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I. Introduction

From a banking industry perspective, a corporate governance system can be defined as a set of mechanisms in setting the incentives for a banking organization to act prudently and for control of the risks that a bank takes. Good corporate governance has been regarded as one of the paramount factors in maintaining financial stability in a country.[1] This significant consensus was reached after a series of well-known bank failures: the collapse of the Bank of Credit and Commerce International,[2] the debacle of the Barings Bank,[3] and the scandal in the Daiwa's New York branch.[4] In addition, even more significant financial crises in Asia, Russian, and other transition countries added a new urgency to the establishment of legal,

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1. *See* JOSEPH J. NORTON, FINANCIAL SECTOR LAW REFORM IN EMERGING ECONOMIES 37–38 (2000). Other factors include a robust financial system, a strengthening and expansion of domestic capital markets and the need for an effective insolvency regime combined with the creation of a suitable social safety net. *See id.* The IMF also holds a similar viewpoint. *See* IMF, INTERNATIONAL CAPITAL MARKETS: DEVELOPMENTS, PROSPECTS AND KEY POLICY ISSUES (Charles Adams et al. eds., 1999).

2. For a general discussion of the BCCI collapse, see generally Richard Dale, *Banking Regulation after BCCI*, 8(1) J. INT'L BANKING L. 8 (1993); HOUSE OF COMMONS, BANKING SUPERVISION AND BCCI: INTERNATIONAL AND NATIONAL REGULATION (1992); Maximilian J. B. Hall, *The BCCI Affair*, BANKING WORLD, Sept. 1991; Hal S. Scott, *Supervision of International Banking Post-BCCI*, 8 GA. ST. U. L. REV. 487 (1992).

3. For a more detailed analysis of the role played by bad corporate governance in the failure of Barings Bank, see Joseph J. Norton & Christopher D. Olive, *Globalization of Financial Risks and International Supervision of Banks and Securities Firms: Lessons from the Barings Debacle*, 30 INT'L LAW. 301 (1996).

4. For a discussion of the Daiwai scandal, see, e.g., Sarah Marks, *Regulators Justify Reactions to Barings and Daiwa*, INT'L FIN. L. REV. (1996); Brian P. Volkman, *The Global Convergence of Bank Regulation and Standards for Compliance*, 115 BANKING L.J. 550 (1998).

regulatory, and internal systems for corporate governance in banking organizations.[5] Thus, corporate governance has become a topic of global concern.

Numerous public and private bodies, at national, regional, and international levels have realized the importance of corporate governance and established standards and norms related to important aspects of corporate governance.[6] In particular, on a general company level, the Organization for Economic and Cooperation Development (hereinafter OECD) issued Principles of Corporate Governance in June 1999.[7] As to banking institutions, the Basle Committee on Banking Supervision published Enhancing Corporate Governance for Banking Organizations in September 1999.[8]

5. *See generally* SAY GOO ET AL., INTERNATIONAL FINANCIAL SECTOR REFORM: STANDARD SETTING AND INFRASTRUCTURE DEVELOPMENT, Part III (forthcoming 2002). For a general discussion of recent financial crises, *see* DOUGLAS ARNER ET AL., INTERNATIONAL FINANCIAL CRISIS OF THE 1990s (forthcoming 2002).

6. For example, in the United States, there are the General Motors Board Guidelines on Significant Corporate Governance Issues 1995, Statement of Governance Principles; in the United Kingdom, there are the 1992 Cadbury Report, the 1995 Greenbury Report, and the 1998 Hampel Report. In Canada, the Toronto Stock Exchange drafted the Guidelines for Improved Corporate Governance in 1994, while France had the Vienot Report on "the Board of Directors of Listed Companies in France" in 1995. In the EU context, there are the First Directive (68/151/EEC), Draft Fifth Directive, Draft Ninth Directive, the Twelfth Directive, and the Proposal for a Thirteenth Directive dealing with the matters of approximation of corporate governance. On a discussion of harmonization of national corporate governance laws in the EU, *see generally* John H. Farrar, *The New Financial Architecture and Effective Corporate Governance*, 33 INT'L LAW. 927, 937–43 (1999). The U.S. Securities and Exchange Committee (SEC) had been working with the International Accounting Standards (IASC) for nearly a decade to promulgate a core set of accounting pronouncements. The finance ministers and central bank governors of the G7 countries have also announced their support for the IASC and have encouraged it to complete its proposed set of core principles. *See* Lawrence A. Cunningham, *Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance*, 84 CORNELL L. REV. 1133, 1154–57 (1999).

7. ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, OECD PRINCIPLES OF CORPORATE GOVERNANCE (1999) [hereinafter OECD Principles].

8. BASLE COMMITTEE ON BANKING SUPERVISION, ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANISATIONS (1999) [hereinafter BIS BANKING CORPORATE GOVERNANCE].

9. The Third Plenum of the Fourteenth Chinese Communist Party Congress endorsed the creation of a modern enterprise system. *See* Central Committee of the Communist Party of China, *Decision of the CPC Central Committee on Some Issues Concerning the Establishment of a Socialist Market Economic Structure*, PEOPLE'S DAILY, Nov. 17, 1993, at 1–2, *available at* http://english.peopledaily.com.cn. In December 1993, the Fifth Plenum of the Standing Committee of the National People's Congress adopted the Company Law, in which a limited liability company or a joint stock limited company is required to implement internal management mechanisms characterized by clear definition of rights and responsibilities, scientific management, and a combination of encouragement and restraint. *See* Company Law of the People's Republic of China (Dec. 29, 1993, art. 6 [hereinafter 1993 Company Law], *available at* http://www.cietac-sz.org.cn/cietac/English/Convention/Com01.htm. Due to weak monitoring mechanisms in wholly state-owned companies, in December 1999 the National People's Congress amended the 1993 Company Law by replacing the provision on state-authorized institution (article 67) with the provision on supervisory board in wholly state-owned companies (Article 67 of the 1993 Company Law reads: a state-authorized investment institution or a department authorized by the state shall exercise supervision and management of the state-owned assets in wholly state-owned companies in accordance with laws and administrative regulations. 1993 Company Law, art. 67. Article 67 of the 1999 Company Law reads: the supervisory board in a wholly state-owned company consists of members mainly from the State Council or institutions and departments authorized by the State Council with the participation of the employee representatives of the company. The number of the supervisory board members shall not be less than three. The supervisory board shall perform functions in accordance with the articles (1) and (2) of this Law and other functions stipulated by the State Council. 1999 Company Law, art. 67 (P.R.C.). In March 2000, the State Council promulgated the Interim Regulations on Supervisory Board in State-Owned Enterprises, which clearly provides that the supervisory board, delegated by the State Council, is responsible to the State Council for supervising the matters relating to preserving and increasing the value of state-owned assets on

The Chinese government has paid a great deal of attention to the issue of corporate governance in companies.[9] In the banking industry the Central Bank, the People's Bank of China (hereinafter PBOC), promulgated the Interim Regulations on the Supervisory Board in Wholly State-Owned Commercial Banks in November 1997. In March 2000, the State Council issued the Interim Regulations on the Supervisory Board in Major State-Owned Financial Institutions, which replaced the PBOC's 1997 Interim Regulations. Moreover, in both the 1993 Company Law and 1999 Company Law the relevant provisions with respect to corporate governance also apply to state-owned commercial banks as limited liability companies.

