CHINA

KEY POINTS

- **Enforcing good corporate governance standards in China's state owned enterprises, SOEs, including encouraging them to operate in the interests of state and private minority shareholders, is the major corporate governance issue facing the Chinese Government.**
- **The huge and growing scale of banks' non performing loans, primarily owed by SOEs, increasingly threatens China's financial system stability and fiscal outlook, heightening the urgency of the task of reforming SOE corporate governance.**
- **In the last five to ten years, the Government has accelerated SOE reform and rapidly is developing the legal and institutional framework to support market economy controls on SOE and private company behaviour. However, enforcing this framework in the large scale corporate sector, dominated by SOEs and state banks, presents a major challenge for regulators.**
- **Furthermore, major elements in the legal and regulatory framework still are missing, including a functioning bankruptcy act, developed commercial credit analysis capacity in the banking system and qualified, independent boards in SOEs with the power to direct management to represent shareholders' interests.**
- **Recent strengthening of the securities industry's regulatory framework and market oriented listing rules eventually should help share and bond markets play a greater role in financing larger corporates, bypassing the ailing banking system.**

To sustain rapid economic growth, the Chinese Government is striving to reduce its role in small and medium sized enterprises and labour intensive sectors, and increase market discipline on SOEs. While the largely state owned banking system still faces many serious challenges in improving its lending quality and assessing creditor risk, with China Securities Regulatory Commission oversight, eventually the rapidly developing stock market could become a more market based vehicle for efficiently intermediating savings. WTO accession also should increase market discipline on firms through greater trade, investment and financial sector competition.

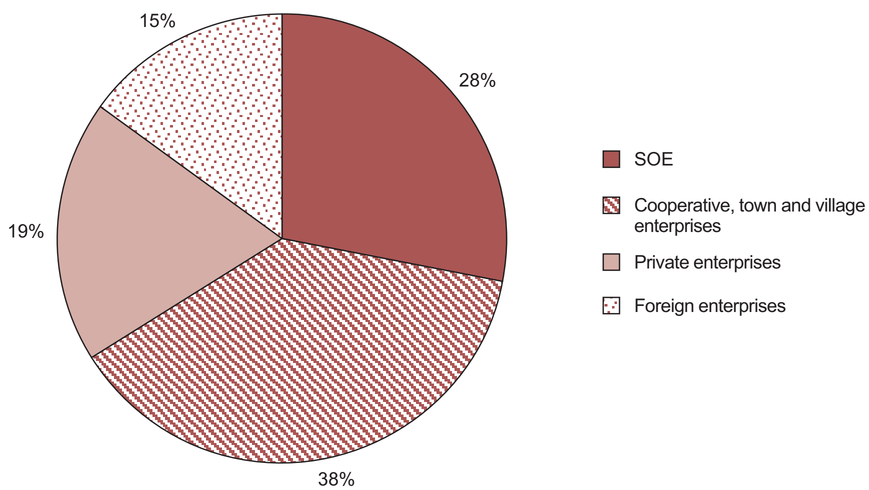
THE CORPORATE SECTOR

The state owned sector's role in the economy is diminishing rapidly, with generally positive effects on corporate governance. SOEs' share of industrial output shrank from almost 75 per cent in 1980 to only 28 per cent in 1999 (CEIC, 2002).[1] The role of township and village enterprises, cooperatives, joint venture, wholly foreign owned, individually owned and other private enterprises has grown commensurately (Figure 7.1).

Figure 7.1

Non-state Ownership Dominates Industrial Sector

Ownership Shares in Industrial Value Added, 2000



Source: CEIC, 2002.

[1] Here SOE refers to any firm the central, provincial and municipal governments owns outright or in which it owns a controlling interest (CEIC, 2002).

Increasingly private individuals, cooperatives, villages or townships own small and medium sized enterprises; however, SOEs still dominate the large scale corporate sector, particularly the financial sector, heavy industry and utilities. SOEs still account for nearly half of urban employment (OECD, 2000).

While the Government still holds most shares in large SOEs, it has corporatised many. By early 2002, over 1 000 SOEs were listed on the Shanghai, Shenzhen or foreign stock exchanges and the pace of new listings should accelerate under new rules based listing procedures. Though most SOEs list less than 50 per cent of shares, share sales to individuals and enterprises are diversifying SOE ownership. Private companies could list for the first time only in 1999, so SOEs dominate listed companies, accounting for over 70 per cent of market capitalisation through direct or indirect ownership (OECD 2000; CEIC, 2002).

Governance Impacts

Despite these reforms, state ownership still creates poor governance incentives. First, many SOE managers undertake investments to boost market share, generate employment or support local growth, even if proposed projects are unlikely to be profitable (Wang, 2001a). If these investments fail to generate adequate returns to repay bank loans, managers rarely are replaced or held personally responsible for losses. Second, government and workers select enterprise managers, usually Communist Party cadres, often giving insufficient weight to management expertise and commitment to enterprise profitability. Hence, party and worker concerns often are their main priority rather than the return to shareholders, including the state. Third, government appointed boards of directors also are expected to represent government, party, worker and creditor interests. Hence, as directors are not directly responsible to shareholders and even the Government has mixed motives in operating SOEs, boards have less incentive to independently scrutinise managers' behaviour and maximise shareholder value (East Asia Analytical Unit, 1997).[2] While in 2000 and the first half of 2001, SOEs increased their profitability, in 1999, about half of the 48 000 SOEs ran at a loss and SOE audits found significant irregularities (China Online, 2001a).[3]

Some Markets Lack Competition

While non-state enterprises, including foreign enterprises, have a rapidly growing share of total output, in more capital intensive and infrastructure sectors, SOE reservations and preferential SOE access to bank credit deter new local and foreign firms from entering. Furthermore, although foreigners can own 100 per cent of manufacturing firms, authorities still restrict foreign entry in several important service sectors.[4] However, China's WTO accession, expected in early 2002, will progressively open

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2 For example, the party committee must approve 95 per cent of staffing decisions in most SOEs.

