Reforming the Governance of China's Banks

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1 Introduction

Faced with the enduring challenges of continuing state control, large portfolios of non-performing loans and weak internal controls and risk management, corporate governance has become a central issue in the reform of the Chinese banking sector. The Chinese authorities have implemented comprehensive and far-reaching reforms in recent years, including recapitalization of banks, extensive governance regulations and gradual ownership transformation, with the introduction of strategic investors and public share offerings. However, the primary focus of this paper is not these enduring challenges nor the various policy responses, but rather the practical steps that must be undertaken by each bank, without which the policy initiatives will have largely been in vain.

When considering governance reform in China's banks, the subject should not be seen narrowly as reconstituting the boards of directors or clarifying the rights of shareholders, but in a broader context as the nexus of a diverse set of key issues, including improved risk management, ownership transformation and the gradual decline in the state's role in the banks. Despite the wide spectrum of types and sizes of banks in China, the common origin of the banks as lending arms of the state allow us to identify common challenges among the banks and then to suggest a program of eight steps that every bank should take on the road to stronger governance. The first step is to strengthen the role of the Board of Directors, which is complemented by the second step of enhancing the role of independent directors. The third step is to strengthen overall risk management and oversight, while the fourth step is more specifically to strengthen credit risk controls, including the appointment of a chief credit officer. The fifth step is to structure an independent audit function. The sixth is to structure a central finance function and appoint a chief financial officer. The seventh step is to leverage the role of outside investors, which is often done in preparation for the eighth step of moving to a public share offering.

Finally, although these eight steps should achieve significant progress at each bank, there are some issues that remain unresolved and will need to be addressed in the coming years, such as the extent of state control, the constraints on foreign ownership and control and the ambiguous role of the secondary board, called the Board of Supervisors.

2 Defining Corporate Governance

Corporate governance refers to the structures and processes for the direction and control of companies, concerning the relationships among the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders. The *OECD Principles of Corporate Governance*, first issued in 1999 and revised in 2004, provide a useful framework for the specific issues that should be addressed: the rights and equitable treatment of shareholders and other financial stakeholders, the role of non-financial stakeholders, disclosure and transparency, and the responsibilities of the Board of Directors.

There are two types of benefits of good corporate governance – improving access to capital and improving company performance. An increasing volume of empirical evidence indicates that well-governed companies have better access to outside capital and consequently receive higher market valuations.[1] Most of the attention of policymakers and researchers in emerging markets has focused on the role governance can play in improving access to global portfolio equity. Improving corporate governance should also increase other types of capital flows to companies, both domestic and global capital, both equity and debt, and both public securities markets and private capital sources.

Less attention is paid to the role of good governance in improving company performance, irrespective of the need to access capital. Improved governance structures and processes help ensure better risk management, encourage effective succession planning for senior management and enhance the long-term strategic direction of companies, regardless of the need to access outside capital.

While the *OECD Principles* provide a useful framework for considering the governance of listed commercial "real sector" companies, state-owned banks have two additional layers of complexity. First, as deposit-taking financial institutions, these banks pose greater risks than real sector companies and consequently are subject to greater regulatory oversight. Second, as state-owned enterprises, the Chinese banks face the same governance challenges that are faced by state-owned enterprises across the world in terms of defining the appropriate relationship with the state and, where appropriate, accommodating public policy objectives.

[1] GOMPERS, P./ISHII, J./METRICK, A. (2003): Corporate Governance and Equity Prices, *Quarterly Journal of Economics* 118 (1), February 2003, pp. 107–155.

2.1 Governance of banks

Banks pose extra risks both at the level of the individual institution and at the systemic level – indeed, it is not too simplistic to say that it is the business of a bank to buy and sell risk. At the level of the individual institution, banks are intentionally highly-leveraged institutions, but have the potential to rapidly change their risk profile by taking imprudent lending decisions and are also able to hide risks due to the opacity of loan quality. Furthermore, as deposit-taking institutions, there are an additional set of financial stakeholders at risk – not only shareholders, but also public depositors. At the systemic level, problems at one bank can trigger a banking crisis as they spread throughout the banking system, primarily by undermining the confidence of depositors in the banking system, through the correspondent banking relationships and through failure of the payment system. As a consequence of these additional risks, banks are subject to substantially greater regulatory oversight – not just concerning prudential restrictions and reporting requirements, but increasingly concerning governance structures.

