Banking Reform and Bank Bail Outs in the Chinese Mirror

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Banking and financial sector reform has proved to be a challenging undertaking for domestic reformers and policy advisors around the globe. Many reform attempts have gone astray as the chosen strategy failed to take account of the institutions and incentive structures the newly privatized, merged, acquired, or re-capitalized banks would operate under. Against this background it is puzzling that the recent reform of China's banking sector has not only proved to be remarkably successful within China, but that key aspects of the reform strategy, namely the terms on which foreign strategic investors were involved, served as a model for the recent series of financial transactions between Western banks and sovereign investment vehicles predominantly from Asia.

Structuring Deals with Western Banks

Consider first the transaction between Blackstone and the yet to be formed China Investment Corporation (CIC) of May 2007. This deal made CIC the largest single investor in the newly formed Blackstone Holding. While the structure of the legal entity in which Blackstone was reorganized did not grant extensive voting rights (or "voice") to the unit holders, an investor with such a stake and, perhaps even more importantly, large amounts of assets under its control, is likely to be heard by any management. The reorganization of Blackstone and the subsequent initial public offering (IPO) was prompted by the desire of Blackstone's senior partners to cash in their holdings in the partnerships they controlled. The choice of CIC as the most significant outside investor came as a surprise. It is therefore worth analyzing the structure of the deal and the commitments both parties undertook.

Blackstone is a US based asset manager with global reach. Until May 2007 it operated as a series of general partnerships, all separately owned by various Blackstone partners and all sharing the same "family" name. Total assets under management at the time of its reorganization were valued at US$88 billion.[1] In May 2007 Blackstone was reorganized with the aim of allowing the company to raise equity capital from outside investors without sharing control. A holding structure was created with a limited partnership, Blackstone Group LP, functioning as the holding company for the group. The sole general partner of Blackstone Group LP is Blackstone Group Management LLC,

[1] These assets are divided into Corporate private equity funds (US$33.04 bln), real estate opportunity funds (US$ 19.95 bln) and Marketable alternative asset funds (US$ 35.34 bln), consisting primarily of hedge funds. For details on Blackstone see the prospectus for its public offering of June 2007, available at http://apps.shareholder.com/sec/. [#5262437]

a limited liability company formed by Blackstone's senior partners under Delaware law. The other partnerships were reorganized into Blackstone Holdings,[2] using the limited partnership form for most, and the limited liability company form for some entities, with Blackstone Group LP functioning as the sole general partner for the (subsidiary) limited partnerships. By implication, the senior partners of Blackstone who are the sole equity holders in Blackstone Group LP have exclusive managerial power and control key decisions, including mergers and takeovers, changes in the capital structure, and the like. Blackstone Group LP holds common partnership units in the various entities belonging to the group via wholly owned subsidiaries.

Subsequent to the reorganization Blackstone Group LP (the holding structure) issued 133,333,334 units to the public as limited partnership "units". Common unit holders enjoy limited liability, but have only limited voting rights. The General Partner (i.e. Blackstone Group Management, LLC) has the sole discretion of changing the terms of the partnership agreement except for provisions affecting the limited partner's voting rights;[3] decides whether to enter into a mergers or other business organizations and only then puts the case before the limited partners;[4] and may trigger the liquidation of the partnership by withdrawal unless the limited partners elect a successor.[5]

Another 101,334,234 non-voting common units were sold at the time of the IPO at a discount of 5 percent to "an investment vehicle established by the People's Republic of China with respect to its foreign exchange reserves", referred to in the prospectus as the "State Investment Company"[6] and in a Report filed with the SEC (Q10 Report) as "Beijing Wonderful Investments".[7] The proceeds from this sale were used by Blackstone Group to invest in equity in other Blackstone entities, primarily by acquiring stakes from its senior partners – thus cashing them out to the tune over several billion dollars.[8]At the time of the transaction, this new investment corporation had not been officially launched. When the China Investment Corporation (CIC) was officially launched in September, it

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[2] The former partners of the partnerships received – in addition to over US$ 3.98 bln in cash -- units in these Holdings, which they could convert into units in Blackstone Group LP.

[3] Art.XIII Section 13.1 of the LP Agreement states that "each partner agrees that the General Partner, without approval of any Partner, any Unitholder or any other Person, may amend any of this Agreement …" as long is it does not "adversely affect the Limited Partners considered as a whole (…) in any material respect)" (subsection e). or affects the voting rights of unit holders as set forth in the agreement (Section 13.3.).

[4] According to Art.XIV, Section 14.2 any "merger or other business combination" requires "prior consent of the General Partner" who is permitted to decline any offer to the extent permitted by law "free of any duty (including any fiduciary duty)". Note, however, that the approval of limited partners is required to effecutae the merger (Section 14.3).

[5] The withdrawal of the General Partner can trigger the liquidation of the partnership unless the limited partners decide to continue the partnership and elect a successor to the General Partner. See Art. XII, esp. Section 12.2.

[6] Blackstone's prospectus supra note 1 at p. 1.