3 Authorities audited 1 290 SOEs in 2000, finding irregularities in the reported assets valued at Rmb 100 billion. These included falsified accounts, off-book activities using state funds and fake value added tax receipts (*South China Morning Post*, www.scmp.com, 16 May 2001).

4 Currently, foreign investment in utilities and other natural monopolies, land and air transport, retailing, telecommunications and finance are subject to restrictions.

many of these sectors to foreign competition and should consolidate and accelerate non-state sector growth and foreign firm entry, influencing all aspects of corporate behaviour (Economic Analytical Unit, 2002 forthcoming; The Economist, 20 November 1999, p. 32; Burke, 1999; Woo, 2000).

MARKET FORCES GATHERING

In the last 23 years, China has made major reforms in the course of its transition from a command to a more market driven economy, significantly increasing private ownership of enterprises and agriculture and embracing private, including foreign, participation in investment and trade (East Asia Analytical Unit, 1997; Economic Analytical Unit, 2002 forthcoming).

SOE REFORMS

Reforms started in the late 1970s increased SOEs' autonomy and incentives to increase production of saleable items and make profits. In the 1990s, the Government rationalised, and in some cases closed, loss-making SOEs (Huang et al., 2000; East Asia Analytical Unit, 1997).[5] In 1995, authorities also began privatising small and medium sized SOEs, further removing political influence from commercial decision making. Allowing employees to own shares in SOEs has increased incentives to generate profits (Bersani, 1993). However, evidence exists many SOEs are optimising worker and management benefits rather than profits for owners (Meng et al., 1998).

In the 1990s, to further separate owners and managers, state government departments transferred responsibility for managing SOE assets from government ministries to government asset management companies. In addition, banks and their asset management companies, formed to take over banks' worst performing loans, hold some SOE shares via debt for equity swaps. Large SOEs were corporatised and appointed boards of directors to represent their diverse owners. Hence, minority shareholder rights, board of directors' independence and the relationship between managers, boards, owners and workers are now major issues in Chinese SOEs.

Listing SOEs

Listing SOEs is designed to increase pressure on managers to maximise shareholder value. To comply with listing rules, firms often need to restructure, shed non-profitable assets and improve management. Furthermore, private shareholders in listed SOEs can select some directors. Over the next decade, the Government plans to reduce the number of industrial SOEs to a few thousand, all of which should be large SOEs in strategic sectors and many of which will be listed (OECD, 2000; East Asia Analytical Unit, 1997). In early 2002, the Government unveiled a guide for boosting SOE competitiveness ahead of WTO accession, suggesting they list domestically and abroad to diversify their funding channels (*South China Morning Post*, www.scmp.com, 10 January 2002).

[5] During the first eight months of 1999, 7 900 large and medium sized SOEs were closed and 4 million workers lost their jobs (China Online, 2001a).

Research shows joint stock and privatised companies perform better than wholly state owned firms, reducing losses to banks and other investors (Fan, 2001). Nevertheless, authorities fear excessive privatisation may destabilise the labour market, especially in the overstaffed oil, banking, steel and rail industries; hence, at least in these sectors SOE privatisation will be gradual.

STATE BANK REFORMS

Reform of state banks is an urgently needed, but as yet incomplete complement to SOE reform. SOEs mainly finance investment with loans from government owned banks and, until 1996, the Government guaranteed both parties if the investment failed.[6] Since then, banks supposedly have been responsible for all their loans. However, SOEs which cannot repay bank loans rarely are bankrupted. Although non performing loans are believed to be at record highs and have continued to grow since 1996, no major banks have failed or are likely to fail (Lardy, 2001; East Asia Analytical Unit, 1999). Hence, many SOEs treat bank borrowing as the state injecting equity, and banks rarely query firms' investment plans or seek to improve their management capacity (Fan, 2001).

As many SOEs do not really expect to repay loans, demand for funds often exceeds supply, and banks usually ration credit by non-market mechanisms, reducing market discipline on firms.[7] These practices reduce incentives for banks to evaluate thoroughly clients' credit worthiness and can also result in corrupt lending practices (Hovey et al., 2000; Far Eastern Economic Review, January 31, 2002, pp. 30-36).[8]

Achievements to Date

Despite serious concerns, the Government accords very high priority to overcoming banking system problems and the poor incentives they provide to SOEs.[9] 1996 legislation theoretically makes banks responsible for their lending, and penalises loan officers and branch managers who advance loans which become non performing.[10] In early 2002, for example, authorities sacked the president of China Construction Bank for negligence and suspicious lending and authorities have charged several other senior bank officials for corruption (*South China Morning Post*, www.scmp.com, 16 January 2002; *Far Eastern Economic Review*, January 31, 2002, pp-30-36). In 1998 and 1999, the People's Bank of

6 The state owns virtually all financial institutions. The four major state owned commercial banks account for 62 per cent of loans, dominating banking. Overall, various types of state owned lending institutions provide well over 90 per cent of loans (East Asia Analytical Unit, 1999).