In China, as in many other markets, the regulators have now issued detailed governance requirements, addressing the composition of the board and the establishment of board committees to address audit issues and risk management issues. However, the governance issues in banks go much deeper than the board structures and shareholder rights and it is still left to the individual banks to address structural issues such as the division of risk management responsibilities, the internal audit function, the central finance function and how these areas report to senior management and to the board of directors. The effectiveness of these management functions is essential to the effective governance of a bank and, therefore, in banks, even more than in real sector companies, there is no clean distinction between management issues and governance issues.

2.2 Governance of SOEs

With the sole exception of Minsheng Bank, all the banks in China are effectively controlled by the state, with the state and Party selecting the senior management of the banks. This includes not only the big state-owned banks controlled at the national level, but also the joint stock commercial banks, city commercial banks and rural banks controlled by provincial or municipal governments. Notably, it also includes those banks that have been partially-privatized through the introduction of minority strategic investors and even those that have publicly listed their shares, since the

state remains as the controlling shareholder. This creates a second layer of governance complexity for China's banks, as they are essentially state-owned enterprises (SOEs) and face the same questions of SOEs across the world, such as the degree and type of influence of the state on the individual bank and through what channels the state exercises this influence. As a general rule, state-controlled banks are even more susceptible to undue interference from the state than other SOEs given their key role in economic management. Through control of banks, the state can ensure that favored industries and companies (most obviously, other SOEs) receive preferential access to capital, with the consequence that the credit controls of the bank are undermined under the pressure to make sub-optimal lending decisions. As SOE managers, the bank's senior managers are unlikely to be rewarded or punished on their ability to maximize shareholder value or for the prudent use of depositors' money, but rather for their ability to fulfill the policy priorities of the state.

The related governance challenge resulting from state control across the world is that the state will typically exercise its influence through alternative channels – rather than working through the shareholders' meeting or the board of directors, the state will influence management directly. The practice of by-passing the standard governance structures may be especially difficult to reform in Chinese SOEs, where the institutions of the Party, including the personnel department of the local Party and the Party Committee within the enterprise, provide a well-established and formal structure for decision-making that by-passes the shareholders' meeting and the board of directors.

3 Governance Reforms in China

The China Banking Regulatory Commission (CBRC) was established in 2003 and takes the leading role in setting governance standards for the banking sector. Prior to the establishment of the CBRC as an independent banking regulator, this responsibility rested with the central bank, the People's Bank of China (PBOC), which continues to take an active role in banking sector reform. Another key institution is Central Huijin Investment Company (also known as China SAFE Investments), which acts as the investment arm of the central government for the state's shareholdings in the biggest banks once they have been corporatized into shareholding firms. Once these banks introduce strategic investors, Central Huijin becomes the controlling shareholder. Notably, the Chinese authorities took the decision to separate the state asset management of the big four banks, under Central Huijin, from the state asset management of the largest SOEs in other industries, under the State-owned

Assets Supervision and Administration Commission (SASAC), which should reduce the pressure on these banks to give preferential loans to other SOEs. However, beyond the biggest banks, the second and third tier banks are controlled by provincial and municipal levels of government.