Despite these efforts, however, the situation of corporate governance in China's state-owned banks has not been satisfactory. Low efficiency, political intervention, nonperforming loans, corruption, and the like have been frequently described as characteristics of the four biggest wholly state-owned commercial banks (i.e., the Industrial and Commercial Bank of China, the Bank of China, the Construction Bank of China, and the Agricultural Bank of China). For this reason, a number of calls for privatization of the four banks have emerged. It seems that privatization is a panacea for improving corporate governance in China's wholly state-owned commercial banks.

This article is intended to discuss whether privatization is an appropriate approach to improving corporate governance of wholly state-owned commercial banks in China's special context. Section II summarizes the OECD Principles of Corporate Governance and the BIS Banking Corporate Governance, and makes a brief comment on these two guidelines. This section also discusses China's 1999 Company Law and the State Council's Interim Regulations on the Supervisory Board in Major State-Owned Financial Institutions, and points out weaknesses in terms of law, institutions, and property rights which have posed impediments to the formulation of sound corporate governance in China's state-owned banks. Most of the significant problems with corporate governance can be attributed to the lack of effective monitoring. Section III reaches a conclusion that privatization is not a workable way to improve corporate governance in China's state-owned banks under its present circumstances. In this part we suggest that setting up a special bank investment company may provide an effective monitoring mechanism. In section IV, we conclude that the problems corporate governance reforms are facing are not only to who state-owned banks are accountable, but also for what they are accountable.

II. General Frameworks for Corporate Governance

For this article's purpose, we will summarize and comment on the OECD Principles of Corporate Governance and the BIS Banking Corporate Governance. To have an entire understanding of corporate governance in banks, the BIS Banking Corporate Governance must be considered in conjunction with the OECD Principles of Corporate Governance. Against this general background the frameworks for corporate governance in China's state-owned banks will be dealt with and their weaknesses will also be discussed in this section.

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behalf of the state. *See* State Council, Interim Regulations on Supervisory Board in State-Owned Enterprises, art. 1 (P.R.C.). The initiative of enhancing corporate governance in state-owned companies is paralleled by the Basic Norms for the Establishment of Modern Enterprise System and Enhancement of Management in Large- and Medium-Sized State-Owned Enterprises issued by the State Commission for Economy and Trade in October 2000. This Basic Norms emphasize once more the separation of the government and the enterprise and the setting up of corporate governance structures. *See* State Commission for Economy and Trade, Basic Norms for the Establishment of Modern Enterprise System and Enhancement of Management in Large- and Medium-Sized State-Owned Enterprises, para. 1 (P.R.C.).

A. OECD Principles of Corporate Governance and BIS Banking Corporate Governance as a Reference

1. *OECD Principles of Corporate Governance*

The OECD has a long experience in the area of corporate governance. Work on various aspects of corporate governance has been carried out by specialized OECD groups working on topics such as accounting, financial markets, and private sector development. In 1999, the OECD Principles of Corporate Governance were published and intended to assist member and non-member governments in their efforts to evaluate and improve the legal, institutional, and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance.[10]

The OECD Principles of Corporate Governance focus on the relationships between a company's management, its board, its shareholders, and other stakeholders, by setting incentives for the board and management to act in the interests of the company and shareholders, and to facilitate effective monitoring. The OECD suggests that this purpose can be achieved through the protection of shareholders' rights[11] and equitable treatment of shareholders.[12] Also, the OECD recognizes that the competitiveness and ultimate success of a corporation is the result of co-efforts from various participants including investors, employees, creditors, and suppliers. Accordingly, the corporate governance framework should respect the role of stakeholders in corporate governance.[13]

Market discipline of companies depends largely on information disclosure, which is a basic pre-condition for shareholders to obtain the ability to exercise their voting rights. The OECD Principles of Corporate Governance strongly advocate timely and accurate disclosure of all material information.[14]

Although sound corporate governance depends on the co-efforts of stakeholders, the board still plays a major role. On the one hand, the board should exercise effective monitoring of management; on the other hand, the board is accountable to the company and the shareholders. The corporate governance framework should establish the responsibilities of the board.[15]

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10. OECD Principles, *supra* note 7, at 2.

11. "Basic shareholder rights include the right to: (1) secure methods of ownership registration; (2) convey or transfer shares; (3) obtain relevant information on the corporation on a timely and regular basis; (4) participate and vote in general shareholder meetings; (5) elect members of the board; and (6) share in the profits of the corporation." *Id.* at 5.

12. The equitable treatment of shareholders can be achieved through the following means: (1) all shareholders of the same class should be treated equally; (2) insider trading and abusive self-dealing should be prohibited; and (3) members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation. *Id.* at 6.

13. The role of stakeholders in corporate governance can be facilitated where (1) the corporate governance framework respects the rights of stakeholders that are protected by law; (2) stakeholders have the opportunity to obtain effective redress for violation of their rights; (3) the corporate governance framework permits performance-enhancing mechanisms for stakeholder participation; and (4) stakeholders are able to have access to relevant information when they participate in the corporate governance process. *Id.* at 7.

14. This information includes the financial and operating results of the company; company objectives; major share ownership and voting rights; members of the board and key executives, and their remuneration; material foreseeable risk factors; material issues regarding employees and other stakeholders; governance structures and policies. *Id.* at 8.

15. *See id.* at 23–25 (regarding the responsibilities of the board).

2. *BIS Banking Corporate Governance*

As part of its ongoing efforts to establish sound corporate governance guidelines,[16] the Basle Committee, in September 1999, published Enhancing Corporate Governance for Banking Organizations. The BIS Banking Corporate Governance focuses on the manner in which the business and affairs of individual banking institutions are governed by their boards of directors and senior management.[17] Based on supervisory experience with corporate governance problems at banking institutions, the Basle Committee suggests that sound corporate governance practices include (1) establishing strategic objectives and a set of corporate values that are communicated throughout the banking organization; (2) setting and enforcing clear lines of responsibility and accountability throughout the organization; (3) ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance, and are not subject to undue influence from management or outside concerns; (4) ensuring that there is appropriate oversight by senior management; (5) effectively utilizing the work conducted by internal and external auditors; (6) ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment; and (7) conducting corporate governance in a transparent manner.[18]

3. *Brief Comments*

Corporate governance patterns can be classified into outsider models and insider models according to the degree of ownership and control. An outsider model, notably in the United States and United Kingdom, is characterized by widely dispersed ownership. An insider model, notably in Germany and Japan, is characterized by concentrated ownership. The basic conflict of interest in the outsider model is between strong managers and widely dispersed weak shareholders. By contrast, the conflict in the insider model is between controlling shareholders and weak minority shareholders. The OECD Principles of Corporate Governance try to reduce these conflicts. They intend to balance the interests between the board and shareholders by protecting shareholders' rights and delineating the responsibilities of the board on the one hand. On the other hand, they provide equitable protection to all shareholders, whether controlling shareholders or minority shareholders.