7 SOE officials seeking funds often must deposit a specified proportion of loans secured with the same bank at low interest rates, effectively increasing the cost of funds (China Online, 2001b; Lardy, 2001).

8 For example, during 1994, loss-making and profitable enterprises attracted almost the same rate of lending (Huang et al., 2000).

9 In 1998, Zhu Rongji told the National People's Congress a financial sector crisis is a more serious threat to the Communist Party than unemployment.

10 The Government also established separate policy banks responsible for non-commercial lending, particularly to agricultural and infrastructure sectors. This was intended to relieve commercial banks of directed lending responsibilities, but has only been partially effective as it has not overcome non-commercial lending to industry (Lardy, 2001).

China, China's central bank, merged and closed several financial institutions, including the Guangdong International Trade and Investment Corporation, one of China's largest non-bank financial institutions (East Asia Analytical Unit, 1999).

In 1999, to limit the systemic risk from high levels of non performing loans, the Government recapitalised the banks and established asset management companies at the four major commercial banks.[11] These are responsible for taking over and resolving a significant share of the banks' non performing loans, restructuring defaulting companies and recovering collateral where possible. Now, banks and asset management companies can swap non performing loans for equity and intervene in firms in which they hold equity.[12] However, while some banks made debt equity swaps with SOEs, so far, corporate restructuring or asset shedding is limited, as is asset management companies' capacity to enforce better corporate performance. They usually lack sufficient authority, since they seldom have a controlling shareholding in the delinquent SOE and many large SOEs have a higher position in the bureaucratic hierarchy than the asset management companies. The latter also lack resources, as they have shareholdings in far too many SOEs for them to be able to actively monitor or intervene. Hence, asset management companies have been rather passive investors (Lardy, 2001).

Banking reforms aim to increase bank independence to act as commercial entities and hence increase market discipline on SOEs. From the mid 1990s, the Government relaxed interest rate controls and allowed private bank entry. In 2000, the People's Bank of China broadened the discretionary band around fixed interest rates, freeing up deposit and lending rate movements (Liu et al., 2001). Nine banks now have some private ownership and discretion over their lending rates.[13] Private banks, including Minsheng and Pudong Shanghai Banks, compete with the big four state banks in attracting deposits and corporate clients (Fan, 2001). In February 2002, as part of its WTO entry commitment, China loosened controls on foreign-owned and joint-venture banks and financial companies offering Yuan services, exposing domestic banks to further competition. Competition is likely to be more fierce in corporate than retail banking as some regulations would remain in the retail sector (*South China Morning Post*, www.scmp.com, 27, 31 December 2001). Since then, HSBC became the first foreign lender to take an equity stake in a mainland bank, purchasing 8 per cent of the Bank of Shanghai (*South China Morning Post*, www.scmp.com, 29 December 2001). Chinese bank executives are increasing their call for the removal of regulations separating bank, insurance and securities businesses, so they may better compete with foreign banks (*South China Morning Post*, www.scmp.com, 19 December 2001).

[11] Officials estimate 25 per cent of loans are non performing, although private analysts estimate a much higher rate. Standard and Poor's estimates Rmb 3.3 trillion in non performing loans, equivalent to 37 per cent of GDP (*South China Morning Post*, www.scmp.com, 5 June 2001). Other estimates are over 50 per cent (Lardy, 2001).

[12] In 2000, around 600 SOEs undertook debt to equity swaps with asset management companies, and this should rise to 1 000 by 2002 (China Online, 2001b). However, firms can buy back equity injections at some future point, undermining the authority of outside shareholders (Fan, 2001).

[13] Several companies, including Shanghai Brilliance Group and FAW Jinbei Automotive, acquired shares in private banks, including nearly 10 per cent in the Guangdong Development Bank, subject to Guangdong Bank and People's Bank of China approval (*South China Morning Post*, www.scmp.com, 15 March 2001).

While many reforms appear to have boosted bank lending standards, they still heavily favour SOEs (OECD, 2000). Many state banks seem more reluctant to lend to poorly performing SOEs, preferring the rapidly growing consumer credit and mortgage markets.[14] However, over 70 per cent of state bank lending still goes to SOEs while lending to the dynamic private sector remains minimal (Institutional Analysis, 2001). Banks can lend to foreign companies, potentially providing competition for SOE borrowers, but few have done so yet. Without the capacity to assess risk adequately or a strong bankruptcy regime, banks appear to be minimising risks, anticipating that the Government is more likely to compensate them for losses incurred in lending to SOEs, rather than stringently applying penalties for accruing more non performing loans.

FINANCE MARKETS GROWING RAPIDLY

Banks also face competition in attracting funds from the rapidly developing equity market; eventually this should increase discipline on them in lending to SOEs.[15] Equity market and other non-bank sources of enterprise financing are booming (OECD, 2000). Stock market capitalisation has increased dramatically, approaching 60 per cent of GDP by mid 2001, or over Rmb 5 trillion (US$600 billion) (Figure 7.2).[16]

In the 2000s, several major trends should accelerate stock market listings and expand firms' access to equity financing, increasing discipline on corporates. First, recent listing rule reforms allow all SOEs and local private firms that meet listing requirement to list.[17] Second, foreign funded joint stock companies can sell A or B shares to mainland investors on domestic exchanges and nationals can buy B shares (*South China Morning Post*, www.scmp.com, 12 July 2001).[18] Third, the Government plans to sell equity in more SOEs to fund its massive pension liabilities and increase market discipline on SOEs.[19] Finally, bank asset management companies eventually should sell some of their SOE equity.