[7] See http://www.sec.gov/Archives/edgar/data/1393818/000119312507180760/d10q.htm at p. 9.

[8] In the language of the report at p. 61: "The Blackstone Group L.P. used approximately $4.57 billion of the proceeds from the initial public offering and the sale of non-voting common units to the State Investment Company to purchase interests in its business from its existing owners, including certain members of Blackstone's senior management. Accordingly, The Blackstone Group L.P. did not retain any of these proceeds."

started off with US$200 billion in assets (i.e. more than double the amount of assets Blackstone controls) transferred from China's excess reserves.[9] Future investments by CIC in Blackstone were restricted so that at no time it would own more than 10 percent equity in Blackstone Group LP. CIC committed not to sell its units for a period of four years except in the even to a change of control at Blackstone. Should CIC decide to sell at the end of this lock-in period it agreed not to sell more than 1/3 of its units in each of the following three years. Finally, CIC "agree(d) to explore in good faith potential arrangements pursuant to which it or its affiliates would invest in or commit fund amounts to current and future investment funds managed by [Blackstone] and to evaluate in good faith and consider investing in any comparable funds or vehicles offered by [Blackstone] in connection with any investment they make in alternative funds or vehicles."[10]

The details of the agreement between Blackstone and CIC show that both parties have committed to a long-term relation that went beyond a simple equity investment. By agreeing to the lock-in provision CIC committed to retain a stake in Blackstone for at least 7 years. Moreover, CIC offered to explore potential business opportunities for Blackstone with regards to "current and future investment funds managed by Blackstone" – which raises the prospect of CIC using Blackstone or Blackstone vehicles for future investments. There is some evidence that the relation with CIC has helped Blackstone in China, as Blackstone served as the advisor to China Development Bank (CDB) when it invested in the British bank Barclays' in the summer of 2007.[11] Blackstone certainly has benefited from the lock-in provision at a time when the market value of the newly issued investment units declined by more than 30 percent.

The Mirror Image

Closer scrutiny reveals that the Blackstone-CIC transaction is the mirror image of transactions in which only 2 years earlier foreign investors acquired *minority* stakes in China's big state owned banks at the time these banks were slated for (partial) privatization in 2005. The first of China's big state-owned bank to launch an initial public offering (IPO) was China Construction Bank (CCB). Prior to placing its shares on the market the bank placed substantial minority stakes with strategic investors. Bank of America acquired a nine percent stake in CCB for US $ 3bln; and Temasek, a state

[9] CIC was officially launched on 28 September 2007. Press reports confirmed the amount of assets under its management and also revealed that Gao Xiqing, a lawyer who earned an LLM at Duke university law school in the 1980s and had previously served as General Counsel of China's Securities Regulatory Commission (CSRC) would manage the fund. See "China set to launch state investment vehicle", Daily Telegraph, 25 September 2007, available at http://www.efinancialnews.com/assetmanagement/index/content/2448809601.

[10] See Blackstone's prospectus supra note [] p. 5. Note that the text refers to "us" where [Blackstone] has been inserted.

[11] The transaction came in the midst of Barclays' attempt to consummate a friendly merger with ABN-AMRO, a Dutch bank. The merger was challenged by a bid made by European banking consortium led by the Royal Bank of Scotland. In July 2007 CDB acquired a 2.6 percent and Temasek of Singapore a 3.2 percent stake in Barclays. This transactions made the two Eastern sovereign vehicles the largest investors in Barclays and enabled it to raise its bid for ABN-AMRO. While this did not secure its bid for ABN-AMRO, which was ultimately acquired by the RBS consortium, the acquisition was not reversed.

investment vehicle of Singapore, another 6 percent stake for US$ 1.4 bln.[12] Both transactions gave the foreign investors an option to appoint members to the management board, but no executive positions. Moreover, the Chinese government guaranteed the value of both transactions by agreeing to compensate the foreign investor should the price of the acquire bank's shares fall below the acquisition price over the next three years.[13] Finally, BoA was given an option to increase its stake in CCB to a maximum of 19.9 percent. Only after these deals were finalized did CCB launch its IPO in Hong Kong.

Note the similarities between the Blackstone-CIC and the CCB-BoA transaction. In both cases the outside investor(s) acquired minority stakes without control rights in an entity that was controlled by a majority owner: The Chinese government (through an investment vehicle called Hujin Investment Corporation, which is now a 100 percent owned subsidiary of CIC) on one hand, and Blackstone Group LP representing the senior partners of Blackstone on the other. By agreeing to a ceiling for the minority investor's stake in the target company, the two parties took precaution to maintain this control structure.[14] Despite these constraints, the outside investors agreed to lock-in provisions, which constraints its exit option for several years. In combination, these features create strong incentives for the outside investor to take measures that will ensure an increase in value of its stake over the medium to long term and thereby encourages strategic investments with long term value rather than short term value maximization. By the same token they allow both parties to explore their relationship and to develop business and investment strategies that are in their mutual interest.