In 2002 the PBOC issued two sets of governance standards for the banking sector: the *Guidance on Corporate Governance of Joint Stock Commercial Banks* and the *Guidance on Independent Directors and External Supervisors of Joint Stock Commercial Banks*. These documents set the standards for the composition of the board of directors, with management directors, shareholder-nominated directors and independent directors, and the role of the directors, with a special emphasis on the role of independent directors. The guidelines also outline the composition and basic function of various committees of the board, namely the Audit Committee, the Compensation Committee, the Risk Management Committee and the Related Party Transactions Control Committee. The practical requirements of these guidelines are very similar to the governance requirements for listed companies, although only banks are required to establish the risk management and related party transactions committees. In 2005, the CBRC issued the *Guidelines for Board of Directors Code of Conduct of Joint Stock Commercial Banks,* which builds upon the earlier PBOC guidelines, emphasizing the responsibility of the board of directors for ensuring the effectiveness of risk management in banks. Strictly speaking, these documents are only “guidelines”, rather than regulations and are only applicable to that sub-set of banks defined as “joint stock commercial banks”, which excludes both the big “state-owned banks” and the city commercial banks and rural banks. In reality, however, these documents have a very broad and significant impact. Most banks interpret these documents as mandatory regulations, even if they are called guidelines. Furthermore, these guidelines set the standard for all banks of any significant size, such as the larger city commercial banks, not just the joint stock commercial banks. In addition to these governance guidelines, four of the five largest banks in China have been identified as “Reforming Banks” and are subject to concerted efforts by Central Huijin and by the bank regulator to overhaul their performance across a broad range of areas, including governance.[2]

[2] The Big Five banks in China are ICBC, Bank of China, China Construction Bank, Agricultural Bank of China and Bank of Communications. Of these five, only Agricultural Bank of China is not a “Reforming Bank” because its challenges are so great that it will need longer-term and more tailored attention.

The bank governance reforms of the last several years have been paralleled by governance reforms for listed companies. With the number of listed banks steadily increasing, the reforms for listed companies also have great significance for the banking sector. In 2001, the China Securities Regulatory Commission (CSRC) issued the *Code of Corporate Governance for Listed Companies in China* and late 2005 saw reforms to the Company Law and Securities Law. In addition, the comprehensive capital markets reforms, including the transformation of non-tradable state shares into tradable shares, will also have a significant impact on governance standards in China since without well-functioning capital markets, there will be little market discipline on listed companies. Taking a longer view, since the early 1990s, China has seen the gradual emergence of all the basic institutions of corporate governance of listed companies, both in terms of the market framework, with stock exchanges, securities regulators and state asset management companies, and within companies, with the separation of roles among shareholders, boards of directors and managements teams. However, as a result of the incremental approach to state sector reform taken by the Chinese authorities (in contrast to the rapid, mass privatization in Central and Eastern Europe), these new governance institutions sit side-by-side with the older institutions of the state and Party. Meanwhile, in Hong Kong, the securities authorities continue to strengthen their governance framework as they strive to positively differentiate their higher governance standards from the standards of companies listed only on the domestic stock exchanges in Mainland China.

A-share market[3]	**H-share market**[4]
• Bank of China • China Huaxia Bank • China Merchants Bank • China Minsheng Bank Corporation • Shanghai Pudong Development Bank • Shenzhen Development Bank	• Bank of China • Bank of Communications • China Construction Bank

Table 1: Chinese Listed Banks

[3] The A-share market is China's domestic stock market, consisting of the Renminbi-denominated stocks listed on the Shanghai and Shenzhen stock exchanges.

[4] The H-share market is the market composed of Mainland China incorporated companies listed on the Hong Kong Stock Exchange. So far, no Chinese banks have listed on any other international exchanges. In addition to the banks listed on this table, two Chinese banks have local subsidiaries in Hong Kong that are listed on the Hong Kong Stock Exchange, Bank of China (Hong Kong) and ICBC (Asia). At the time of writing, Bank of China is the only bank with both A-shares and H-shares.

4 Eight Practical Steps

While the banking and capital market authorities in China should be commended for their ongoing efforts to overcome the significant governance challenges in China, the policy and regulatory reforms will only have a real impact if they are complemented by governance improvements at the level of individual banks. Despite the diversity of banks in China in terms of their size, business focus and ownership structure, all Chinese banks would benefit from following this program of eight steps to improved governance. Certainly, the success of this reform program will require the effective implementation of each step – with the improvements being undertaken in earnest, rather than adopting the same "box-ticking" approach that undermines many of the existing regulations.

4.1 Board of directors

The first step for China's banks is to strengthen the role of the board of directors. A board of any company has two basic roles: to provide guidance on strategy and to provide oversight of management. For a bank, this second role is especially important, with the board taking the ultimate responsibility for ensuring the effectiveness of the risk management systems in the bank. In addition to ensuring that the necessary systems and processes are in place, the board of a bank should have a clear view of the major risks facing the banks and any major transactions.