14 However, SOEs in strategic sectors obtain credit easily, as they still receive strong state backing.

15 The Government launched the Shanghai Securities Exchange and the Shenzhen Securities Exchange in December 1990 and July 1991, respectively.

16 However, only about 70 per cent of these shares are traded. The number of firms listed on the two exchanges increased from 183 in 1993, to over 1 130 by August 2001 (Xu et al., 1997; CEIC, 2002).

17 Previously, authorities placed strict limits on the number of newly listed firms, using non-commercial criteria to determine those allowed to list. Also, a lack of alternatives to bank deposits and limited numbers of initial public offers drove strong local investor demand for shares. Most initial public offers still are oversubscribed and authorities often impose ceilings on price rises.

18 A shares, denominated in local currency, are only available to Chinese residents. B shares, denominated in US dollars, were previously only available to foreign nationals but are now available to local as well as foreign investors.

19 The Government estimates pension funds' debts exceed Rmb 7 trillion, representing about 33 per cent of GDP in 2000. The sale of SOE shares will contribute substantially to raising these funds (*South China Morning Post*, www.scmp.com, 15 May 2001).

Figure 7.2

Rapid Rise in Stock Market Capitalisation

Stock Market Capitalisation to GDP

Source: CEIC, 2002

China Securities Regulatory Commission

1999 legislation amalgamated provincial regulatory authorities into the China Securities Regulatory Commission, strengthening the new body's powers over insider trading and price manipulation and significantly enhancing disclosure requirements (OECD, 2000). The Commission has considerable independence from party organs to pursue its regulatory duties vigorously, auguring well for future stock market growth and higher corporate governance standards (Zebregs et al., 2001; *Far Eastern Economic Review*, January 2002, p. 32). For example, in December 2001, the Commission fined Zheijiang Securities an undisclosed amount for misappropriating funds from clients' margin accounts and irregularities in proprietary trading (*South China Morning Post*, www.scmp.com, 29 December 2001).

Institutional Investors and Managed Funds

In December 2001, the Government allowed the state run Social Security Fund to invest up to 40 per cent of its Rmb 61 billion in funds in the equity market, opening the way for large scale institutional funds management (*South China Morning Post*, www.scmp.com, 19 December 2001). Previously such activity was limited; in 1999, only about 12 institutional investors invested in the share market, holding under 1 per cent of market capitalisation.

A 2001 People's Bank of China survey showed the burgeoning private funds market manages around Rmb 800 billion (almost US$100 billion) in private investment funds.[20] Proposed new laws would allow open ended funds to enter the market.[21] In addition, the Chinese and US funded China Key Enterprises Investment Fund restructures and invests in key SOEs under a joint venture arrangement, preparing them for WTO accession (China Online, 2001b).

Bond Markets

Corporate bond markets are underdeveloped and no domestic ratings agency exists, inhibiting short term growth.[22] In 2001, only about ten corporate bonds were traded on the Shanghai and Shenzhen stock exchanges, although SOEs have issued many more bonds informally to their workers. In 2000, outstanding Chinese Treasury National Bond issues amounted to Rmb 400 billion (almost US$50 billion), providing a basis for pricing corporate bonds (Liu et al., 2001). The Government also recently launched municipal and city bonds and China Development Bank issued a three year bond, with demand coming mainly from other financial institutions. In early 2001, Yanzhou Coal Mining announced it might issue yuan denominated convertible bonds (*South China Morning Post*, www.scmp.com, 9 May 2001). In early 2002, the People's Bank of China allowed the large four state banks to issue long term bonds, developing the market and increasing external discipline on their management (*South China Morning Post*, www.scmp.com, 17 January 2002).

A SHARE BY ANY OTHER NAME

Companies may issue a range of shares: A shares are issued to nationals, comprising state held shares and legal person shares, including institutional investor shares, employee shares and those tradeable on the stock exchange. B shares can be issued to foreigners and domestic investors; these are US dollar denominated and are traded on both Chinese stock exchanges. H and N shares are traded on the Hong Kong and New York Stock Exchanges respectively.

The A share market is large and liquid. Since the B share market opened to domestic investors in February 2001, liquidity and trading in that market also has increased significantly. As foreign stock exchanges impose stricter listing rules on firm management, only large and strong SOEs, such as China Mobile, list on these.

In mid 2001, authorities announced plans for a second Shenzhen board for hi tech start up companies (*South China Morning Post*, www.scmp.com, 8 May 2001). Authorities will not merge the A and B share markets until they open China's capital account, but proposals exist to merge the Shanghai and Shenzhen stock exchanges; this should increase liquidity and may reduce volatility.

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20 The People's Bank of China conducted the survey between April and June 2001, identifying 7 000 investment managers, consultants and financial advisers; previously funds under management were believed to be about Rmb 300-500 billion (*South China Morning Post*, www.scmp.com, 5 July 2001).

21 A draft investment funds law, focusing on open ended funds, went to the National People's Congress in August 2001. The law sets broad principles for funds that raise capital privately from institutional investors and the general public. Open ended funds should channel money to the stock market once the pension system is overhauled (*South China Morning Post*, www.scmp.com, 30 April 2001).