Understanding the Transactional Model

The transactional model described creates incentives for longer term cooperation without sharing control. It stands in stark contrast to the dominant transactional type that Western banks have used throughout the 1990s when acquiring financial institutions in emerging markets around the world. In most cases, the Western banks acquired a majority stake, and frequently bought out domestic banks completely. A typical example is Santander's acquisition of controlling stakes in countries throughout Latin America, or Citigroup's acquisition of the Mexican banking group Banamex in 2001, which turned Banamex into a 100 percent owned subsidiary of Citigroup.[15] Similar transactions occurred throughout Latin America and Eastern Europe in particular. As a result in many countries in these regions the banking sector is now majority controlled by foreign banks: According to the Bank for International Settlement (BIS), in Latin America as of 2002

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[12] Details of the investment by BoA into CCB are available from BoA's filings with the US Securities and Exchange Commission (Form 10-K), file # 1-6523

[13] See Min Xu, *Feedin frenzy for overseas banks*, Asia Times Online Ltd, September 30th, 2005. Available at http://www.atimes.com/atimes/China_Business/GI30Cb03.html (last visited 23 May 2008).

[14] Clearly, the parties could agree to change this, but it would require an agreement. A hostile transaction by which they minority would launch a takeover of the target has thus been ruled out.

[15] See Mauro F. Guillén and Adrian E. Tschoegl, "At Last the Internationalization of Retail Banking? The Case of the Spanish Banks in Latin America," (Philadelphia: Wharton Business School: Financial Institutions Center, 1999).for a detailed account of foreign banks in Latin America in the 1990s. See also Adrian E. Tschoegl, "FdI and Internationalization: Evidenc from U.S. Subisidaries of Foreign Banks," *Journal of International Business Studies* 33, no. 4 (2002).

the share of total bank assets controlled by foreign investors ranges from 27 percent in Brazil to 82 percent in Mexico. In Eastern Europe the range is between a "low" of 63 percent in Poland to 99 percent Estonia.[16] Most of these investments came from the US and Western Europe.[17]

China used this model for foreign investments in other state owned banks. Interestingly, Western banks queued to participate in these transactions and secure themselves minority stakes in what would remain for some time state controlled banks. Table 1 below summarizes the core features of the privatization deals.

[INSERT TABLE 1 HERE]

Notably, the transactions between Western banks and foreign sovereign investment vehicles that began with the Blackstone-CIC deal and included deals with major Western banks, such as Citigroup, Morgan Stanley, Merrill Lynch, Bear Stearns, and UBS, used the same model that China had developed as part of its banking reform. To illustrate, consider another transactions in the course of the unfolding credit market crisis in the fall of 2007 in which CIC has been involved. In December of 2007 CIC acquired a 9 percent stake in Morgan Stanley. This time the investment took the form of convertible debt securities at a fixed interest rate of 9 percent. This change came in response to the losses CIC had suffered in Blackstone and reflected the greater awareness of the risks involved in investing in major Western banks at this point in time. Essentially, the revised structure of the deal provided a similar guarantee to the investor (i.e. a fixed return on the investment) as BoA and Temasek had been given in the CCB transaction. Again, the quid pro quo of the transaction went well beyond a simple exchange of securities for capital: the investment of CIC into Morgan Stanley coincided with Morgan Stanley becoming the first Western bank to acquire a banking license in China by acquiring a small local bank. While this may be mere coincidence, the proximity of the two transactions suggests that they were linked.

Table 2 below summarizes core features of the transactions which involved either CIC of China or one of the two sovereign investment vehicles of Singapore: Temasek or GIC, the Government of Singapore Investment Corporation. As can be seen, in all cases did the foreign investor acquire only a minority stake. Many transactions had lock in provisions or other deal features that signaled a longer term relation between the parties to the deal.

[INSERT TABLE 2 HERE]

[16] See Bank for International Settlement (BIS), "Foreign Direct Investment in the Financial Sector of Emerging Market Economies," (Basel: Bank for International Settlement: Committee on the Global Financial System, 2004). esp. Table 1 at p. 9 for details. Note that the share of foreign assets was only 9 percent in Russia, which the BIS included in its category of "Eastern Europe".
[17] Ibid at p 5.

In the public debate the similarities of these two sets of transactions have not been noted. Standard interpretations at least in the Western press focus on the short-term gains of the parties. With regards to the SWF deals it is widely believed that these are temporary bail out transactions: Western banks were in need of capital, which SWFs, including CIC, GIC and Temasek were ready to provide it, and presumably at lower costs or with fewer strings attached than what private investors from the West might have demanded. Why SWFs would enter into such deals and risk their foreign exchange reserves to bail out Western banks rather than invest in their own countries has been discussed in less detail. Some observers suggest that they lacked expertise and thus were duped into these transactions, while others engaged in fear mongering by pointing to the possibility of the re-emergence of state capitalism.[18]

Conversely, observers have puzzled over the motivations of the Western banks who bent over backwards to acquire minority stakes in these state controlled entities, many of which had a history of corruption, mismanagement and substantial non-performing loans.[19] The most common explanation has been that these banks were buying an entry ticket to the Chinese market.[20] The interpretation of why China pursued these transactions seemed more straightforward, the standard explanation being that they were trying to engage Western banks in order to benefit from the expertise and the capital these banks would transfer. This interpretation was, of course, based on the assumption that a minority stake would lead transfer of both capital and expertise and the Chinese banks were indeed in need of these inputs – an assumption that has become much less plausible in light of the SWF deals with Western banks.

