

## **Corporate Governance and Banking Reform in China**

*Speech by*  
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Thank you Professor Zhao. Very distinguished panelists, ladies and gentlemen, it is my privilege to be here today to address this important issue. It is fitting to speak about corporate governance here—at the Shanghai International Banking and Finance Institute, or SIBFI. The International Finance Corporation is proud to be a shareholder in SIBFI because we understand that the best financial institutions require that top managers continually upgrade their skills. Banks need locally trained Chinese professionals who are able to implement change, adapt international practices to the Chinese situation, and, in doing so, become industry leaders. That process is underway here at SIBFI.

I feel very strongly about the need for better corporate governance practices and the need for better trained practitioners to bring them about. I have been involved personally with these issues through IFC's work with a number of financial institutions in China.

Some people tell me that Chinese banks are very risky today. While this may be true, I have seen great improvement take place over a short period. Yet bank managers and investors still have many things to be concerned about. Chinese banks face serious issues related to credit analysis, risk management, internal controls and so on. Of course, these issues must be addressed. In banking, they are fundamental. Yet it has become clear to me that these problems are merely symptomatic of the larger, chronic problem of poor governance—the structures and processes that define how a company is directed and controlled. At the end of the day, who wants to put his money in a bank perceived as lacking transparency or accountability? What if shareholders feel that bank managers don't know who they work for? These are issues of trust. And trust is what a sound financial system is built on.

So the stakes are high for getting corporate governance reform right. There is more riding on banking reform than the success or failure of individual institutions. This could be a make or break issue in China's rise to economic prominence. Whether the economy will continue its phenomenal growth will, to a large extent, depend on improving practices in Chinese banks because continued economic expansion hinges

on the health of the financial system. Economic and social stability are largely dependent on whether Chinese depositors will keep their trust in banks and whether Chinese banks begin channeling these deposits to efficient companies.

But the process is underway and we are beginning to see real commitment to improved practices at one institution after another. In one case, IFC has been dealing with Bank of Shanghai. About ten years ago, we offered a small amount of technical assistance in areas including risk management and human resources. Bank of Shanghai wanted to go further. They asked “How can we learn about international standards?” “How can improved corporate governance strengthen our bank?” So six years ago, IFC entered a more substantial relationship to help the Bank of Shanghai achieve these far-reaching changes.

Based on our global experience in the financial sector, we explained that we could only invest in a bank that produced accounts according to international accounting standards. This was a big step for a Chinese bank, but Bank of Shanghai took it. We also encouraged a more significant role for the board of directors in setting the strategy for the bank. Bank of Shanghai’s board—which had taken on an IFC-nominated director—began to play a more important role. It determined that managers needed to be motivated differently. The bank introduced a new performance-based compensation system for the president and top management. These changes were not easy. People had to be judged on different criteria. The business culture had to change. Is the result perfect? No. It is a process. But Bank of Shanghai has made progress—step-by-step—because their management recognized the long term competitive value in doing so.

The reason I am telling you this story is because the changes that seemed far-reaching just six years ago have become standard for Chinese banks that are trying to attract new investors and bring in new ideas. Today, more bank managers understand that this effort can make them stronger and more competitive.

Since our first banking investment in Bank of Shanghai, IFC has taken equity stakes in five other Chinese banks: Bank of Beijing, Industrial Bank, Minsheng Bank, Nanjing City Commercial Bank and Xian City Commercial Bank. We support shareholders’ and managements’ efforts to make progress on corporate governance and international standards every time we invest. We hope financial institutions across China can continue to look to these banks for guidance on how striving for best practice and good governance can enhance their strength.

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I feel that good corporate governance practices are so important because they help ensure that managers act in the best interest of their shareholders rather than acting solely in their own interests or those of a majority shareholder. Well governed companies are directed by their boards, have mechanisms for protecting minority shareholders, and are transparent. IFC has learned a great deal by working with

Chinese banks and in trying to help them strive for better practices. So I'd like to share some thoughts on how to maintain the reform momentum through improved corporate governance practices.

