



Executive Summary

Over the past decade or so, China has made significant progress in developing the institutional foundations of a modern corporate governance system. More than 80 percent of all small and medium enterprises have been transformed, with a significant portion sold to employees and outside investors. About 1,200 large companies have diversified their ownership through public listing. A basic legal framework underpinning the corporate form and including company law, contract law, accounting, and securities laws has been established. The financial system has become more diversified and independent of political influence. The regulators' capacity to enforce the new rules and prevent wrongdoings has been strengthened. In the past several years, the efforts of the authorities to improve corporate governance practices have intensified as exemplified by initiatives such as the system of independent directors for listed companies and the code of corporate governance for listed and nonlisted companies introduced by the China Securities Regulatory Commission and the State Economic and Trade Commission. Notwithstanding these impressive achievements, there is vast scope for further institution building to improve the corporate governance practices of Chinese companies. The following sections focus on remaining weaknesses, outstanding issues, and recommended priorities for policy actions.

Summary Assessment

The present structure of state ownership and control of enterprises accounts for some of their poor performance. This results from weak incentives for managers to maximize value for all investors and creditors and from protectionist practices of government agencies that shield firms from market discipline. The process of ownership diversification is itself often conducted in ways that inhibit the evolution of healthy corporate governance practices. In the case of listed companies, the

initial public offering process has tended to select companies that have strong links with local governments and fuzzy boundaries with their parent groups. This has created strong incentives for the controlling shareholders to exploit companies' interdependence through related-party transactions. Implicit support by the government and parent companies, the franchise value of listing, and weak creditors' rights generate expectations among investors that they are engaging in low-risk investments. As a result, investors have few incentives to assess companies' fundamentals carefully or to demand good corporate governance. In the case of transformed small and medium enterprises, unrealistic valuation of assets, and the exclusion of land-use rights from the asset pool to circumvent the insiders' wealth constraint to taking a majority position are likely to make future access to capital markets more difficult, thereby preventing banks and outside investors from playing an important role in the governance of these enterprises.

Banks and outside investors lack the capacity, the regulatory support, and the incentives to actively monitor and influence companies' behavior. Bankruptcy of state-owned enterprises is largely an administrative process, and the effective rights of creditor banks in cases of debtor default are weak. State-owned commercial banks generally suffer from similar corporate governance weaknesses as nonfinancial state-owned enterprises: their profit incentives are weak at best. The separation of commercial and investment banking means that banks cannot use ownership to supplement their creditor rights and exert more influence on firms. Local governments' practice of supporting their enterprises in difficult times makes credit decisions a function of an enterprise's implicit or explicit government support rather than of its merits, thereby reducing banks' incentives to evaluate and monitor companies' behavior. Private equity markets, especially venture capital, are in an embryonic stage of development, and the state still plays a ubiquitous role as sponsor, investor, and fund manager. National regulations on venture capital and investment funds are still missing, although work on important legislation is in progress. In addition, China does not have an adequate legal framework for structuring contractual arrangements of particular importance to private equity investors, such as convertible loans and options.

Corporatization and ownership diversification have introduced new institutional forms for exercising corporate control without the dismantling of old representative bodies. The division of labor between old and new governance structures is unclear and is further

complicated by many companies' practice of combining such positions as chair of the board of directors with secretary of the Party committee. As a result, key decision-making powers tend to be vested in informal mechanisms, and some institutions such as boards of supervisors have assumed largely decorative functions. In the case of listed companies, large shareholders often overstep the bounds of shareholders' meetings and boards of directors and exercise direct effective control. Relative to practices in other countries, boards are less independent, and some of their powers are, in effect, exercised by controlling shareholders and government agencies.

Chinese capital markets lack mature users of financial information, such as institutional investors and analysts. Financial reporting and disclosure are primarily oriented to satisfy the information needs of the taxation authorities. The interdependence between listed and parent companies creates strong incentives to distort information, particularly concerning related-party transactions. The quality of audits suffers from the narrow minimum requirements regarding coverage of the audit, the unclear liability of auditors, the challenges to the independence of many auditors from the state as the owner of audited enterprises, and a general shortage of well-skilled auditors at the local level.

Recommendations

Recommended priorities for action are based on the following guiding principles:

- Corporate governance scandals in emerging and developed markets indicate that there is no perfect corporate governance model. An effective corporate governance system should above all be capable of identifying weaknesses before they develop into systemic problems, of learning from failures, and of taking prompt corrective actions. Critical ingredients of such a system are a credible threat of market failure and an effective regulation that builds on the incentives of market players in order to develop an effective system of checks and balances.
- The institutional mechanisms of corporate governance comprise a system that can employ alternative yet complementary instruments of control to effectuate changes in companies' behavior. An effective corporate governance system contains a multiplicity and certain redundancy of control mechanisms. This principle implies that



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priority should be given to mechanisms that (a) are relatively underdeveloped or altogether missing from a country's institutional arsenal of corporate governance mechanisms, and (b) exhibit strong synergism with other existing mechanisms.