In both scenarios, the standard interpretations miss crucial aspects of these deals. Closer inspection of the design features of these transaction helps reveal their deeper rational and supports an interpretation that can actually be reconciled with both sets of transaction. The key conceptual move is to view the transaction not simply as a one shot deal but as an agreement designed to create a governance structure for a medium to long-term relation between the two parties. The critical question is then not, what can the parties get out of the deal here and now, but how can will this initial transaction shape their future relation and what impact will this have on the operation of the target bank and the market they are serving. Notably, the structure of these deals did not prescribe the content of such collaboration. Even in the Blackstone-CIC deal the language is vague and open-ended, and certainly not a legally enforceable contractual provision. On the positive side, however, the open-ended nature of this language makes the relation flexible and adaptable to changes in the environment.

To give one example, how parties to these initial transactions have developed their relationship subsequently, consider a transaction between BoA and CCB auf August

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[18] See, for example, the op-ed by Larry Summers, "Sovereign funds shake the logic of capitalism", FINANCIAL TIMES, 30 July 2007, p. 9.

[19] ADD

[20] In fact, in an earlier incident, Goldman Sachs simply bailed out a state owned financial asset company and declared the expenses as "market development fees" in documents filed with the SEC in the US. ADD details.

2006, whereby BoA transferred ownership in its Hong Kong subsidiary "Bank of America Asia" to CCB in return for a cash payment. BoA may not have anticipated selling its Hong Kong unit to CCB at the time it invested in CCB. But after having worked with CCB for a year and having explored expansion opportunities in the Far East, it apparently became a viable strategy to transfer its retail banking operations in Hong Kong to CCB. BoA, of course, was in the process of helping CCB to develop grater expertise in the retails banking sector. Another example for future transactions that have grown out of initial deals structured as relational contracts are ongoing negotiations between CIC and the major financial holding group Allianz of Germany, over CIC's acquisition of investment operations of Dresdner Bank, one of Germany's largest commercial banks. Allianz, of course, invested in the Industrial and Commercial Bank of China (ICBC) prior to its IPO in 2006.[21]

With its emphasis on structuring a relation between the parties to the initial transaction, this business model differs from those geared primarily at the realization of short-term gains. It creates the foundation for repeat deals and thereby enhances the willingness of parties to cooperate in the future.[22] Interestingly, the structure of the deal creates incentives to cooperate even between parties who do not possess equal control rights. If one analyzes only the formal aspects of the deal, it remains striking that major investors (whether Western banks or SWFs) would agree to pour billions of dollars into a foreign bank that gave them no "voice" and simultaneously limited their "exit" should the deal turned sour.[23] Such a deal is also at odds with standard analysis of the boundaries of the firm. As Grossman and Hart[24] have famously argued, the boundaries of the firm are determined by the optimal allocation of residual control rights, which in turn are a function of incomplete contracts. Because contracts cannot specify all future contingencies someone, i.e. the owner, must be vested with the power to make decisions in the future about issues the contract has not specified. When one party makes more relation specific investments, it makes sense to allocate the residual rights of control to that party, i.e. to vertically integrate. Where this is not the case, it is optimal for the parties to a transaction to maintain their autonomy and use contracts to govern their deal.

The transactions analyzed in this chapter do not fit either model. They do not resemble vertical integration. Unlike the banking deals struck by Western banks in Eastern Europe and Latin America, they do not give the foreign investor a residual right of control. To the contrary, control rights are retained by the target: the Chinese government in the cases of the Chinese banks, and the owners of the Western financial institutions (in the case of Blackstone a handful of senior partners; in other cases dispersed outside owners) that seeks investments by SWFs. Neither are these deals one-

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[21] See Table 2.

[22] See Robert Axelrod, *The Evolution of Cooperation* (New York: Basic Books, 1984) for the theoretical and empirical foundation of repeat deals.

[23] The classification of core mechanisms of governance into "exit", "voice" and "loyalty" was first introduced by Albert O. Hirschman, *Exit, Voice, and Loyalty; Responses to Decline in Firms, Organizations, and States* (1970).

[24] Sanford J. Grossman and Oliver D. Hart, "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration," *Journal of Political Economy* 94, no. 4 (1986).

shot deals. Instead they resemble relational contracts.[25] Formal control rights are less important than the commitment to consider each other for the development of future business, i.e. to build a (lose) relation. The incompleteness of contracts thus is turned into the foundation not of control, but of cooperation.