22 However, the State Development Bank provides ratings to SOEs so they can issue bonds (Liu et al., 2001).

WTO Accession

China's 2002 entry to the WTO will further reduce barriers to foreign investment and trade, increasing pressure on inefficient SOEs. Already, WTO entry is prompting a raft of SOE mergers and restructuring; eventually this should improve SOE profitability and may help safeguard outside investors (*Far Eastern Economic Review*, 28 June 2001). The expected entry of more foreign products and firms with superior management, technology and skill levels is forcing local firms to upgrade productivity and, in some cases, to exit. A recent survey of 5 075 Chinese entrepreneurs showed 72 per cent feel under 'tremendous pressure' in preparing for WTO accession (China Online, 2001c).

Pending accession also is stimulating further price liberalisation, increasing SOE autonomy in managing revenues and costs. In 2001, authorities eased price controls on another 128 categories of goods and services; markets now determine 90 per cent of retail and agricultural prices (*South China Morning Post*, www.scmp.com, 12 July 2001). Now, only strategic commodities like petroleum, coal, wheat and rice retain price controls, and many of these prices are close to international levels.

PRESSURE IN CAR SECTOR DRIVING MERGERS AND UPGRADES

China's 120 domestic car producers face significant pressure with WTO accession, as agreements pledge to remove car import quotas and reduce car import tariffs from 80 to 25 per cent over the next five years. In 2001, the Government released a five year plan to prepare the industry for this significant market opening, encouraging mergers and technological upgrades. The plan envisages three car giants, with smaller producers forced out of the market or into parts production.

The Government will support remaining large firms by offering special loans and priority treatment in establishing foreign joint ventures. Many Chinese car producers, including the third largest producer, Dongfeng, seek foreign partners. The World Bank expects WTO accession could reduce the car sector's output by 4 per cent and its employment by 66 per cent by 2005, but the industry should grow thereafter.

Source: *South China Morning Post*, www.scmp.com, 5 July 2001.

Foreign Investors Retain Interest

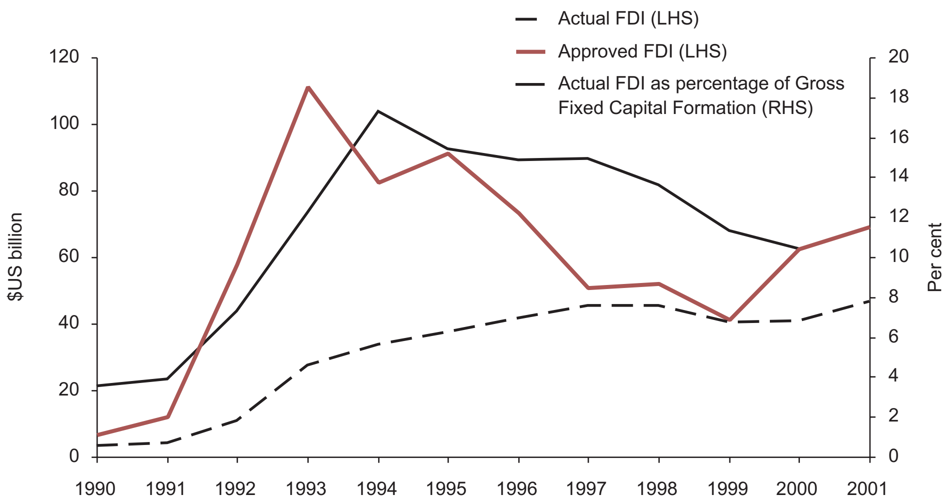
In 2001, foreign direct investment actually disbursed in China increased in the lead up to WTO entry, reaching close to US$47 billion, and remained over 10 per cent of total new investment in China in 2000 (Figure 7.3). Furthermore, approved FDI in 2000 and 2001 exceeded US$60 billion, suggesting the pick up in actual foreign direct investment disbursements will continue into 2002.[23]

[23] FDI commitments usually lead actual spending by a year or more.

Figure 7.3

Resilient Foreign Direct Investment

Foreign Investment including as a percentage of Gross Investment, 1990-2001



Source: CEIC, 2002

Foreign direct investment provides an important source of discipline on Chinese corporates, introducing significant competition in goods and services markets, encouraging them to adopt new management skills and technology and raise production efficiency. As private and joint venture firms have a greater presence on the local stock exchanges, they also should increase pressure for Chinese corporates to improve shareholder value.

STRONGER REGULATIONS

Since 1978, to support its transition to a market based economy, China has enacted numerous laws and regulations to discipline corporate behaviour, reinforce SOE reforms and promote rules based corporate governance.[24] However, SOE and related corporate, legal and regulatory reform is incomplete. For example, SOE reforms increasing the autonomy of managers from owners also increases the need for corporate transparency and shareholder, including minority shareholder protection and representation in firm decision making. Similarly, increasing banks' autonomy requires better prudential controls to monitor their performance and lending decisions, while increasing the role of equity financing requires tighter enforcement of listing requirements to protect shareholders. Key reforms include the 1999 Securities Law revisions to the 1995 Corporation Law and the 1995 law increasing the independence of the central bank, the People's Bank of China.[25]

24 Johnny Chen, Ken DeWoskin, Kevin Young, Nina Ta and Anna Guthleben, PricewaterhouseCoopers and PricewaterhouseCoopers Legal, contributed to this section.