In terms of accountability of the board and management, corporate governance models can be divided into shareholder primacy and stakeholder primacy. Shareholder primacy emphasizes the accountability of the board and management to shareholders—that they should act in the interests of shareholders. Stakeholder primacy holds the board and management accountable to relations involving the corporation. The scope of the relations, however, varies. The scope may extend to social constituents such as members of the community in which the corporation is located, environmental interests, local and national

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16. Over the past few years, the Basle Committee has issued several documents relating to corporate governance in banks. These documents include Principles for the Management of Interest Rate Risk (Sept. 1997), Framework for Internal Control Systems in Banking Organizations (Sept. 1997), Enhancing Bank Transparency (Sept. 1998), and Principles for the Management of Credit Risk (consultative document, July 1999). BIS Banking Corporate Guidance, *supra* note 8, at 3.

17. *See id.*

18. *Id.* at 5–9.

governments, and society at large.[19] The OECD Principles of Corporate Governance may take a compromising approach. They do not clearly define the scope of the relations involving the corporation. They ambiguously limit the scope to investors, employees, creditors, and suppliers.[20] However, the BIS Banking Corporate Governance includes the community, even supervisors and governments, in the scope of stakeholders.[21]

The more numerous the parties to which the board and management are deemed to be accountable, the broader the scope of accountability and the wider the range of corporate objectives. So the corporate governance framework should consider the scope of the stakeholder when setting objectives. Unfortunately, however, both the OECD Principles of Corporate Governance and the BIS Banking Corporate Governance separate the two aspects.

The BIS Banking Corporate Governance focuses on sound practices of the banks inside management. It does not deal with the relations between the board and management and shareholders/stakeholders. As it points out, therefore, the BIS Banking Corporate Governance must not be isolated from laws, disclosure and listing requirements, audit standards, and bank industry principles and sound practices to have an entire understanding of bank corporate governance.[22]

It is widely recognized that markets contain disciplinary mechanisms that can effectively monitor the performance of a firm. Therefore, a strong information disclosure regime is a pivotal feature of sound corporate governance. The OECD Principles of Corporate Governance and the BIS Banking Corporate Governance together with the Basle Committee's Enhancing Bank Transparency re-emphasize the importance of public disclosure. They explicitly and implicitly require that information be disclosed according to the principles of comprehensiveness, relevance, timeliness, reliability, comparability, and materiality. Moreover, the OECD Principles of Corporate Governance address the issue of disclosure of negative information. Under these principles, companies are not expected to disclose information that may endanger their competitive position unless disclosure is necessary to fully inform the investment decision and to avoid misleading the investor.[23] In our opinion, however, public disclosure can serve as a deterrent to companies. It is the damaging effects of disclosing negative information that put *ex ante* pressure on companies to run their business prudently and give companies incentives to control themselves in a proper manner. For this reason, we argue that full disclosure of information, whether bad or good, is essential to strengthen market discipline. However, full disclosure should be respectful to privacy laws and regulations.

B. Legal and Regulatory Framework for Corporate Governance of Wholly State-Owned Commercial Banks in China

Over the past seven years, the Chinese government has realized the importance of corporate governance in wholly state-owned commercial banks. The corporate governance framework for banks has been established. The 1993 Company Law established a basic

19. Maria Maher & Thomas Anderson, Corporate Goverance: Effects on Firm Performance and Economic Growth, at 8 (1999). However, the stakeholder model has more narrowly defined stakeholders to be those actors who have contributed firm-specific assets. *Id.* at 9.

20. *See* OECD Principles, *supra* note 7, at 15.

21. BIS Banking Corporate Governance, *supra* note 8, at 3 n.3.

22. *See id.* at 10.

23. OECD Principles, *supra* note 7, at 17.

structure of corporate governance in a general company, which is critically relevant to wholly state-owned commercial banks. Afterwards, the Commercial Banking Law was adopted in 1995. There are two more important laws worthy to be illustrated. One is the 1999 Company Law where the Standing Committee of the National People's Congress added a new provision on the supervisory board of wholly state-owned companies. The other is the Interim Regulations on Supervisory Board in Major State-Owned Financial Institutions issued by the State Council in 2000. In addition, the PBOC issued the Guiding Principles for Strengthening Internal Controls of Financial Institutions in China in May 1997 and the Guidance for Regulation of Commercial Banks in 2001, respectively.

1. *The 1999 Company Law*

Wholly state-owned commercial banks belong to the category of wholly state-owned companies in the company law. The difference between them is that the four biggest state-owned commercial banks are subordinated directly to the State Council rather than to the state-authorized investment institution or the department authorized by the State. The 1999 Company Law as well as the 1993 Company Law sets up a special section for wholly state-owned companies.[24] A wholly state-owned company is defined as a limited liability company invested in and established solely by a state-authorized investment institution or a department authorized by the State.[25]

Wholly state-owned companies do not need to set up a shareholder meeting. Instead, the board of directors shall be authorized by the state-authorized investment institution or by the department authorized by the State to exercise part of the functions and powers of the shareholder meeting[26] and to make decisions on important matters of the company. However, the merger, division, dissolution, increase and reduction of capital, and issuance of company bonds must be decided by the state-authorized investment institution or by the department authorized by the State.[27]

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24. On the difference in the section between 1993 Company Law and 1999 Company Law, *see* Company Law, *supra* note 9.

25. 1999 Company Law, art. 64. A limited liability company refers to as such a company where shareholders assume liability towards the company to the extent of their respective capital contributions, and the company is liable for its debts to the extent of all its assets. *Id.* art. 3.

26. *Id.* art. 38, the shareholder meeting of a limited liability company performs the following functions and powers:

- To decide on the business policy and investment plan of the company;
- To elect and recall members of the board of directors and to decide on matters concerning the remuneration of directors;
- To elect and recall supervisors appointed from among the shareholders' representatives, and to decide on matters concerning the remuneration of supervisors;
- To examine and approve reports of the board of directors;
- To examine and approve reports of the supervisory board or supervisors;
- To examine and approve the annual financial budget plan and final accounts plan of the company;
- To examine and approve plans for profit distribution of the company and plans for making up losses;
- To adopt resolutions on the increase or reduction of the registered capital of the company;
- To adopt resolutions on the issuance of company bonds;
- To adopt resolutions on the assignment of capital contribution by a shareholder to a person other than the shareholders;
- To adopt resolutions on matters such as the merger, division, transformation, dissolution and liquidation of the company;
- To amend the articles of association of the company.

27. *Id.* art. 66.