To be sure, deals that bear similar features are not uncommon in Western economies. Big and influential investors commonly use their largess to influence management, even in companies in which they hold only minority rights. The SEC issued a specific rule not to long ago that forced company management to publicly disclose all information they shared with some investors – typically large institutional investors who commonly meet with top managers informally.[26] Such a rule would not be necessary were there no regular contacts between major investors and top management, even if these major investors hold only a tiny minority stake in the company in question.[27] The literature on the varieties of capitalism has documented cooperative governance regimes for many Western market economies.[28] This literature has largely focused on mechanisms that allow multiple stakeholders to partake in the governance of firms – such as codetermination in Germany -- or more generally the role of labor unions and employer associations in setting the terms of employment and business strategies. More broadly, this literature has emphasized the compatibility of different governance mechanisms with a market economy.

Thus, China is not unique in emphasizing governance structures that promote future cooperation. However, China is an interesting case for analyzing how this strategy has been developed over the years and how it has been used to overcome critical bottlenecks in China's reform process. The next section therefore places China's approach to banking reform into the broader context of China's economic reform strategy.

Transitional Institutions in China's Economic Reform Strategy

Observers of China's reform process continue to puzzle over how China has been able to grow as rapidly and consistently as it has without the standard ingredients in place that have been associated with economic growth and development, such as a well developed legal system, in particular the protection of private property rights, and the rule

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[25] Ian R. Macneil, "Relational Contracts: What We Do and Do Not Know," *Wisconsin Law Review* 1985, no. 3 (1985).
[26] The "Selective Disclosure and Insider Trading Rule" was adopted in 2000. See http://www.sec.gov/rules/final/33-7881.htm for details.
[27] Institutional investors in the US typically hold stakes around 1 or 2 percent. See Bernard S. Black, "Shareholder Passivity Reexamined," *Michigan Law Review* 89 (1990).. For a comparative institutional analysis of institutional investor ownership, see Bernard S. Black and John C. Coffee, Jr., "Hail Britannia?: Institutional Investor Behavior under Limited Regulation," *Michigan Law Review* 92, no. 2087 (1994).
[28] For an overview of this literature, compare Peter A. Hall and David Soskice, eds., *Varieties of Capitalism* (Oxford: Oxford University Press, 2001).

of law.[29] At the outset of China's reform process the legal system was in shambles, private property rights were not recognized, nor was an independent and effective court system in place.[30] To this day China ranks relatively low on standard "rule of law" or "doing business" indices. While some observers continue to predict China's imminent decline lest it adopted "best practices" such as those condoned by the World Bank it is World Governance or Doing Business indices,[31] others have attempted to explain China's success by analyzing the institutional features as they have evolved in China since 1978.

China's approach to institutional reform – whether by design or inadvertently -- has been to start with governance systems that were already in to gradually complement them with new sets of institutions that signaled change and provided alternative forms of governance, or to create "transitional" institutions.[32] As Qian put it: "Underlying China's reform is a series of institutional changes in the novel from of transitional institutions. These institutions work because they achieve two objectives at the same time – they improve economic efficiency on the one hand, and make the reform compatible for those in power on the other. *They also take into consideration China's specific institutional conditions*."[33] Among the examples that Qian analyzes as cases of successful institutional reform are the dual track approach to market liberalization and township and village enterprises, or TVEs. An essential feature of both reform strategies has been to maintain existing governance structures – a state controlled price system and state ownership of enterprises while creating the space for new activities to unfold and new institutions to evolve. Maintaining existing governance structures served as quasi insurance against the possibility that governance structures would be destroyed without anything to replace them. That is essentially what happened in Russia, where aggressive efforts to de-politicize economic decision making[34] triggered what was widely called "the big snatch" – widespread looting and tunneling of enterprise assets.[35]

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[29] On the importance of property rights protection for economic growth and development, see Douglass C. North, "Why Some Countries Are Rich and Some Are Poor," *Chicago-Kent law Review* 77 (2001).
[30] For an overview of the role of law in China's earlier growth experience, see James V. Feinerman, "Economic and Legal Refom in China, 1978-91.," *Problems of Communism* (1991). and Donald C. Clarke, "What's Law Got to Do with It? Legal Institutions and Economic Reform in China," *UCLA Pacific Basin Law Journal* 10 (1991).
[31] See in particular Kenneth W. Dam, *Law-Growth Nexus* (Washington D.C.: Brookings Institution Press, 2007). who predicts that unless China reverts to a conventional property rights protection model growth will not be sustained.
[32]Yingyi Qian, "How Reform Worked in China," in *In Search of Prosperity: Analytical Narratives on Economic Growth*, ed. Dani Rodrik (Princeton: Princeton University Press, 2003).
[33] Ibid atp. 305 (emphasis added).
[34] This was the main purpose for designing the mass privatization program according to its architects. See Maxim Boycko, Andrei Shleifer, and Robert Vishny, *Privatizing Russia* (Cambridge, Mass.: MIT Press, 1995). The predictable result was that many enterprises was a governance vacuum. For a critique of the mass privatization program from the perspective of corporate governance see Katharina Pistor, "Privatization and Corporate Governance in Russia: An Empirical Study," in *Privatization, Conversion and Enterprise Reform in Russia.*, ed. Michael McFaul and Tova Pelmutter (Boulder, Co: Westview Press, 1995) and Katharina Pistor, "Company Law and Corporate Governance in Russia," in *The Rule of Law and Economic Reform in Russia*, ed. Jeffrey D. Sachs and Katharina Pistor (Boulder, Co: Westview Press, 1997).
[35] For a detailed account of theft of enterprise assets during Russia's transition see Bernard Black, Reinier Kraakman, and Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong?,"