Chinese banks need to articulate the role of the board of directors, distinguishing the board's responsibilities from the responsibilities of senior management, on the one hand, and the responsibilities of the shareholders' meeting, on the other hand. Often the board is seen as either a meeting of senior management or as a meeting of major shareholders. One particular expression of this confusion is that whereas banks are required to formally separate the roles of Chairman as the non-executive head of the board, and President, as the head of senior management, in practice, the chairmen of banks still play an executive role and are effectively the most senior member of bank management. One key responsibility of a board of directors is to hire (and fire) the President and senior management, but the current practice among Chinese banks is that the Party and the state, as the controlling shareholder, choose the senior management directly.

Even when the proper role of the board of directors is understood, the effectiveness of the board should be enhanced by introducing basic procedures and formalities.

Some of these basics include: issuing a twelve month board calendar, with specified dates for board meetings, the annual shareholder meeting and other major corporate events; providing directors with sufficient information in advance of board meetings and giving directors the opportunity to add items to the meeting agenda; producing a board manual for the directors, which would contain all the key corporate documents and related reference materials.

The role of committees of the board of directors should be strengthened so that they enable the board to make a more detailed examination of key issues. In most cases, this will require not only improving the formal operations of the committees, but also ensuring that the most committed directors, with the right skills, sit on each of the committees. However, in most Chinese banks, the committees are only established to fulfill the regulatory requirements and serve no other useful purpose. In line with the more general confusion between board and management responsibilities, the board committees are often not distinguished clearly from the management committees.

4.2 Independent directors

Banks need to put talented independent directors on their boards and then give these independent directors the capacity and, where appropriate, the authority to fulfill their function effectively. The role of independent directors is probably the area with the greatest discrepancy between the lofty aspirations of the regulators and disappointing implementation among banks. Both the bank governance guidelines and the listed company regulations envisage a key role for independent directors, especially playing a leading role through the audit and related party transactions committees. By constituting these committees with independent directors, the committees are able to take an independent view on audit issues and on related party transactions, free from the conflicts of interest that would prejudice the judgment of other directors. In reality, independent directors are placed on bank boards to comply with the regulations and they lack both the skills and the motivation to be effective. Banks not only need to find talented and truly independent directors for their boards, but they also need to compensate these independent directors sufficiently so that they take their role seriously. A number of banks in China have seen the benefit of providing training to their boards of directors. This training should focus not only on governance issues, but also on banking itself since many of the independent directors will not be bankers by profession.

4.3 Risk management

The third step is to consolidate overall risk management so that both senior management and the board have a clear view of the overall risk situation facing the bank. Effective risk management should provide an overview of all the risks facing the bank, including credit risk, market risk and operational risk, and also how these risks may relate to one another. While the CEO or President has the primary responsibility for risk management, the board's role is to determine the risk appetite for the bank, ensure that the senior management has put effective systems in place and be satisfied that the various categories of risk have indeed been identified. On a regular basis, the Board should be presented with a review of the bank's risk exposure and changes to the risk management policies. The development of effective risk management systems is especially important for Chinese banks at this particular time as they transition from a controlled economy to a market economy – from an environment of policy-directed lending and capital controls to an environment of commercial lending and free markets.

A major challenge in most Chinese banks is clarifying the division of responsibilities across the bank for various aspects of risk management and then bringing together these disparate perspectives so that the senior managers at the top of the bank have the overview of all risks facing the bank. In Chinese banks, risk management responsibilities are typically divided among the planning and finance department, the treasury and the credit departments, but the exact division of responsibilities is not clear and there is no one department that sees all the risks at the same time. Now that it is mandated that bank boards must have a Risk Management Committee that looks at overall risk issues, the banks need to develop the role of this committee and distinguish it from the management committees that look at more specific risks, namely the Credit Committee and the Asset and Liability Committee.

Some of the leading banks in China are following the international trend among banks and appointing a Chief Risk Officer, so that there is one individual who is explicitly charged with having a view on the overall risk situation. However, since this role is relatively new to banks across the world, there is no one model for the scope of the role and, therefore, each bank must articulate how this role complements – rather than overlaps with or even undermines – the crucial risk management responsibilities of the CEO or President, the CFO and the Chief Credit Officer.