My first observation is that boards of directors should become more engaged in the selection of top management at Chinese banks. Top management positions should be filled by a transparent process where the board makes the final decision so that the most qualified candidates are chosen.

Today, the top bank managers are appointed by the government and seem to serve a government function as well as acting as the chairman of the board of directors. They are often placed at institutions without a process of consultation with the board of directors and therefore may not become sensitive to the full range of shareholder issues. They will better understand all shareholders goals if they take part in a bona fide selection process.

Where the government is the largest shareholder in a bank, there is no question that it should drive the selection of the chairman and top management. In the initial phase of investments into the banking sector, in which IFC has taken part, our experience has been that the interests of existing majority shareholders and the new investors have largely been very similar.

But the process is changing and banks are bringing in a wider range of outside shareholders and subjecting themselves further to market forces that require new skills from top executives. In this changing environment, the boards should take an active part in the executive selection process. For example, a selection committee should be established and the directors should have an opportunity to interview candidates before being asked to vote on them.

Without involvement in this key process, minority shareholders may be unwilling to make strategic investments or buy shares at IPO. Let's think for a minute about why outsiders might be reluctant to invest under such circumstances. To manage risks in the industry going forward, banks will require very skilled management. Chinese banks are thinly capitalized and are expanding their loan books by up to 70 percent annually. Their risk management and internal controls are still evolving. The lending boom is taking place in an environment where property prices are overheated and banks are not yet adequately evaluating, pricing and monitoring the risks. So expansion is rightly fuelling new concerns that lending quality may be deteriorating. China cannot afford a new NPL crisis equivalent to the historical burden that it is still working to resolve.

The new generation of bankers needs to better understand the risk-reward profile. Given many years of unparalleled growth, there is little experience in dealing with economic downturns and the impact on collateral values, default rates and erosion of capital. Boards need to continually identify and attract managers who can address the issues during good times and be ready to respond to others during times of stress.

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My second observation is that good corporate governance is most effective when boards establish proper incentives to support the bank's overall strategy.

Many boards, especially those at banks that are taking on new investors, recognize the need to add quality assets to strengthen profitability during growth periods, and to establish a strong capital base. To accomplish this, Chinese banks must align the incentives of top executives and managers to meet these goals. It is up to the board of directors to set the tone for how managers do their jobs. Their strategy should be driven in different areas by board committees, which require managers to put good systems in place. With the right incentives, managers will build and acquire more quickly the skills they need in the critical areas of credit analysis, risk management, and so on.

We saw this process work at Bank of Shanghai. Every bank in China is growing at a frantic pace. But Bank of Shanghai wanted to also strengthen its foundation. So the board created a scheme that set program targets for managers on capital adequacy, asset quality and profitability. It tied compensation to achieving those targets. Top management responded enthusiastically to the incentives. They expanded their focus from growth to credit quality, efficiency and capital adequacy. As a result the Bank of Shanghai is now a stronger and better managed bank.

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My third observation is that boards must align their development strategies for banks with their efforts to bring in outside investors. Many banks plan to leverage strategic investments from international banks into technology and knowledge transfers. Boards need to ask themselves whether their current governance system supports this.

There are a couple of components to the best practice model that has emerged from a variety of investment models we have observed. First, the strategic partner is increasingly engaged in the board and the operations of the bank. Second, the partner has developed a good working relationship with bank management and is willing to share technology and transfer skills. This happens best when there is good governance and rights of minority shareholders are protected. The incentive for strategic partners to share knowledge is enhanced if regulations allow them to increase their shareholding in the future.

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My fourth observation is that banks should understand that good governance is a very powerful tool for providing positive incentives. It can reinforce a good credit culture. It is crucial to develop managers who make credit decisions in the best interest of their shareholders—where they lend money based on sound business judgment and

then hold borrowers accountable for repayment. This makes borrowers more committed to repaying debts and will contribute to the overall health of the Chinese banking system. To accomplish this, banks must consolidate risk management and strengthen credit controls. In specific terms, the board of directors should review the bank's risk exposure quarterly and implement changes to the risk management policies accordingly. The development of effective risk management systems is a top priority for Chinese banks given the transition from a controlled economy to a market economy—from an environment of policy-directed lending to an environment of commercial lending.