25 Key prudential reform institutions include the State Council, under Premier Zhu Rongji and Vice-Premier Wen Jiabao, the People's Bank of China, the Chinese Insurance Regulatory Commission and the China Securities Regulation Commission.

Consistent legal treatment of different types of Chinese companies is needed, and not all company laws and regulations conform to international practice. For example, China's 1995 Corporation Law applies to limited liability and limited joint stock companies, covering most foreign owned firms and listed firms, but does not apply to other entities, including non-listed SOEs (Appendix Table 7.1). A priority issue is improving governance in firms whose boards consist of managers, and party and government officials, particularly as firms move from state to partial private ownership.

TRANSPARENCY

To attract new outside investors, listed firms will need to provide adequate information and employ transparent accounting and auditing practices; often this has not occurred.

Corporate Reporting

To address this situation, in 2000, the Ministry of Finance released new accounting and disclosure guidelines, *Accounting Systems for Business Enterprises.* These define the required content of financial and accounting reports, set minimum notes to the financial statements and specify regular and frequent reporting for all companies from 1 January 2001. From 2002, listed companies must provide quarterly reports which will be published in newspapers and on designated web sites. In December 1999, the China Securities Regulatory Commission increased disclosure requirements, requiring listed firms to account for all aspects of their operations. For example, companies must report how independent company management, assets and finance are from major shareholders. Listed firms also must report profit forecasts. Firms running losses and profitable firms not issuing dividends must provide reasons in their quarterly reports (China Online, 2001a). From 2001, companies must report on a consolidated basis; this is important, as many Chinese companies belong to large diverse groups, *jituan*.

Accounting Standards

In 1993, authorities began upgrading accounting standards to be in line with international best practice.[26] *Accounting Systems for Business Enterprises* includes several new and revised accounting standards in line with International Accounting Standards, such as provisions requiring consolidated reporting and valuing assets.

However, implementing these new standards will require time and resources; current accounting practices vary greatly. Chinese firms listed in Hong Kong or foreign stock exchanges comply with International Accounting Standards, as do large multinational joint ventures. However, a recent Ministry of Finance survey indicated wholly domestic enterprises usually employ poor accounting practices, and in some cases falsify their earnings (*South China Morning Post*, www.scmp.com, 28 May 2001). To overcome these problems, the Ministry of Finance is sponsoring training programs involving major foreign accounting firms, and improving the training and testing of Chinese chartered public accountants. The Government also undertakes large scale audits of SOEs to boost compliance.

26 Since then, authorities have issued ten final standards and are reviewing a further 20 standards.

Auditing Standards

Auditing should improve compliance with new accounting standards. Under 2001 regulations, both domestic and international auditing companies must audit all financial companies listed on the Shanghai or Shenzhen stock exchanges (*South China Morning Post*, www.scmp.com, 25 May 2001). From April 2002, international accounting firms must audit annual reports and interim results of all firms applying for A-share initial public offerings, or making secondary issues (*South China Morning Post*, www.scmp.com, 4 January 2002). External audits have proven very effective in uncovering financial malpractice and fraudulent accounting (Lin, 2000). However, internal audit quality varies greatly, as CEOs define their scope. In 2001, the National Audit Office announced 14 accounting firms had written 23 "gravely inaccurate" auditor's reports for companies listed on the Shanghai and Shenzen stock exchanges (*South China Morning Post*, www.scmp.com, 27 December 2001).[27]

MINORITY SHAREHOLDERS' RIGHTS

Currently, all private shareholders in SOEs own minority shares, increasing the need for sound laws to protect them from company insiders. Also, the largest shareholder, usually a state agency, on average holds more than 40 per cent of a listed company's equity (*South China Morning Post*, www.scmp.com, 11 January 2002). Despite this, the Corporation Law provides little protection for minority shareholders and only allows legal action against ongoing, rather than past, unlawful conduct. Currently, the best protection for minority shareholders is to free-ride on institutional investors at annual general meetings, but these still have a small market presence. In early 2002, however, the China Securities Regulatory Commission issued guidelines prohibiting controlling shareholders from intervening in listed company decision making and preventing asset restructuring that damages minority interests (*South China Morning Post*, www.scmp.com, 11 January 2002).

Listing Rules

The China Securities Regulatory Commission, the 1999 Securities Law, and State Council regulations provide listing principles for companies listing domestically and abroad.[28] Listing firms need equity of at least Rmb 50 million, while SOEs aspiring to list must be willing to issue shareholder capital equivalent to at least 30 per cent of total shares, and have run profitably for at least three years (China Securities Regulatory Commission, 2001). Before making an initial public offer, firms also must submit a financial report for state approval (Fang, 2001).

27 A Shanghai University of Finance and Economics survey showed 88 per cent of market participants believed most listed firms provided inaccurate financial data in the previous year (*South China Morning Post*, www.scmp.com, 27 December 2001).

28 Previously, provincial regulators in Shanghai and Shenzhen formally determined listing requirements, but the Government selected firms it allowed to list, based on social and political, as well as financial and economic, criteria.