4.4 Credit management

Moving beyond overall risk management to consider credit risk specifically, the fourth step to improved governance requires strengthening credit controls and appointing a chief credit officer. For many Chinese banks, the single biggest source of risk at this point in time is credit risk, or that involving the ability of the borrower or other counterparty to meet its obligations for each loan or other transaction. All banks must have a credit management function that oversees the credit risk of each transaction before and after disbursement of loans and the development and implementation of policies concerning credit risk.

A strong credit management function needs to be independent from the business operating units, so it can resist pressures to approve credit decisions that will impose unreasonable risk on the bank. In particular, the credit officers must not report to the loan officers, whose incentive is to build up the loan portfolio, rather than be concerned with the creditworthiness of borrowers. Credit decisions must also be insulated from the influence of the shareholders, especially the controlling shareholder, and in this the credit management function and chief credit officer need to be reinforced by a strong and active Related Party Transactions Control Committee at the board level. The credit function needs to be led by an experienced chief credit officer, who has sufficient rank and profile to withstand pressure from other senior managers in the bank.

4.5 Internal audit function

All banks need to have a rigorous and independent internal audit function. The responsibility of the internal audit function is to carry out an ongoing audit of the most important processes and *ad hoc* audits on particular issues. It must be independent of operations of the bank so that it can act as a check and balance against weaknesses or breaches of procedures within the organization. This has been particularly challenging for the largest, geographically far-flung banks, where the internal auditors in branch offices have traditionally reported to local management, rather than having an independent reporting line to the central headquarters and the central internal audit department. The internal audit function needs to be led by a head of internal audit that has the status and standing within the bank in order to work effectively with the board and senior management.

The internal audit function should have a dual reporting line, not just to the CEO or President, but also to the board of directors through the board's audit committee. In principle, the audit committee is the most important committee of the board, both providing oversight of internal audit and internal controls, and overseeing the appointment of external auditors and implementation of the auditor's recommendations. However, most Chinese banks need to significantly strengthen the role of the audit committee and ensure that the chairman of the audit committee has the skills, the independence and the motivation to effectively play this key role.

4.6 Central finance function

The sixth step is to appoint a chief financial officer (CFO), who leads a centralized finance function. A centralized finance function should have an overview of the whole bank, independent of the business operating units. This central finance function should lead the funding activities of the bank, including any public listing of shares or public issuance of debt. The central finance function would also take the lead in public disclosures. To be effective the central finance function must be led by a CFO, who would be a single focus of authority and have an important voice in management. In some cases, the creation of the CFO position may result from expanding the terms of reference of one of the existing senior managers. However, the CFO position will often need to be filled by an experienced finance professional recruited from outside the bank, who has extensive relevant experience and who has credibility with outside providers of capital.

4.7 Strategic investors

The seventh step in improving corporate governance is leveraging the role of outside investors. Although the banks obviously benefit from the capital that is injected by these investors, it is important that the banks receive more than just money from their major shareholders. More and more Chinese banks, including almost all the largest banks, have now introduced outside investors, including both strategic investors, most commonly large foreign banks, and financial investors, such as private equity investors or cash-rich local firms. However, the role that is played by these strategic investors and the major financial investors varies significantly from one bank to the next (although there does appear to be a pattern of increasing involvement with more recent investors). The Chinese banks should see the presence of these foreign banks as an opportunity to benefit from their technical assistance

across a broad range of areas from consumer finance to information technology. Perhaps even more important in the longer term is the role of both the strategic investors and the financial investors in pushing for governance reforms from their position on the boards of the Chinese banks.

4.8 Public listings

The eighth and final step is to move towards a public listing on an established stock exchange. In theory, listing on a stock exchange ensures the better governance of a bank through both a one-time overhaul of governance to meet the listing standards at the time of the IPO and subsequently through the ongoing monitoring by the public markets after the bank is listed. The previous seven steps should go a long way to ensuring the success of this final step of public listing.