At too many banks there is still a need for a stronger credit management function that oversees the credit risk of transactions before and after disbursement of loans and the development and implementation of policies concerning credit risk. A strong credit management function ensures that credit decisions are independent from the business operating units. A chief credit officer, who can withstand pressure from other senior managers in the bank, is needed at every bank. Often that requires recruitment from outside the bank.

Another needed step toward building a better credit culture is the creation of a centralized finance function. A chief financial officer 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 disclosure and financial transparency.

Here let me spend just a moment on an issue that can't be emphasized strongly enough: To ensure bank policies are being properly implemented, banks need to establish an independent audit function. For this to be effective, internal and external bank auditors must report to a board's audit committee. The head of internal audit department must have the standing within the bank to task senior managers to task and hold them accountable. While providing incentives, an effective system of corporate governance creates less room for embezzlement, for mistakes, and for abuses of shareholders' and depositors' trust.

A strong audit function, preferably led by the board's audit committee and able to effectively question management, will change the culture of a lax institution. A key part of the audit committee is the role of independent directors who can ensure financial transparency so that all shareholders can understand a bank's financial condition.

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The final observation I would make is that regulation must continue to play a crucial role in supporting good corporate governance practices. I am sure you will be hearing a better and more thorough presentation on this issue later from Vice Chairman Tang of the China Banking Regulatory Commission. I have suggested this morning that competition and other market forces build a strong business case for banks to improve

their practices beyond regulatory requirements. But I want to also recognize the importance of regulation in setting the right tone for the market. The China Banking Regulatory Commission has been sending clear signals about the importance of good practices.

We are already seeing how measures to improve corporate governance in banks are exposing shortcomings. I don't need to recount the headlines here. Not surprisingly the well publicized cases have been revealed as the banks began improving their auditing practices. The silver lining for the banking system is that transparency and disclosure and regulatory pressure are helping identify problems that urgently need to be addressed and resolved.

The list of recent reforms is impressive: adopting provisioning and capital adequacy rules with international standards; removing the interest rate band; recapitalizing banks; introducing administrative controls to reduce lending to overheated sectors; and preparing several banks for listing.

The good news for the system is that CBRC is pushing for improved accountability and other measures to further strengthen the sector. Just last month the CBRC issued a new circular intended to introduce accountability and an incentive system to reduce poor oversight and malpractice. The circular includes rules on operating risks and the audit function. As I mentioned earlier, this is absolutely critical to the foundation of good governance. I am pleased to note that CBRC also has been pushing for more and better qualified independent directors. As a result, accountability will become the industry norm.

The message is clear: the quality and effectiveness of a bank's board and management *are* the long term solutions to the problems that ail Chinese banks. Good governance plays a role in ensuring effective credit controls and risk management and protects not only shareholders but depositors, who entrust their savings to the banks.

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The new practices we are talking about here are about changing the way things are done. They are about internationalizing the business of banking in China—and using good corporate governance practices to achieve that goal.

Strategic investors and the expertise tied to it have a role, but Chinese professionals will be the foundation and driver of change for the banking industry. The challenges are enormous. The banking sector needs more professional directors, more skilled managers, more people who can support competitive Chinese banks.

This is where SIBFI fits in. SIBFI has been set up with strong local and international partners – Shanghai University of Finance and Economics, or SUFE, and Bankakademie – to combine SUFE's history of educating Chinese financial experts with Bankakademie's track record for training successful international bankers. While

Chinese professionals are already well educated and hard working, SIBFI can give them the tools to become world class bankers in China's increasingly international market. IFC's investment here is small, but we anticipate SIBFI's impact will be large, given this market's needs.

Effective and responsible boards; good incentives; independent auditing; innovative and proactive regulators; committed professionals -- these are the building blocks for the bridge that will lead China's banks into the future. Today, I commit to you that IFC will continue to support your efforts to build a strong and robust banking sector. We look forward to working with all of you to meet this exciting challenge.