Pistor and Xu provide a similar analysis for the development of China's stock market.[36] They show that while China gradually developed a formal legal system for stock markets and shareholder rights protection throughout the 1990s, the core governance features of the emerging stock market had little to do with law and legal institutions as they are known in the West.[37] Instead, China used the quota system as a form of "administrative governance"[38] of the exchange. China had long used quotas to allocated scarce resources among provinces and other administrative or economic entities. It thus came naturally to use this system to allocate a new resource: external sources of finance that would be provided by private investors. In an attempt to wean enterprises off subsidized credits provided by China's state owned banking system, the People's Bank of China devised a scheme whereby it determined the total amount of capital that state owned enterprise could raise in a given year by issuing shares to the public. Each province received a share, which resembles an option to access new sources of finance for companies under the jurisdiction of that province.[39] The exact amount allocated to provinces as well as ministries in control of firms directly under the central government was the process of intense bargaining. Once the quota had been allocated it was up to each province and each ministry respectively to identify companies that would be put forward for listing on one of the major stock exchanges and public issuance of shares. This triggered another intense round of fact finding and bargaining at the provincial level. Finally the selected company had to be approved by China's financial market regulator, the China Securities and Regulatory Commission (CSRC).

Pistor and Xu argue that the quota system served important governance functions. Most importantly, it ensured that agents with access to information about the viability of companies played a critical role in selecting companies for listing and public emission of shares. The danger that these agents would consistently choose "lemons"[40], rather than the most viable firms was mitigated (not eliminated) by holding the provinces accountable for past errors. Indeed, provinces whose companies performed badly on the market received fewer quotas in subsequent years.[41] Moreover, in several instances provinces were forced to bail out firms they had brought to the market. The conventional economic analysis would suggest that this creates moral hazard problems. However, in an environment where state agents at the provincial level are in charge of selecting companies for listing, saddling them with the responsibility of making bad decisions enhances their incentives to select companies more carefully.

Stanford Law Review 52 (2000) and Merritt Fox and Michael Heller, "Pathologies," ed. Merritt Fox and Michael Heller (Princeton: Princeton University Press, 2003).

[36] Katharina Pistor and Chenggang Xu, "Governing Stock Markets in Transition Economies: Lessons from China," *American Review of Law and Economics* 7, no. 1 (2005).

[37] This assessment is shared by many other observers. See Franklin Allen, "Law, Finance, and Economic Growth in China," *Journal of Financial Economics* (2005).. More critically Sanzhu Zhu, *Securities Regulation in China* (Ardsley, New York: Transnational Publishers Inc., 2000).

[38] Pistor and Xu (2005), ibid.

[39] For a detailed account of the operation of the quota system, see also Liufang Fang, "China's Corporatization Experiment," *Duke Journal of Comparative and International Law* 5 (1995).

[40] On this common problem see George A. Akerlof, "The Market For "Lemons": Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 84 (1970).

[41] See ibid, especially, Table 5.

In sum, the quota system served several important functions. It created competition among provinces and ministries for a critical resource. It used existing governance systems, namely the state bureaucracy which had created overseen state owned enterprises to select companies for listing. In this sense, the quota system performed an important function as an “information system”. Critically, it also allocated responsibility to these agents should firms under-perform and thus provided for enforcement against state agents with bad judgment. While the system has not been without flaws, it provided a second best solution in a context where the first best was simply not available. China had thousands of state owned enterprises in need of external finance. A viable financial market did not yet exist, but had to be created. Reliable information about companies was not available to many agents except those directly involved with these companies. And finally, market watchdog institutions and a formal legal system were only in the process of being established.

The strength of the Chinese approach to financial market development becomes apparent when comparing it with the approach taken by many of the former socialist countries in Eastern Europe and the former Soviet Union. In that part of the world setting up a stock exchange was almost synonymous with making the transition form a centrally planned economy to a market economy.[42] Yet the obstacles firms, investors, and newly created regulators faced in this environment were numerous and in many cases proved insurmountable. As in China, most of the existing firms had been created under a system that was based on political fiat, not efficiency grounds. Information about firms was not widely available and the future viability of individual firms was difficult to assess. A legal system was put in place by adopting laws based on Western models, but if and how they would be enforced in practice was not clear at the outset.[43] Not surprisingly, investors were reluctant to trade in shares of companies under these circumstances and many markets remained underdeveloped or even had to be closed down.[44] Jump-starting stock exchanges by mandating that all privatized companies would be immediately listed on the market, as the Czech Republic did, proved to be a futile exercise. In fact, Czech regulators de-listed hundreds of companies in 1997 and began to rebuild the market with fewer firms that were subject to extensive listing requirements.[45] The countries that faired somewhat better, such as Poland, had taken a different approach and supported the gradual expansion of the market.