A wholly state-owned company shall have the board of directors, each term of office of which shall be three years, which shall exercise its functions and powers in accordance with the provisions of Article 46 and Article 66 of the 1999 Company Law.[28] The board of directors shall be composed of three to nine members, who shall be appointed and replaced by the state-authorized investment institution or by the department authorized by the State in accordance with the term of office of the board of directors.[29] The chairman and vice-chairman of the board of directors shall be designated by the state-authorized investment institution or by the department authorized by the State from among members of the board of directors.[30] The participation of the employee representatives, who are democratically elected by the employees, in the board of directors is legally mandatory according to this Company Law.[31]

The manager of a wholly state-owned company is appointed and dismissed by the board of directors; a member of the board of directors may, subject to the approval of the state-authorized investment institution or the department authorized by the State, serve concurrently as manager.[32] The manager shall exercise his functions and powers in accordance with the provisions of Article 50 of the 1999 Company Law.[33]

To avoid conflicts of interest, the 1999 Company Law stipulates that the chairman, vice-chairman, and directors of the board, or the manager of a wholly state-owned company may not, without the approval of the state-authorized investment institution or the department authorized by the State, serve concurrently as responsible persons in other limited liability companies, joint stock limited companies, or other business organizations.[34]

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28. *Id.* art. 68. Article 46 of the 1999 Company Law reads as follows: the board of directors shall be responsible to the shareholders' meeting, and exercise the following functions and powers: (1) to be responsible for convening shareholders' meetings and to report on its work to the shareholders' meetings; (2) to implement the resolutions of the shareholders' meetings; (3) to decide on the business plans and investment plans of the company; (4) to formulate the annual financial budget plan and final accounts plan of the company; (5) to formulate plans for profit distribution and plans for making up losses of the company; (6) to formulate plans for the increase or reduction of the registered capital of the company; (7) to formulate plans for the merger, division, transformation and dissolution of the company; (8) to decide on the establishment of the company's internal management organs; (9) to appoint or dismiss the company's general manager (hereinafter manager), and, upon recommendation of the manager, to appoint and dismiss the company's deputy manager(s) and persons in charge of the financial affairs of the company, and to decide on matters concerning their remuneration; and (10) to formulate the company's basic management structure. 1999 Company Law, art. 66, see *supra* text accompanying note 27.

29. *Id.* art. 68.

30. *Id.*

31. *See* 1999 Company Law, art. 68.

32. *Id.* art. 69.

33. *Id.* art. 50. A limited liability company shall have a manager, who shall be appointed or dismissed by the board of directors. The manager shall be responsible to the board of directors and shall exercise the following functions and powers: (1) to be in charge of the production, operation and management of the company, and to organize the implementation of the resolutions of the board of directors; (2) to organize the implementation of the annual business plans and investment plans of the company; (3) to draw up plans on the establishment of the internal management organs of the company; (4) to draw up the basic management system of the company; (5) to formulate specific rules and regulations of the company; (6) to recommend the appointment or dismissal of the deputy manager(s) and of persons in charge of the financial affairs of the company; (7) to appoint or dismiss management personnel other than those to be appointed or dismissed by the board of directors; and (8) other functions and powers granted by the articles of association of the company and the board of directors.

34. *Id.* art. 70.

State-owned asset stripping, i.e., the illegal transformation of state assets to non-state ownership, is one of the causes for deteriorating financial performance of state-owned firms.[35] For the purpose of safeguarding state-owned assets in wholly state-owned companies, the 1999 Company Law requires that where a wholly state-owned company transfers its assets, the procedures for examination and approval and the transfer of property rights shall be handled by the state-authorized investment institution or the department authorized by the State in accordance with the laws and administrative rules and regulations.[36]

One objective of the 1999 and 1993 Company Law is to separate government and business functions, which is also reflected in the provisions on wholly state-owned companies. The 1999 Company Law allows large-sized wholly state-owned companies with a sound business management system and relatively successful operation, authorized by the State Council, to exercise the rights of state asset owners.[37]

2. *Interim Regulations on Supervisory Board in Major State-Owned Financial Institutions*

The 1999 Company Law adds a new article in the section of wholly state-owned companies, which requires a wholly state-owned company to establish the supervisory board,[38] while the 1993 Company Law does not make reference to the supervisory board in wholly state-owned companies. In the banking industry, this provision is concurrent with the provision of the Commercial Banking Law of 1995, which requires wholly state-owned commercial banks to set up the supervisory board.[39] According to the Commercial Banking Law and the 1999 Company Law, the State Council, in March 2000, issued the Interim Regulations on Supervisory Board in Major State-Owned Financial Institutions. The Interim Regulations illustrate in detail various aspects of the supervisory board in wholly state-owned commercial banks and other major state-owned financial institutions.

The supervisory board in wholly state-owned commercial banks is delegated by the State Council, is responsible to the State Council, and exercises supervision of the quality of state-owned assets and the matters relating to preserving and increasing the value of state-owned assets on behalf of the state.[40] As a supervisor, the supervisory board does not participate in or intervene in operation strategies and management of wholly state-owned commercial banks.[41]

Financial supervision is the core function of the supervisory board. In addition to this, the supervisory board conducts supervision of operational activities and management of the directors, managers and other major persons in charge, ensuring that the interests of state-owned assets are not violated.[42] Putting it concretely, the supervisory board performs the following functions and powers:[43]

35. On a discussion of asset stripping in China's state-owned enterprises, see NICHOLAS R. LARDY, CHINA'S UNFINISHED ECONOMIC REVOLUTION 51–52 (1998).

36. 1999 Company Law, art. 71.

37. *Id.* art. 72.

38. *Id.* art. 67.

39. Commercial Banking Law, art. 18 (P.R.C.).

40. Interim Regulations on Supervisory Board in Major State-Owned Financial Institutions, art. 3.

41. *See id.* art. 5.

42. *Id.* The spirit of this provision is consistent with article 18 of the Commercial Banking Law. Under article 18 of the Commercial Banking Law, the supervisory board conducts supervision over loan quality, ratios of assets and liabilities, maintenance and increase of the value of state-owned assets, and bank's senior management's violations of laws, regulations, and articles of association and their damages to the interests of the bank.

43. *Id.* art. 6.

- Examine wholly state-owned commercial banks' implementation of financial, and economical laws, regulations, and rules;
- Examine wholly state-owned commercial banks' financial affairs, review their financial and accounting materials and other materials relating to their operations and management, and verify the truthfulness and legality of financial statements and fund operations reports; and
- Examine operational activities of the board of directors, managers and other major persons in charge, assess their performance and put forth the proposal for rewards, punishments, appointments and removals.

The supervisory board shall conduct regular examinations of wholly state-owned commercial banks twice annually, and may conduct a targeted examination, if necessary.[44] Depending on the needs, the chairman of the supervisory board may attend or designate other members of the supervisory board to attend, as non-voting participants, the meetings of the board and other meetings of wholly state-owned commercial banks.[45]

Wholly state-owned commercial banks have a duty to submit their true financial statements and fund operations report to the supervisory board on a regular basis, and to report major business operations on a timely basis.[46]

The supervisory board consists of a chairman and several supervisors.[47] The chairman is appointed by the State Council and must be a civil servant ranked as deputy minister of the governmental ministry.[48] The term of office is three years, and the chairman and full-time supervisors must not be re-appointed consecutively in the same wholly state-owned commercial bank.[49] The chairman and other supervisors should not assume office in the wholly state-owned commercial banks where they either used to work, or have close relatives in senior management.[50] The governmental financial department will appropriate funds for the examinations conducted by the supervisory board.[51] The supervisory board is prohibited from accepting any gift or reward, and reimbursing any expense from a wholly state-owned commercial bank.[52]

3. *Legal Weaknesses, Institutional Dilemmas, and Ambiguity of Property Rights*

The Chinese legal framework has established a basic structure of corporate governance for wholly state-owned commercial banks: the board of directors (who is also authorized to exercise part of the functions and powers of the shareholder meeting),[53] the supervisory board, management, and employee participation in the board of directors and the supervisory board. The nominal functions and powers bestowed on the different participants in the corporate governance process are not vastly dissimilar to those found elsewhere. However, legal weaknesses with respect to corporate governance, institutional dilemmas in corporate governance structure, and inherent ambiguity of property rights in wholly state-