NEW MARKET ORIENTED LISTING RULES

In 2001, the China Securities Regulatory Commission released new listing practices. In future, all firms meeting new listing requirements will be allowed to list and new listings complying with standards may issue unlimited equity. The Commission introduced new rules on secondary offerings, and clarified reporting rules and statements on dividend policies. In April 2001, the Commission required all listed companies to issue quarterly financial reports within a month of the end of the first and third quarters; firms issuing B shares also must summarise their interim reports in English in foreign newspapers. In 2000 and 2001, the China Securities Regulatory Commission successfully prosecuted a number of firms for failing to comply with its listing rules. For example, it forced Shanghai Narcissus, a home appliance maker, and Guangdong Kingman, to delist because of their debts (*South China Morning Post*, www.scmp.com, June 14 2001). The commission also disciplined or dismissed several dozen executives involved in insider trading. However, some investors have resisted the Commission's robust approach; in April 2001, nine investors took the China Securities Regulatory Commission and a Shanghai SOE to court over losses from delisting Shanghai Narcissus.

Board Structure and Duties

Authorities are acting to bolster board independence and directors' understanding of their duties. The 1995 amendments to the Corporation Law specify directors' fiduciary duties in limited liability and joint stock companies, including joint ventures and listed private firms. A director may be liable personally for resolutions the board passes (Fang, 2001). The Civil Procedure Law allows collective actions against directors. Recent amendments to the 1995 Corporation Law require at least one third of a listed company's directors be independent and include at least one accounting professional (Neoh, 2000). The China Securities Regulatory Commission also recently issued guidelines on shareholder representation and board directors.

In 2000, the Commission released *Suggestions for Standardizing Shareholders' Meetings of Listed Companies*, providing voluntary guidelines on strengthening shareholder representation and outlining directors' duties to shareholders (China Online, 2001c). This document lays out procedures for introducing motions, voting on directors and conducting annual general meetings.

Under the Corporation Law, limited joint stock companies also must appoint a supervisory board, as well as a board of directors, to supervise company finances, directors and managers. Underwriters must conduct a one year training course for key personnel in listed companies, covering the company and securities laws.

SHAREHOLDERS NEED PROTECTING

Despite tightened requirements to uphold minority shareholder rights and ensure directors act in all shareholders' interests, practice considerably lags behind these new provisions. Although shareholders should select boards at annual general meetings, the Government often appoints board members directly. The Party continues to influence SOE decisions, including selecting CEOs, and can over-rule annual general meeting resolutions via the supervisory board (Zhao, 2001).

In a survey of 350 companies listed with the Shanghai stock exchange, the state owned two-thirds of stock, and private investors the remainder. However, in many firms, private shareholder protection is weak. Boards of directors enjoy a close relationship with the Government and enterprise managers. In 45 per cent of firms, the Chairman of the Board and the CEO shared executive power; in 23 per cent of firms, they were the same person; and only in 35 per cent of firms, were these roles strictly separate (Zhao, 2001).

Annual general meetings generally play a limited role in supervising firm behaviour, and attendance by small and medium shareholders is minimal. Only two or three legal person votes, comprising the government or another SOE owner can pass a resolution, reducing the influence of small shareholders.

CREDITORS' RIGHTS

Creditors, mainly the state owned banks, are reluctant to lend to small and medium sized private enterprises and SOEs which have failed to repay loans because the bankruptcy regime is weak. However, the Government is loath to allow widespread bankruptcy of insolvent SOEs. Recent scandals indicate bank risk assessment and internal loan control procedures often are relatively weak, though new bank supervision standards eventually may increase protection for depositors (*Far Eastern Economic Review*, January 31, 2002, pp. 30-36.).

Bankruptcy Regime

China's bankruptcy regime currently provides inadequate creditor protection. SOE bankruptcy still is relatively rare given the large number of insolvent SOEs; the low risk of bankruptcy undermines the credit culture and keeps non performing loans high. The National People's Congress has held up passing a new bankruptcy law strengthening creditor protection. Concerns about social stability predominate and, in early 2002, a 1988 temporary bankruptcy law continues to apply. If passed, the new bankruptcy law would expedite industrial restructuring through mergers and acquisitions and firm exits.

In lieu of a functioning bankruptcy system, government officials decide which firms will go bankrupt, administer the liquidation or reorganisation of assets and seek new employment for workers. In all but hopeless cases, authorities prefer SOEs to survive, meaning many trade while insolvent, further undermining creditors' capacity to retrieve assets (Godwin, 2001). Even when bankruptcy is declared, creditors have no automatic rights to collateral. Creditor banks' asset management companies generally waive most bankrupt firms' debts and spread losses across all stakeholders; workers' entitlements receive top priority in claims on assets. A State Economic and Trade Commission survey showed only around 1 per cent of bankrupt firms' loans are repaid, suggesting bankruptcy comes too late and insolvent firms strip assets to pay workers' wages and management salaries for long periods (Fang, 2001).

Banks generally do not push bad debtors to declare bankruptcy, as this would force them to book non performing loans as losses, reducing their capital base and possibly bringing sanctions against bank management. Instead, banks prefer to roll debts over, deferring and concealing the problem. Authorities also prefer to consolidate non-viable firms with more viable ones, rather than declaring bankruptcy. Cases that proceed to bankruptcy hearings face inconsistent regulations in dealing with SOE assets, land use rights and obligations to employees. As well, political interference may impede local courts applying the law (Wang, 2001b). To counter problems in the local courts, in December 2001, authorities announced they would establish a new bankruptcy court in Shanghai ahead of WTO entry (*South China Morning Post*, www.scmp.com, 22 December 2001).