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[42] William C. Philbrick, "The Paving of Wall Street in Eastern Europe: Establishing the Legal Infrastructure for Stock Markets in the Formerly Centraly Planned Economies," *Law & Policy in International Business* 25 (1994).

[43] For a detailed analysis on the development of shareholder and creditor rights in transition economies see Katharina Pistor, "Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies," *European Business Organization Law Review* 1, no. 1 (2000). Despite the strengthening of these rights in the law on the books this had little impact on actual market development. See Katharina Pistor, Martin Raiser, and Stanislav Gelfer, "Law and Finance in Transition Economies," *The Economics of Transition* 8, no. 2 (2000).

[44] For a comparison of stock market development in China and Eastern Europe and a critical assessment of the comparability of these markets, see Pistor and Xu (2005).

[45] Katharina Pistor, "Law as a Determinant for Stockmarket Development in Eastern Europe," in *Assessing the Value of Law in Transition Economies*, ed. Peter Murrell (Ann Arbor: University of Michigan Press, 2001).

The above analysis is consistent with Lin's insight that the former socialist countries face fundamental obstacles that cannot be addressed with recipes taken from neoclassical economic textbooks.[46] In his words, "many firms in transitional economies and developing countries are not viable, i.e., they cannot earn acceptable profits in an open, competitive market even though their management is normal. The non-viability of these firms arises from the fact that the sector in which the firm operates, the products it produces, and the technology the firm uses in production are inconsistent with the economy's comparative advantage as determined by the factor endowment structure, namely the relative abundances of labor, capital, and natural resources"[47] Simply calling for an exit of those firms was not an option in light of the social and political effects the mass closure of large industrial firms would have had. Instead, ways need to be found to resolve the viability issue. In part this can be accomplished by subsidizing non-viable firms while new firms enter the market and grow. However, to a larger extent it requires target government interventions to make different enterprise sectors competitive.[48]

To summarize, throughout China's 30 year old experiment with economic reforms we find evidence of a careful engineering of the *process of reform*. Old governance structures were not simply dismantled – as they frequently were in Eastern Europe and the former Soviet Union – but with only few changes used to promote a new direction of institutional development. This allowed policy makers and economic agents to adjust their behavior to the changing circumstances. In the meantime new governance structures were often put place. Some were installed top down, including China's company, securities, and banking laws as well as the regulators charged with overseeing stock markets and banks.[49] Others evolved in a bottom up manner, as the governance structure of township and village enterprises, which varied greatly across provinces and in response to local institutions.[50] This multiple-track approach to institutional reform has allowed the system to adapt to an ever-changing environment, indeed has made adaptability a hallmark of the system.[51]

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[46] Justin Y. Lin, "Viability, Economic Transition and Reflection on Neoclassical Economics," *Kyklos* 58, no. 2 (2005).
[47] Ibid at p. 243.
[48] For a detailed account of such measures see ibid at p. 258.
[49] See Fang, "China's Corporatization Experiment." Donald Clarke, "Coporate Governance in China: An Overview," *China Economic Review* 14 (2003); Nicholas C. Howson and Lester Ross, "Foreign Minority Equity Investments in Chinese Commercial Banks," *The China Business Review* 30, no. 4 (2003); and Zhu, *Securities Regulation in China*. for details of these three areas of legal reform.
[50] Hehui Jin and Yingyi Qian, "Ownership and Institutions: Evidence from Rural China," (Cambridge, MA: Harvard Institute for International Development, 1997), Andrew Walder and Jean C. Oi, "Property Rights in the Chinese Economy: Contours of the Process of Change," in *Property Rights and Economic Reform in China*, ed. Andrew Walder and Jean C. Oi (Standford, CA: Stanford University Press, 1999).
[51] Yingyi Qian, Gerard Roland, and Chenggang Xu, "Coordination and Experimentation in M-Form and U-Form Organizations," *Journal of Political Economy* 114, no. 2 (2006) associate the adaptability of the system with organizational form.

Meanwhile, the strategy of evolving transitional institutions has been implemented to reform Chinas big state owned banks and for those banks to expand their reach beyond mainland China and into foreign and global markets. As the transactions reviewed at the outset of this paper reveal, they were designed as relational deals between two or more parties that would facilitate mutual learning and engagement counterparties from very different governance regimes. The foreign banks that invested in China's big state owned banks were accustomed to operate in systems that combined market autonomy with a sophisticated regulatory regime that sought to constrain bank activities in areas that were deemed risky to the financial system. The Chinese banks they invested in were accustomed to operate under direct government control and an evolving regulatory regime that had complemented but not yet replaced direct government control. Involving foreign strategic investors provided an new source of governance and has allowed the Chinese government to rely more and more on regulatory oversight rather than direct control as foreign investors had an incentive to monitor the banks they invested in. For once, they had a sufficiently large stake so as not to be overtly passive investors. Moreover, they could not exit at will for a number of years and thus had incentives to ensure that their investment would increase in value over time. And finally, they were eager to please Chinese authorities in the hope of expanding their activities in the Chinese market.