44. *Id.* art. 7.
45. *Id.* art. 8.
46. Interim Regulations on Supervisory Board in Major State-Owned Financial Institutions, art. 13.
47. *Id.* art. 15.
48. *Id.* art. 16.
49. *Id.*
50. *Id.* art. 19.
51. *Id.* art. 20.
52. Interim Regulations on Supervisory Board in Major State-Owned Financial Institutions, art. 21.
53. So far only the Bank of China has set up the board of directors.

owned commercial banks have significantly prevented wholly state-owned commercial banks from forming sound corporate governance.

a. Legal Weaknesses

Under the 1999 Company Law, wholly state-owned commercial banks will not set up the shareholder meeting and the board of directors will be authorized to exercise part of the functions and powers of the shareholding meeting of a limited liability company.[54] Since the four biggest state-owned commercial banks are subordinated directly to the State Council, it can be inferred that the State Council will grant authorizations. However, the 1999 Company Law does not clearly stipulate what functions and powers among those of article 46 of the 1999 Company Law can be authorized to the board of a wholly state-owned commercial bank. Therefore, the possibility exists that different wholly state-owned commercial banks or the boards of directors of the different periods in the same state-owned commercial bank would obtain different authorizations. This will leave room for the government to intervene in bank affairs. As a matter of fact, some important decisions such as mergers, division, dissolution, increase and reduction of capital, and issuance of company bonds have been left by the law to the state-authorized investment institution or the department authorized by the State, the State Council in the case of wholly state-owned commercial banks, rather than banks themselves.[55] As regards the appointment and dismissal of senior management, even if the powers may nominally be authorized to wholly state-owned commercial banks, the final decision is in the hands of the government. An example is the reshuffling of senior leadership in the four biggest state-owned commercial banks. It was reported that it was the Central Committee of the Communist Party and the State Council that decided to adjust senior leaders in the four biggest state-owned banks.[56]

The supervisory board in wholly state-owned commercial banks is different from that in the German two-tier model. In the two-tier board model, corporations have two separate boards, a supervisory and a management board. The management board manages the company on a day-to-day basis. Its members are appointed and may be removed by the supervisory board. The supervisory board supervises the activities of the management board but may not assume any management functions. The management must report regularly to the supervisory board, and certain transactions may only be concluded by explicit consent of the supervisory board.[57] By contrast, although the supervisory board in wholly state-owned commercial banks is a supervisory organ, it is only granted rather loosely defined monitoring powers and functions over the board of directors and management.[58] In particular, the supervisory board is only allowed to submit a proposal for appointment and removal

54. 1999 Company Law, art. 66. On the functions and powers of the shareholder meeting of the limited liability company, see *supra* note 26.

55. 1999 Company Law, art. 66. In addition, merger and division of a commercial bank must obtain the PBOC's approval under the Commercial Banking Law. *See* Commercial Banking Law, art. 25.

56. Guang Ming Daily (*Guangming Ri Bao*), Feb. 24, 2000, at 1.

57. Stephen Prowse, Corporate Governance in an International Perspective: A Survey of Corporate Control Mechanisms Among Large Firms in the United States, the United Kingdom, Japan and Germany 42–43 (BIS Economic Papers, No. 41, 1994). The cause for the difference is that the establishment of the supervisory board is not based on the same social and philosophical considerations as for the setting up of supervisory boards in the German model of corporate governance. No broader social and historical issues seem to have been involved in designating the official functions of the supervisory board in China. *See* On Kit Tam, The Development of Corporate Governance in China 86 (1999).

58. On the functions and powers of the supervisory board, see *supra* notes 43–44 and accompanying text.

of directors or management, rather than directly appoint or dismiss directors and management. The lack of such a critical right may lead to a decrease in the monitoring role of the supervisory board.

Employee participation in the corporate governance process is emphasized by the OECD Principles of Corporate Governance.[59] The 1999 Company Law of China provides for employee participation in various respects. According to the 1999 Company Law, wholly state-owned commercial banks should, through the employee representative meeting and other forms, conduct democratic management in accordance with the provisions of the Constitution and relevant laws.[60] The employee representatives should participate in the supervisory board and the board of directors of a wholly state-owned commercial bank.[61] However, these employee representatives cannot reasonably be expected to carry out their role effectively in the supervisory board and the board of directors, since this would be likely to involve confrontation with their superiors in the bank hierarchy. This is also because the laws and regulations provide no safeguard for employee representatives to perform their functions. In the 1999 Company Law, there is no provision on the sanctions imposed on the directors and senior management when they violate the interests of the employee representatives.

b. Institutional Dilemmas

According to the 1999 Company Law the directors of a wholly state-owned company are appointed by the state-authorized investment institution or the department authorized by the State. Since wholly state-owned commercial banks are subordinated to the State Council the directors at these banks will be appointed by the State Council (so far only the Bank of China has the board of directors).[62] The government-appointed board would create an institutional dilemma. The government is the owner of the wholly state-owned commercial banks, and therefore has the legal power to appoint the board. As in any other company, the board should be accountable to the government/owner and act in the best interest of the government/owner. So when the government's administrative orders take the form of owner's interests, the board has a duty not only to carry out the orders, but also to ensure that management would implement effectively the orders. As a result, the boards of directors in wholly state-owned commercial banks may be facilitators of government intervention.

The supervisory board in a wholly state-owned commercial bank is delegated by the State Council and is accountable to the State Council.[63] The supervisory board conducts supervision over the directors and management.[64] The dilemma here is that the supervisory board, acting in the interests of the government/owner, is required to supervise the directors and management who act in the interests of the government/owner as well. When the board and management of a bank implement the administrative orders of the government/owner,

59. OECD PRINCIPLES, *supra* note 7, at 14. Germany and other European countries have formalized significant employee involvement in the corporate governance of reformed state-owned enterprises. It is often thought that greater emphasis is placed on long-term corporate growth and employee reward and welfare rather than on a preoccupation with the short-term financial performance of the company. *See* TAM, *supra* note 57, at 59.

60. 1999 Company Law, art. 16.

61. *Id.* arts. 67, 68.

62. GUANG MING DAILY, *supra* note 56, and accompanying text.

63. Interim Regulations on Supervisory Board in Major State-Owned Financial Institutions, art. 3.

64. *Id.* art. 6(1).

the supervisory board is unable to put forth any negative opinion about the bank's activity, because that activity is in line with the interests of the government/owner to which the supervisory board must pay respect. In this case, the supervisory board either remains indifferent to or enhances the bank's behavior. In addition, the functions and supervisory methods of the supervisory board overlap those of the PBOC. How to coordinate their examinations on wholly state-owned commercial banks remains unclear.