BANK SUPERVISION

The People's Bank of China supervises state owned commercial and policy banks, joint stock banks and some non-bank financial institutions, including credit cooperatives (East Asia Analytical Unit, 1999). All banks have a supervisory board, monitoring their management and reporting to the State Council. The People's Bank of China developed bank supervision criteria in conjunction with the International Monetary Fund and Moody's rating agency. In early 2002, the People's Bank of China intends to classify loans following international best practice (*South China Morning Post*, www.scmp.com, 26 December 2001). The Bank of China already includes the level of its non performing loans in its annual report and the Industrial and Commercial Bank of China has also announced it will do the same from 2002 (Lardy, 2001; *South China Morning Post*, www.scmp.com, 12 January 2002).

The banking law governing commercial banks forces banks to take security when lending, even to major multinationals (Godwin, 2001). Also, limits on unsecured lending and securities trading constrain banks' risk and treasury management capacity. However, compliance with formal requirements often is low, particularly with lending to established SOE borrowers.

COMPLIANCE

Lack of resources and weak courts undermine authorities' capacity to implement prudential supervision laws and regulations. For example, when the China Securities Regulatory Commission tried to implement the new Securities Law, it found the police lacked specialised investigative skills, so it launched a new enforcement division (*South China Morning Post*, www.scmp.com, 29 June 2001). The commercial press also is becoming more important in exposing corporate and security industry fraud.

The Legal and Arbitration System

The judicial system's quality, independence and authority remains a major challenge in establishing reliable commercial infrastructure and recourse for creditors, though China's commercial arbitration system is developing a good reputation (East Asia Analytical Unit, 1999). These issues affect all aspects of corporate governance enforcement, as well as shareholder and creditor rights. The Government recognises most judges lack commercial training and local government officials can exert significant influence over judges. Furthermore, holding cases in camera erodes confidence in the legal system's transparency (*South China Morning Post*, www.scmp.com, 25 May 2001).

To support WTO accession, authorities have indicated they plan to develop a fair and transparent legal system and modify existing foreign trade laws and regulations to conform to international standards. The Government will establish legal consulting centres for the corporate sector and sideline local laws if they conflict with major corporate legislation. A draft bill also allows the public to witness commercial legal cases (China Online, 2001b).

Press

An active commercial press is emerging complementing official efforts to enforce new commercial laws.[29] The press was very active in uncovering recent share price manipulation scandals. For example, in August 2001 after a year-long investigation, *Caijing* (Finance) magazine, which has earned a reputation for aggressive reporting on Chinese business activities, uncovered details of a major sharemarket scam by biotech company Guangxia Industry (Chine Online, 2001b). *Caijing* previously uncovered widespread insider trading abuses by Shanghai funds managers. However, as in many other economies, press owners also run non-media corporations, creating possible future conflicts of interest regarding corporate exposures.[30]

IMPLICATIONS

China is vigorously developing the legal and regulatory framework to enforce better corporate governance, both in state and non-state enterprises; the China Securities Regulatory Commission leads this process. However, this long and complex process is far from complete. Market forces also are pressing the corporate sector to improve efficiency and corporate governance compliance; WTO accession will reinforce this discipline.

[29] Since the early 1990s, the Government has tacitly allowed domestic private capital to enter the press sector, without formally changing policy. From 1996, it allowed media companies to list stock (*South China Morning Post*, www.scmp.com, 30 May 2001). Official figures show media revenue growing by 25 per cent a year over the past three years, suggesting a burgeoning industry.

[30] For example, in 2001, Shanghai based company, Sanlian Group backed the launch of the weekly *Economic Observer* with Rmb 80 million over three years. Similarly Shanghai Bus, a bus and taxi operator, invested Rmb 50 million for a 50 per cent share of *Shanghai Commercial News*.

The Chinese Government's main problem in raising corporate governance standards is the continued economic importance of SOEs. In operating SOEs, the Government's roles of corporate and financial regulator, corporate and bank asset owner, deposit taker, creditor and maintainer of social stability inevitably come into conflict. Conflicting objectives weaken corporate governance standards and undermine SOE manager incentives to maximise value for public and private shareholders, repay creditors and provide high quality services for consumers. Without a clear requirement to act on behalf of shareholders, many SOE managers instead optimise outcomes for themselves and their workers.

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APPENDIX

Appendix Table 7.1

Laws Influencing Corporate Governance

Type of Enterprise	Description	Relevant law
SOE	An enterprise with assets owned by central, provincial or municipal governments	Law on Enterprises Owned by the Whole People
Collectively owned enterprise	An enterprise with assets owned jointly by workers and other economic entities	Law on Collectively Owned Enterprises
Private enterprise	The Government recognises three types of private enterprise: • individually funded enterprises, which are funded and managed by one person • partnerships which are funded, managed, and with profits and losses shared jointly • limited liability company, in which the investor liability is limited to their contributions and company liability is limited to its shares	Provisional Regulations on Private Enterprises Partnerships governed by the Partnership Law Limited liability companies governed by the Corporation Law
Foreign enterprise	Includes joint ventures, Sino-foreign cooperation enterprises and wholly owned foreign enterprises	Each firm is subject to the relevant law promulgated for its firm type. If it is incorporated as a limited liability company or a joint stock company, the Corporation Law takes precedence if conflicts arise
Township and village enterprise	An entity owned by local governments and former commune members	

Source: PricewaterhouseCoopers, 2001.