If a bank does not overhaul its governance in preparation for the public listing or is perceived to have weak governance practices, it will not be able to list. Without meeting the minimum regulatory or market standards, either the listing application will be rejected by the stock exchange or the underwriters will conclude that there is insufficient investor appetite or, at the very least, the bank will receive a lower discounted price at IPO. Once the bank is publicly listed, the effect of market discipline should theoretically provide an ongoing assurance of better governance, with institutional shareholders, equity analysts, the financial media and stock market regulators all keeping an eye on the listed bank, in addition to the bank regulator. Unfortunately, looking at the experience of many Chinese banks and other companies that have already gone public, this ongoing effect of market discipline after the IPO appears to be much weaker than the one-time overhaul of governance before the IPO – the banks and other companies undertake a frantic governance reform effort in the run up to a public listing, but lose interest in these issues after the public listing, once their immediate goal has been achieved.

The importance of governance improvements for a successful public listing depends largely on the stock exchange that is chosen for the public listing. At the moment, the main choice is between the domestic A-share market in Shanghai and the overseas H-share market in Hong Kong, although other exchanges, such as London, New York and Singapore are trying to encourage Chinese banks to list in their markets. Between Shanghai and Hong Kong, Hong Kong certainly has the stronger reputation for governance standards. The differences between the two markets concern not so much the details of the listing requirements, which are broadly similar, but rather the

degree of enforcement of regulations and the governance standards demanded by investors in these two markets. Regardless of the exchange on which a bank lists, the governance standards required for the listing will depend not just on the formal listing requirements, but also on the investor appetite for bank IPOs at that particular time. Even if an exchange has extensive and stringent listing requirements, there will be a downward pressure on governance standards at those times when investors are very keen to buy into IPOs. In other words, if the investors do not demand high governance standards, then banks will be able to take a box-ticking or minimum compliance approach to even the most detailed set of governance requirements.

The Chinese authorities have even seen the effect of overseas public listings as being so strong that they have encouraged banks and other companies to list, primarily, in order to improve their governance and only secondarily to raise capital. This is a reversal of the conventional logic that a company improves governance in order to access capital – instead the banks and other companies being pushed to access capital, so that they improve governance. This phenomenon has been termed the "PetroChina Model", following the example of the oil giant's listing in Hong Kong and New York in 2000:

… an overseas listing provided a "one-stop shop" for SOE reform. Instead of civil servants, global management, human resources and investment banking firms took the reins of the restructuring process, identifying and stripping off unproductive assets, clarifying pension liabilities, carrying out full audits, redefining governance responsibilities. Once the listing was completed, PetroChina also inherited a professional investor base intent on scrutinizing accounts and management decisions. … Fast forward a few years to the present day, and this is precisely the government's logic in pushing large state owned banks to list overseas.[5]

5 Unresolved Issues

While it is possible to draw up a program of eight steps to improve governance at Chinese banks, there are also a number of issues where the future is less clear and there is little consensus about the appropriate path to reform.

[5] ANDERSON, J. (2005): How to think about China (Part 3): Which way out for the banking system?, UBS Investment Research.

- **Role of the State and Party**: The first major issue that will not be completely resolved for years to come is the role of the state and the Party in Chinese banks. With one exception, every bank remains under the control of some level of the Chinese state. State ownership of banks is certainly not unique to China, with many of the largest banks in markets as diverse as Brazil, Indonesia and the Philippines being majority owned and controlled by the state. However, state control may be especially complicated in China, firstly, because the institutions of the Party provide a well-established means for decision-making, bypassing the board of directors and shareholders' meeting, and, secondly, because there is no commitment in China to full privatization of banks, even in the longer run. It is likely that some of the smaller banks will be privatized in the medium-term, but the long term ownership and control of the largest banks is harder to predict.

- **Foreign Ownership Control**: Under current regulations, foreign investors are collectively limited to 25% of the shares of a bank, with any one foreign shareholder holding no more than 20%. In effect, this prevents foreign control of a Chinese bank.[6] There has been frequent speculation that the Chinese authorities will lift this 25% threshold, but even when this happens it is very unlikely that foreign banks will be allowed to immediately seize control of Chinese banks. Initially, they may only be allowed a larger minority stake. It is also not certain that all the foreign banks would take advantage of the ability to increase their stakes – it would depend on whether their aim is to exert significant influence over the bank, which would require a higher shareholding, or only to gain access to the Chinese market, for example, through joint ventures or through the Chinese bank's distribution network, which may be achievable with a smaller minority stake and less influence over the bank.