Based on these principles and on our assessment, the following areas emerge as recommended priorities for policy action: (a) alleviating the negative impact of dominant state ownership on market discipline and on the regulatory capacity of the state; (b) building an institutional investor base; and (c) strengthening the role of banks in corporate governance. Many of the specific recommendations are consistent with and reinforce recommendations made in previous World Bank studies, particularly the 1997 report *China's Management of Enterprise Assets* and the 2001 report *Bankruptcy of SOEs*.

Strengthening Market Forces and Regulatory Capacity. Dominant state ownership tends to erode the credibility of the threat of market failure and the regulatory capacity of the state. Given that the effectiveness of each and every corporate governance mechanism ultimately rests on a credible threat of market failure and a strong regulatory capacity, this underscores the point that sustainable improvements in corporate governance are unlikely without fundamental changes in ownership patterns.

China could move more aggressively in experimenting with mechanisms for separating state control from state cash flow rights as a way to reduce political control over companies. Experiments with the management of listed state shares by private institutional investors could promote a more market-based and value-maximizing approach. Modifying the nature of government equity claims by, for example, transforming them into preferred nonvoting shares is another approach. This would make the government's cash flow rights more like certain tax liabilities, thereby promoting greater consistency between the different roles the government is playing with respect to government-owned firms. Such measures can be useful transitional mechanisms, as they could send a powerful signal that the government is committed not to interfere with market forces.

Various ways can be used to reduce the number of state-owned shares: state share placement, share repurchase, negotiated transfer, auctioning, and debt-equity transfers. An appealing way to reduce state shares is through institutional investors, because this has obvi-

ous synergies with capital market development and social welfare reform. The Hong Kong experience with the Tracker index fund suggests a potentially useful method of divesting state shares with minimum disruption of market stability. State and legal person shares should gradually be allowed to become tradable so that market forces can begin to shape the ownership structure of listed companies.

Given the magnitude of the regulatory challenge and the limitations imposed by dominant state ownership on the effectiveness of direct forms of regulatory interventions, the government will have to rely more on indirect methods of regulation including delegated monitoring, self-regulation of professional organizations, and mobilizing civil society in the enforcement process. Indirect control over companies' behavior through regulations of institutional investors and through accounting and legal firms that are independent of government and are not "too big to fail" will enhance regulatory efficiency. Empowering the "right" party, with an interest in certain regulations being enforced, implies enhancing the independence of associations, the media, self-regulatory bodies, and other members of civil society. The recent report on widespread market manipulation by China's 10 fund management companies in *Caijing Monthly* illustrates the enormous social benefits of independent civil discovery. Such practices should be encouraged.

Developing an Institutional Investor Base. Institutional investors can play a catalytic role in activating the use and enhancing the effectiveness of many of the instruments of corporate governance. To facilitate shareholder activism by institutional investors, a priority should be to strengthen shareholders' rights, through, for example, a cumulative voting system or automatic rights for investors above a certain threshold shareholding to appoint a director; quorum requirements for shareholders' meetings based on outstanding shares; a proxy system, which through proxy contests can act as a partial substitute for the takeover process; and class action procedures. Although important in themselves, such rights may not be sufficient to create active institutional investors. Based on international experience, three critical factors for active involvement of institutional investors in corporate governance are: (a) mitigation of conflicts of interests by restricting activities that may create excessive interdependence between companies and institutional investors; (b) making voting an integral part of institutional investors' fiduciary duties; and (c) allowing institutional investors to

be named controlling parties in shareholder lawsuits against company management. Also of importance is the regulators' ability to supervise institutional investors and the corporate governance of domestic institutional investors. In this context, privatization of existing institutional investors and, perhaps more important, accelerated new entry by domestic and international private institutional investors, should be considered. China has the option of importing regulatory and corporate governance capacities in this area by opening its capital markets to foreign institutional investors and by promoting cooperation between foreign and domestic institutional investors in the form of joint ventures and technical assistance arrangements.

Strengthening Banks' Role in Corporate Governance. Creditors are among the least effective instruments of corporate control in China, and strengthening their role in corporate governance should be a priority. This is particularly important in the case of small and medium enterprises whose closely held nature precludes reliance on public monitoring. Legislation currently under preparation should take the opportunity to transform bankruptcy from a purely administrative process to a more market-driven one. This should involve considerable strengthening of creditors' rights in the case of default and enhanced options for banks to engage in reorganizations and restructurings of client companies. Allowing greater room for commercial bank involvement in investment banking activities, such as providing securities advice and custodial services that can lead to proxy voting by banks, will enhance banks' role in corporate governance. There is a strong economic rationale for allowing banks to hold quasi-equity and equity instruments, at least for a predefined maximum period, to facilitate restructuring.