In a wholly state-owned commercial bank, there exist three old committees as well as two new committees (i.e., the board of directors and the supervisory board). The three old committees are the committee of the communist party, employee representative meeting, and the worker union. The employee representative meeting and the worker union have lost their relevance and essentially ceased to function since they came into being. This is why employee participation in the corporate governance process in a wholly state-owned commercial bank is only on paper. By contrast, the committee of the communist party has been very influential in bank activity.[65] The experience has shown that the conflicts between the board/management and the committee of the communist party always pose impediments to sound corporate governance in banks.

c. Ambiguity of Property Rights

One of the main goals of establishing a modern enterprise system in China is to clarify property rights and delineate the roles of the state and of the enterprise.[66] Yet, the state's position as a shareholder and owner in wholly state-owned commercial banks undermines the notion of corporate governance. This fundamental problem of corporate governance arises from the ambiguity of property rights associated with state ownership. Under a system of ownership by the whole people, the whole people possess property rights and the state assumes the role of representative of the whole people. On behalf of the whole people, the state then manages their property by delegating day-to-day operations to companies. However, the whole people are so abstract that the whole people or a particular person has no real property rights and therefore has no effective rights to have a say in a company's governance. By contrast, the central government or its line ministries exercise *de facto* ownership rights over wholly state-owned commercial banks and other state-owned enterprises. However, the government, when acting as a shareholder, does not bear any residual risk over the control of wholly state-owned commercial banks.[67] If it did, then conceivably some governmental objectives such as political stability and economic growth would override sound corporate governance and bank efficiency.[68]

65. As a matter of fact, the current presidents of the Agricultural Bank of China and the Construction Bank of China hold concurrently the position of secretary general the Communist Party Committee of their respective banks.

66. Under the 1999 Company Law, a company shall enjoy the entire property right of the legal person formed by the investments of the shareholders and shall enjoy civil rights and bear the civil liabilities in accordance with laws (1999 Company Law, art. 4). The ownership of state-owned assets in a company shall belong to the State. *See id.* The above company law also provides that a company shall, with all assets of legal person, operate independently and be responsible for its own profits and losses according to law. *Id.* art. 5.

67. In Western corporations, the rights to profits and other benefits accrues to those shareholders who bear the residual losses of their investments. This allocation of risk gives shareholders a greater incentive to support economic efficiency. *See* Joaquin F. Matias, *From Work-Units to Corporations: The Role of Chinese Corporate Governance in a Transitional Market Economy*, 12 N.Y. INT'L L. REV. 1, 47 (1999).

68. In the mid-1990s the response of local political leaders to demonstrations and other actions by workers who had been furloughed from their jobs in state firms was to require local branches of state banks to extend

On the other hand, the ambiguity of property rights gives rise to the classic principal-agent problem. Since the government is only an agent of the ultimate owner—the whole people—the government, unlike a real owner, lacks initiative to ensure that the sub-agent—management—acts in the best interests of the whole people. Except for the case when the government requires state banks to act in its interests, it may not take effective monitoring measures on bank management directly (as in the Industrial and Commercial Bank of China, the Agricultural Bank of China, and the Construction Bank of China) or indirectly through the board of directors (as in the Bank of China). In addition, the absence of shareholders rebellions, takeovers, and bankruptcy risk removes a crucial check on bank management performance, leaving management far more discretion. As a result, insider control prevails in state banks, in particular in the atmosphere of emphasizing the separation of government from management that underpins the establishment of a modern enterprise system. So the focus of bank management is not on preserving and increasing the value of state-assets, but on a policy that justifies paying them and their employees larger salaries, or other strategies which increase their own benefits but pose a risk to state assets.

III. Monitoring Problem

Apparently, China has set up basic legal and regulatory framework for bank corporate governance. With the establishment of the board of directors in the Bank of China, the other three banks (the Industrial and Commercial Bank of China, the Construction Bank of China, and the Agricultural Bank of China) will set up their boards of directors. Despite this, however, the most critical problem, monitoring, remains unsolved. That is, in the big four it is unclear who has economic incentives to assume responsibility to monitoring the banks to maximize the value of state-owned assets. This leads to a strong call for privatization of the four big banks.

A. Privatization: A Workable Approach to Sound Corporate Governance?

Given that the changes in laws and regulations do not eradicate monitoring problems inherent in corporate governance, many people have urged the privatization of wholly state-owned commercial banks. The term "privatization," or corporatization, which China prefers to use,[69] means restructuring ownership at the four biggest state banks and making

additional credit so that back wages could be paid and urban unrest defused. Lardy, *supra* note 35, at 128–29. During the years of 1999 and 2000, the central government had attempted to make use of state commercial banks to support state-owned enterprise reform. At the National People's Congress in March 1999, state banks were reminded of their "political responsibility" to lend to money-losing enterprises. In June 1998 the PBOC advised state commercial banks to increase their financial support of ailing state-owned enterprises and to boost economic growth. It has been reported that state commercial banks have increased their backing of local economic development in different localities. *See* Richard Wong, Competition in China's Banking Industry (Part II), 3 Oct. 2000, *available at* http://www.chinaonline.com/commentary_a...treform/currentnews/secure/c0092960.asp.

69. The terms of privatization and corporatization reflect the difference in ideology. Corporatization, which is the conversion of a state-owned enterprise into a shareholding company is regarded as ideologically compatible with "socialism with Chinese characteristics" while privatization, stemming from the word "private," is identified with the institution of private ownership without necessarily ensuring the preservation of the state as the agent of the whole people. *See* Lan Cao, *Chinese Privatization: Between Plan and Market*, 63 Law. & Contemp. Probs. 13, 14 (2000).

them shareholding companies with listings on domestic or overseas stock markets.[70] The basic consideration is that under a shareholding system there are several sanctions and incentives being used to induce bank management to maximise the value of shareholders' investment. Since investors can withdraw their assets by selling stock (vote with their feet), the market for shares gives owners a means of pressure, while the absence of a share market would remove such a sanction for bad management performance. The threat of bankruptcy and takeovers, which lead to manager dismissals, may also discipline managers.

It was reported that the Big Four are planning to list within next three to five years.[71] It seems that restructuring state banks into shareholding banks can solve the structural problems in corporate governance.[72] However, even if the Big Four state-owned banks can be privatized, they will remain with the government holding the majority share. The Governor of the PBOC, Dai Xianglong, claims that wholly state-owned commercial banks which meet the requirements may be restructured to be joint stock banks with the state retaining a controlling share; and when conditions are ripe, those joint stock banks can be listed.[73]

Under a bank with the government holding a majority share, however, corporate governance cannot be expected to be improved critically, although those banks, as joint stock companies or probably listed companies, have to comply with statutory requirements on protecting minority shareholders and have greater transparency, which represents an improvement over the governance of banks. As in wholly state-owned commercial banks, the government will still have the power to appoint the board of directors. The government's will will continue to be carried out by its appointed board and the board appointed management. The supervisory board will continue to be confronted with the problem of conflict of interests as they are authorized by the government to supervise the government appointed board and management. Ambiguous property rights will not become more clear-cut with the emergence of joint stock banks because in such banks real owners of property will continue to be unable to exercise their ownership rights and the government will continue to exercise *de facto* ownership rights without bearing any residual risks.

As a matter of fact, even in typical joint stock companies, there is a chronic principal-agent problem arising from the separation of ownership and management. Market systems provide three corrective mechanisms to mitigate the problem.[74] One method is to induce

70. The Chinese Academy of Social Sciences, the government's top think-tank, called for listing part of the state banks' shares on the domestic stock markets, placing shares with non-state Chinese firms or selling some stakes to foreign investors. *China: China's WTO Deal Heralds Radical Banking Reform*, REUTERS ENG. NEWS SERV., Nov. 16, 1999, *at* http://web2.westlaw.com/shared/search.