The transactions between Chinese sovereign vehicles and Western banks offer similar advantages to the parties involved in these deals. Operating in global markets implies operating across multiple legal orders and governance regimes, many of which will be unfamiliar to firms or banks seeking to expand their activities. This is true despite numerous attempts to streamline banking regulations by standardizing regulatory practices.[52] Not only do these harmonization attempts remain partial.[53] More importantly, the implementation and enforcement practices, i.e. the most critical ingredients of any governance structure, vary considerably across countries. Banks wishing to explore foreign and international markets therefore need to invest in their own governance regime. One way to accomplish this is to structure transactions with relevant counterparts from other markets in such a way that these transactions themselves create some safeguards for each party and allow each party to acquaint itself with different regulatory regimes and business practices in markets they are less familiar with. As has been shown, the transactions between CIC and several Western banks, and similar transactions between sovereign vehicles from Singapore bear design features that can be used for this purpose. In this sense, China has begun to export critical aspects of institutional reform to the global financial market place, which arguably constitutes the most recent example of economic transformation.

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[52] For an overview of regulatory standardization at the BIS see BIS, "International Convergence of Capital Measurement and Capital Structures," (Basel: Bank for International Settlement, 2005). On the IMF's attempt to build a standardized "international financial architecture", see IMF, "International Standards: Strengthening Surveillance, Domestic, Institutions, and International Markets," (Washington: International Monetary Fund, 2003).

[53] For a critical assessment of international standardization efforts see Katharina Pistor, "The Standardization of Law and Its Effect on Developing Economies," *American Journal of Comparative Law* 50 (2002).

Concluding Comments

The argument developed in this chapter can be summarized as follows:

China has established a new approach to banking or, more broadly, financial sector reform, which recently has been emulated in a series of transactions aimed at rescuing the ailing Western (US) banking sector. At the core of this approach has been the establishment of relational ties between two or more financial institutions from different governance regimes (China and the West) with the goal of stimulating cooperation in business projects and enhancing the governance regime for the banks involved in these transactions.

Closer scrutiny suggests that the strategy of this approach reflects a broader trend in China's economic reforms over the past several decades, which has emphasized the process of reform, in particular the continuous adaptation and experimentation of governance arrangements to a changing environment. Overall, the Chinese state owned banks have performed well – much better than many banks that have been privatized, sold to foreign investors or were otherwise reformed in emerging markets throughout the 1990s. As a result of a series of recent transactions whereby sovereign vehicles predominantly from the Far East (China and Singapore) have invested substantial minority stakes in Western Banks have "globalized" this reform model.

Table 1: Foreign Investors & China's Largest Banks

Bank	Foreign Investor	Stake	Board Representation & other commitments
Industrial and Commercial Bank of China	Goldman Sachs, Allianz, and American Express	8.5 (combined)	Goldman Sachs to nominate one board member
Bank of China	Consortium led by Royal Bank of Scotland	9.6	RBS to nominate one board member
	UBS	1.6	
	Temasek	4.8	
China Construction Bank	Bank of America	8.5	One board member
	Temasek	6.0	Option to nominate one board member
Bank of Communication	HSBC	19.9	Two board members, one on audit committee, one on personnel & compensation committee

Source: Compiled by author from varies news reports.

Table 2: Deal Structures involving East Asian Sovereign Investment Vehicles

Date	Western Bank	SWF/ Foreign	Link Type	Quid pro Quo
5/2007	Blackstone (US)	CIC	9.9 % Non-voting units in LP; 10% ceiling	Transfer restrictions for 3 years Blackstone to receive future asset management opportunities
7/2007	Barclays (UK)	CDB Temasek	2.6% equity stake 10% ceiling for CDB & Temasek combined	Right to nominate directors to Barclays' board
12/2007	UBS Switzerland	GIC	US$9.3 bln convertible debt securities (~9% upon conversion)	*Details of transaction not available*
12/2007	Morgan Stanley (US)	CIC	9.9% convertible equity units @ 9% interest	11/2007 Morgan Stanley becomes first U.S. investment bank to get a commercial banking license in China (through acquisition of small bank)
12/2007	Merrill Lynch	Temasek	Common Stock; option to acquire another US$ 600 million worth of stock by 3/2000	One-year lock up provision 10% upper ceiling for Temasek; no board representation or governance function.
1/2008	Citigroup	GIC	US$ 6.6 bln converible debt securities (if converted ~4%) @ 7 percent	not callable for 7 years; convertible by investor at any time; certain transfer restrictions

Source: Compiled by author from varies news reports.
Note: CDB = China Development; Bank CIC = China Investment Corporation; GIC = Government of Singapore Investment Corporation

(BIS), Bank for International Settlement. "Foreign Direct Investment in the Financial Sector of Emerging Market Economies." Basel: Bank for International Settlement: Committee on the Global Financial System, 2004.
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