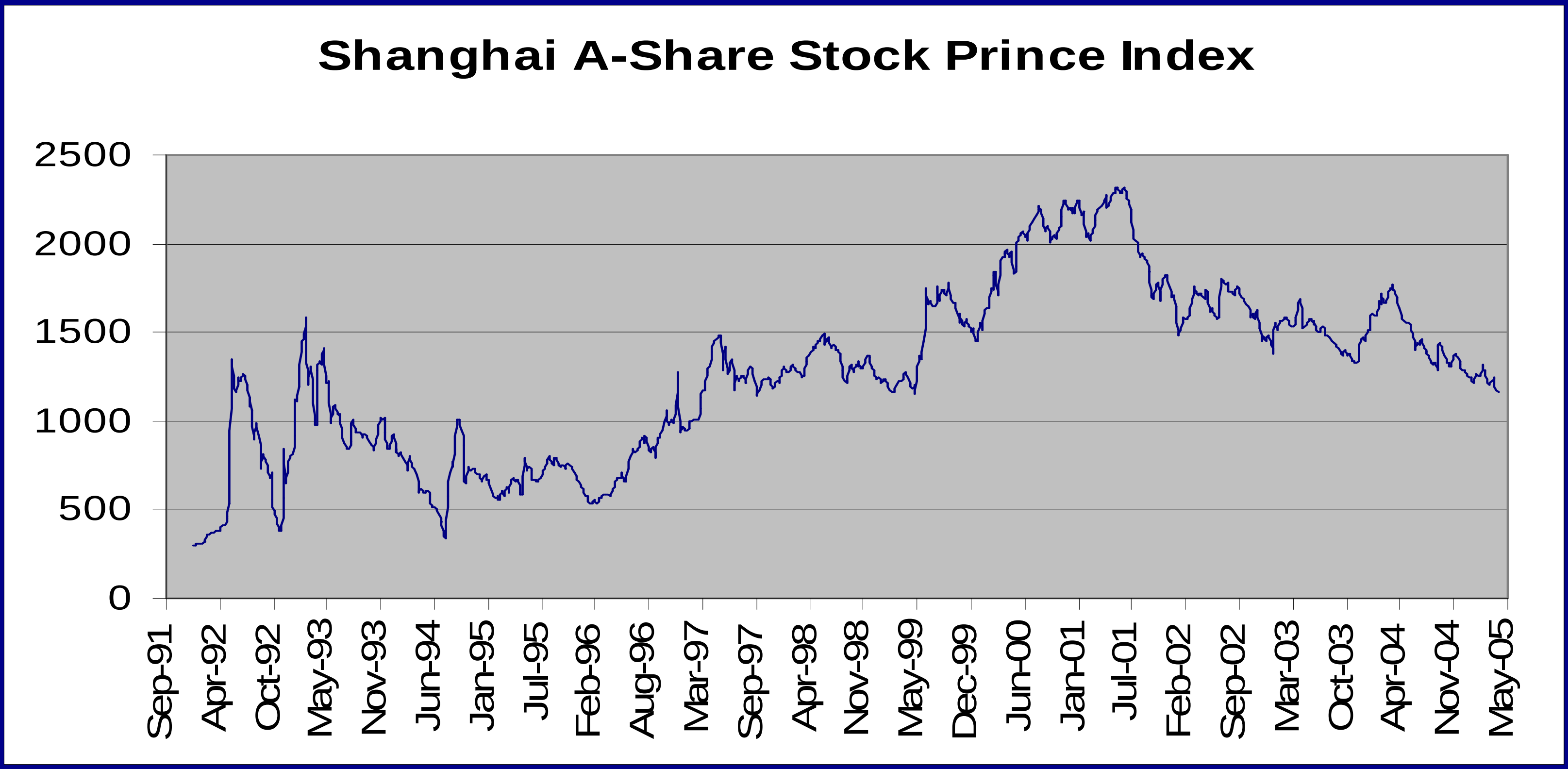
- Equity overhang for the largest SOEs
- Imperfect institutional infrastructure
- Strengthen independence and credibility of CSRC and “reputational intermediaries” first
- Pitfalls of Management Buyouts for small and medium sized SOEs

Equity overhang

- Growth of listed firms:

Equity overhang (2)

- Growth of stock market capitalization



Corporatization of SOEs

World Bank report recommendations:

- Provide full autonomy to SOE managers
- Central and Subnational governments should relinquish all control
- Delegate Control to the Board of Directors
- Give more voice to minority shareholders

The State as Shareholder

- Analogy with Corporate Headquarters of Conglomerates & Holding Companies
  - Alfred P. Sloan’s reforms at GM
  - Governance of French SOEs: Ministry of Industry advocate of SOE against Ministry of Finance

→Model of the French EPICs (SOEs with publicly traded shares; explicit state guarantee; clearly defined mission)

The State as a Shareholder (2)

- SASACs as Monitors or Corporate Headquarters?
  - Benefits of centralized policy formation
  - Mechanism for transferring SOE profits to SASACs or MOF?
  - Capital budgeting procedures at SASACs, MOF or NDRC?

The State as a Shareholder (3)

- Corporate Governance of Listed SOEs
  - Board representation of minority shareholders?
  - Protection of minority shareholders?
  - Lines of Authority between CSRC, Regional Governments and SASAC?

The State as a Shareholder (4)

- Appointment and Incentives for SOE managers?
  - Open and transparent appointment process:
    - Professional managers
    - Shortlists
    - Hearings?
    - Long-term appointments
  - Profit-based compensation
  - Avoid stock-based compensation?

Commercialize state-owned banks

- Banks must have independence & incentives to stop lending to loss-making SOEs

- Subsidies to SOEs when necessary must come through another channel (e.g. MOF)
  - Create a special budget for explicit subsidies at SASACs?
- Break nexus: Government → State Bank → SOE
  - Improves incentives and accountability of all parties

Conclusion

- Good scenario:
  - effective monitoring by SASACs and investment allocation
    - appointments of mid-level technocrats as monitors
    - stable appointments of managers of SOEs
    - create a budget item towards *explicit* subsidies
  - effective bank monitoring of SOEs and non-listed firms
  - effective disclosure & reputational intermediaries for listed firms
  - no government guarantee for equity investments

Conclusion

- Bad scenario:
  – poor disclosure
  – no clear closure rules for SOEs
  – no credible reputational intermediaries
  – captured and ineffective monitors

  => Stock prices poor indicators of performance & risk of major financial scandals