71. R. J. Michaels, *Bullish over Big Four: Experts Favor Top Banks' Plans to List*, Oct. 17, 2000, *available at* http://www.chinaonline.com/topstories/001017/1/c0001101751.asp.

72. For example, Fang Xinghai, general manager of the Construction Bank of China's group coordination committee, said: "I see no better way than listing the banks on the stock market to improve the bank's corporate governance". *See* Reuters, *China: China's Big Four Banks Eye Stock Listings*, REUTERS ENG. NEWS SERV., Apr. 23, 2000, *at* http://web2.westlaw.com/shared/search. *Cf.* The last ten years have witnessed a massive surge in the size and number of firms being sold to private investors by governments around the world. The cumulative value of privatizations passed $1 trillion during 1999. Almost all published empirical research has strongly suggested that privatization is associated with significant performance improvements in enterprises. William L. Megginson, Corporate Governance in Publicly-Quoted Companies, Paper on the OECD Conference on Corporate Governance of SOEs in China, at 15, 17 (Beijing, Jan. 18–19, 2000).

73. Dai Xianglong, *Do Our Best at All Types of the Central Banking Activities in an All-Round Way with an Emphasis of Financial Regulation*, CHINA FINANCE 4, 6 (in Chinese, iss. 2, 2001).

74. Maher & Andersson, *supra* note 19, at 7.

managers to carry out efficient management by directly aligning managers' interests with those of shareholders, e.g., management compensation and direct monitoring by boards. The second solution involves the strengthening of shareholder's rights so shareholders have both a greater incentive and ability to monitor management. This approach enhances the rights of investors through legal protection from expropriation by managers, e.g., protection and enforcement of shareholder rights, and prohibitions against insider-dealings. The third approach is to use indirect means such as takeovers. The takeover market is widely recognized as a potentially important mechanism by which capital markets ensure management discipline.[75]

The above three approaches, however, might not be workable. The role that management compensation currently plays as a mechanism of corporate control may be overemphasized.[76] There is a possibility that the initiatives of managers to maximize shareholder value would be reduced if managers can benefit more from rent-seeking behaviors than from management compensation. In addition, the board of directors often performs its monitoring function either passively or ineffectively.[77] In regards to the second approach above, corporate laws and relevant regulations already have clear stipulations on these issues. Apparently, the reason why the approach may not be workable is ineffective implementation of these laws and regulations. Implementation of law is forever a sticky problem. For takeovers, there are a number of impediments for them to be an effective mechanism of corporate control.[78] The first is the free-rider problem in making a successful tender offer for a firm.[79] The second impediment is the inability to keep tender offers secret, which implies that the original bidder who expends resources to identify the target will have a negative expected profit and will therefore have little incentive to undertake such research in the first place.[80] The final impediment is that current managers are often well placed to take strategic action to deter takeover.[81] In particular, under a rather concentrated ownership

75. PROWSE, *supra* note 57, at 46.

76. *See id.* at 45.

77. *See* Benjamin T. Lo, *Improving Corporate Governance: Lessons from the European Community*, 1 IND. J. GLOBAL. LEGAL STUD. 219, 223-24 (1993). The reasons are that first, board members are often nominated by chief executives to serve on corporate boards; second, directors usually do not have adequate time to carry out their assigned duties; third, directors may be poorly informed about corporate matters; fourth, boards are unable to work as a cohesive group for the corporation; and finally the chief executive officer also often assumes the role of the chairman of the board of directors.

78. *See* PROWSE, *supra* note 57, at 63–64.

79. Shareholders in a company subject to a hostile takeover bid have an incentive not to accept the bid and will hope that others will sell out. Should the bid succeed the resistant shareholder can reap the full value of the equity arising from the reorganization of the company, which may exceed the value of the bid. The shareholder will fee-ride on the eventual returns to the bidder. If all shareholders behaved in this way a bid would fail. For an overview of the free-rider problem, see Sanford Grossman & Oliver Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980).

Free-rider problem is a common phenomenon in corporate governance. Monitoring and good management are public goods in the sense that all shareholders benefit from them and that those who monitor may not obtain all gains from monitoring. Furthermore, while a single shareholder bears the full costs of his monitoring activities, he receives only a pro rata share of the benefits. As a result, he prefers to rely on other shareholders' monitoring and good management and reaps the return from these public goods. *See* David Eu, *Financial Reforms and Corporate Governance in China*, 34 COLUM. J. TRANSNAT'L L. 469, 475–76 (1996). But Black argues that shareholder passivity and free-rider problem might be overstated. *See cf.* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 822 (1992).

80. *See* PROWSE, *supra* note 57, at 63–64.

81. *See id.* at 64.

structure, a bidder would find it difficult to attain a sufficiently large stake in a company to take it over without the consent of the largest shareholders, the government in a Chinese joint stock bank, for instance. In China, government approval for takeover may pose an additional impediment to successful takeover.[82]

B. Alternative Approach: The Idea of an Investment Company for State-Owned Assets in State-Owned Commercial Banks

In the absence of well-developed and efficient capital markets, privatization of China's wholly state-owned commercial banks is not a workable approach to improving corporate governance in these banks. As a matter of fact, in China the problem with corporate governance is not whether to privatize state-owned commercial banks, but who will assume responsibility for monitoring, i.e., maintaining and increasing the value of state assets in those banks. As discussed above, the government is not eligible for this monitoring role, and therefore privatization with the state holding a controlling share will not work either.

Monitoring patterns can roughly be classified into three types: German bank-centered monitoring, Japanese exchange-centered monitoring and American investor-centered monitoring.[83] Due to its fragmented financial system, the American pattern was blamed for fragmented corporate ownership and shareholder passivity.[84] In contrast, German and Japanese patterns are regarded as better models of monitoring because of concentrated ownership in portfolio companies. As a result, proposals for creating institutional monitoring have been put forth.

From this perspective, the existence of concentrated holdings by the government in China's state-owned commercial banks may constitute an important way to overcome the perennial problem of principal and agent in corporate governance. It has been argued that ownership concentration can overcome the problems with the monitoring of management that are associated with dispersed ownership. This is because if the equity of the firm is concentrated in the hands of a few investors, each investor will have sufficient private incentive to invest in information acquisition and monitoring of management;[85] and they are less able to sell their shares and take the "Wall Street walk."[86] In addition, large shareholdings also give them the ability to exert control over management either through their voting rights or through representation on the board of directors, or both.[87]

As a matter of fact, the Chinese government has paid attention to the role of the dominance of the state as equity holder in corporate governance. For general joint stock limited companies and limited liability companies, the state-authorized investment institutions or the departments authorized by the state hold state-owed shares exercise the rights of the

82. Under the 1999 Company Law, the merge or division of a joint stock limited company must be approved by the government departments. 1999 Company Law, art. 183. For a bank, its merger or division must be approved by the PBOC. Commercial Banking Law, art. 69.

83. *See* Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 Stan. L. Rev. 985, 987–990 (1993).