- **The Board of Supervisors**: The third question that remains unresolved is the role of the Board of Supervisors. A cursory examination of the Companies Law may suggest that China has a two-tier board structure, similar to that found in Germany or the Netherlands. However, closer inspection of the legislation and, more significantly, the actual practice in Chinese companies shows that China effectively has a one-tier board structure, with the complication of a secondary

[6] One interesting exception to this is Shenzhen Development Bank, where the foreign investor, Newbridge, was granted management control, without owning a controlling shareholding in the bank. At the present time, Citigroup is attempting to assemble a consortium to bid for control of Guangdong Development Bank, but is not clear that the regulators will allow this transaction to move forward or exactly what type of control would be granted.

board with an unclear role and unclear authority. In a two-tier system, a "supervisory board", composed exclusively of non-executives, supervises a "management board", composed exclusively of executives of the company. In contrast, a one-tier system, such as that found in the UK or USA, has only one "board of directors" typically composed of both non-executive and executive directors. Chinese companies are required to have both a "board of directors" (suggesting the one-tier system) and a "board of supervisors" (suggesting the two-tier system). However, the key point is that the board of directors is composed of both executive and non-executive directors and wields the ultimate authority in the company, as in the one-tier system. In contrast, the "board of supervisors" has a very unclear function and does not have the authority of a "supervisory board" in the two-tier system.

This lack of clarity concerning the board of supervisors creates at least two practical challenges within banks and other companies. First, there is a confusion of roles for audit and control within the companies. In principle, the board of directors, working through the board's audit committee, should have the ultimate responsibility for both the internal and external audit of the company. However, the law suggests that there is some kind of role for the board of supervisors in auditing, though it is not clear what exactly it is supposed to audit – the work of the company as a whole or merely the work of the board of directors. To reinforce this confusion, PBOC's 2002 governance guidance even required that the audit committee be a committee of the board of supervisors, rather than the board of directors. Fortunately, this was recently reversed by the CBRC's 2005 governance guidelines, with the audit committee required to be a committee of the board of directors. The second challenge posed by the board of supervisors is that it is often composed of senior Party officials and, therefore, strengthens the role of the state in the banks. In some cases, the Chief Supervisor, who chairs the board of supervisors, will be the Deputy Party Secretary within the bank, while the Chairman of the board of directors is the Party Secretary. This reduces the ranking of the President within the bank to third place, beneath not only the Chairman but also the Chief Supervisor.

In the past few years there was an assumption in some quarters that the significance of the board of supervisors would gradually be reduced until eventually it would be eliminated as a legal requirement. For the banking sector, the declining importance of the board of supervisors was reflected in the contrast between the 2002 PBOC *Guidance*, which envisaged a significant role for the board of supervisors, and the 2005 CBRC *Guidelines*, which barely even mentioned the board

of supervisors. However, the 2005 amendments to the Companies Law moved in the opposite direction, aiming to articulate and enhance the role of the board of supervisors. How this will be implemented in practice is uncertain, but the unclear role of the board of supervisors looks set to continue in the medium term.

6 Conclusions

This paper has outlined a program of eight practical steps that should be undertaken by every Chinese bank and respond to many of the common challenges across the Chinese banking sector. While extensive regulations have been introduced in recent years by both the banking authorities and the capital markets authorities, they will only have a real impact if related reforms are implemented by individual banks. In turn, the banks will need to implement the eight steps in earnest, not just as a minimum compliance exercise. Public listing will not solve all governance problems on its own, but it may provide the impetus to undertake a program of reforms across many areas. However, governance reforms should also be undertaken by those banks that have no plans to list and those banks that have already listed, they should continue to adhere to higher standards even after they pass the milestone of the initial public offering. Although the future of state control and foreign ownership are uncertain in the longer term, it is still possible to strengthen bank governance in a broad range of areas from the board of directors to risk management to internal audit and controls.

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