84. *See generally* Mark Roe, *A Political Theory of American Corporate Finance*, 91 Colum. L. Rev. 10 (1991); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520 (1990); *see also* Black, *supra* note 79.

85. *See* Prowse, *supra* note 57, at 11.

86. John H. Matheson, *Corporate Governance at the Millennium: The Decline of the Poison Pill Antitakeover Defense*, 22 Hamline L. Rev. 703, 735 (1999).

87. *See* Prowse, *supra* note 57, at 11–12.

state shareholder on behalf of the government.[88] These institutions or departments include holding companies, investment companies, parent companies of enterprise groups, and the Bureau of State Property Management when the state-authorized investment institutions are not clarified.[89] These institutions and departments enjoy the same rights as other general shareholders.[90] However, this practice has been criticized as unsuccessful.[91] At least we can say that corporate governance of China's companies has not benefited from the advantages associated with the concentration of state ownership in companies. The main reason is that most of the state-authorized institutions were directly restructured from government departments and have not become true modern companies. The management of these institutions is in fact composed of civil servants. Governmental bureaucratism still inherently exists. In addition, there are conflicts of interest between the Bureau of State Property Management (BSPM), as a special administrative agency for state-owned shares, the state-authorized investment institutions, and companies.[92]

Apparently, the idea of the state-authorized investment institution or the department authorized by the state as shareholders may not be helpful to improving corporate governance of state-owned commercial banks. To make full use of the advantages arising from concentrated ownership, China should establish special, professional, and commercial-based Investment Companies for state-owned assets in wholly state-owned commercial banks (Special Bank Investment Companies). The government should delegate state-owned assets in the Big Four banks to these Special Bank Investment Companies. Under this structure, the government is no longer the shareholder of the Big Four banks. The banks do not have any relationship with the government.

The Special Bank Investment Company would be a privatized company, whether joint stock limited company or limited liability company, with clear corporate objectives, strong economic incentives, and delineated lines of responsibility. For the purposes of diversifying

88. *See* Bureau of State Property Management and State Commission for the Reform of the Economic System, Interim Regulations on the Administration of State-Owned Shares in Joint Stock Limited Companies, arts. 2, 16 (Nov. 1994); Bureau of State Property Management and State Commission for the Reform of the Economic System, Opinions on the Formalization of the Exercising of the Rights of State-Owned Shares in Joint Stock Limited Companies, art. 2 (Mar. 1997); and 1999 Company Law, arts. 20, 21, 64.

89. Interim Regulations on the Administration of State-Owned Shares in Joint Stock Limited Companies, art. 16.

90. These institutions and departments have the following shareholder rights: (1) to delegate a shareholder's representative to attend the general shareholders' meeting and exercise his/her voting right; (2) to participate in company elections and be elected; (3) to increase purchase, receive, donate, transfer, or mortgage shareholding according to the rules; (4) to inspect company articles of association, minutes of general shareholders' meeting, and financial and accounting reports of the company; and to monitor the management of production, business and finance of the company, and make suggestions and inquires; (5) to obtain dividend and other distributed benefits according to the proportion of shareholding; and (6) to take legal action against any illegal and harmful behavior of the company. *See* Opinions on the Formalization of the Exercising of the Rights of State-Owned Shares in Joint Stock Limited Companies, art. 6.

91. Some authors have asserted that the higher ratio of the state-owned shares, the worse the situation of corporate governance. *See* Junju Ma & Decong Nie, *Recent Development of Corporate Governance Structure*, 22 LAW STUDIES 81, 87 (in Chinese, iss. 2, 2000). Xiaonian Xu & Yan Wang, Ownership Structure, Corporate Governance, and Firms' Performance: The Case of Chinese Stock Companies, at 23 (unpublished manuscript, on file with author, May 1997) (stating that the state as a large shareholder has negative or insignificant effects on a firms' value).

92. For example, when a company needs to raise new capital through rights offerings, the BSPM will force the state-authorized institution or through its representatives on the board to vote against it as the offerings will likely dilute state shares. *See* Xu & Wang, *supra* note 91, at 24.

risk and enhancing competition, a separate Special Bank Investment Company would be set up for each wholly state-owned commercial bank. The Special Bank Investment Companies are long-term investors in these banks. Their main business activity would be to monitor management by the Big Four state-owned assets. Their main income would be the dividends associated with the investments in the banks, shared with the government. Therefore, their own economic interests would be closely interrelated with the performance of the banks, which would provide strong incentives to actively monitor the banks.

The Special Bank Investment Company would specialize in asset management with possession of time, expertise and monitoring skills. As the sole shareholder of a wholly state-owned commercial bank, the Special Bank Investment Company would enjoy shareholder's rights stipulated in the company law. It would delegate day-to-day monitoring to the supervisory board (the German two-tier board model should be adopted in state-owned commercial banks, see below). It could hire executive directors and non-executive directors to undertake bank-specific monitoring on its behalf. It could also place its own representatives on the supervisory board. The representatives are likely to be more accountable to the Special Bank Investment Company that appoints them, and less to bank management.

Furthermore, in a state-owned commercial bank, the German two-tier board model should be adopted to create a clear institutional and personal separation of monitoring and management organs. The supervisory board will appoint managing directors and exercise day-to-day monitoring activities on behalf of the Special Bank Investment Company. Managing directors will be unable to influence or dominate the supervisory board meetings as they cannot be present or represented on the supervisory board. Thus, the supervisory board will act independent of the managing board and lead to effective monitoring of the bank.[93]

The Special Bank Investment Company would owe fiduciary duties to the government concerning state-owned assets in a wholly state-owned commercial bank. These duties include duty of care, duty of loyalty, and duty of good faith.[94] Related to the issue is who will monitor the monitor. The issue in the case of Special Bank Investment Company is less serious that in other cases. Due to the specifics of the business of the Special Bank Investment Company, *i.e.*, monitoring bank management of state-owned assets, the duties owed to the government and benefits produced to the company are interrelated. Its indolence in monitoring, thereby resulting in bad performance of a bank, would directly affect its economic income. In addition, the government will have the power to withdraw its assets from a problem Special Bank Investment Company and delegate them to other Special Bank Investment Companies. Therefore, the Special Bank Investment Company will have limited incentives to breach fiduciary duties because it loses more if it is "caught" than it gains if it succeeds.[95]

The idea of the Special Bank Investment Company would overcome some most common problems faced by institutional investors, such as institutional passivity,[96] conflicts of inter-

93. *See* Lo, *supra* note 77, at 241.

94. *See* Julian Javier Garza, *Rethinking Corporate Governance: The Role of Minority Shareholders – A Comparative Study*, 31 St. Mary's L.J. 613, 628–34 (2000).

95. Fiduciary liability is a strong constraint on institutional investors. *See cf.* Black, *supra* note 79, at 856.

96. If an institutional investor collects a large amount of one company's stock, the investor will no longer be sufficiently diversified. Unable to manage risk effectively, it will become less attractive to customers seeking to use it to mange risk. As a result, an institutional investor is unlikely to adopt the strong ownership role. Instead, the institution will remain largely passive investors. *See* Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 Cal. L. Rev. 1, 5 (Jan. 1997).

est,[97] and free riding.[98] The primary task of a Special Bank Investment Company would be to monitor bank management. Actively devoting itself to monitoring would be its job. So for a Special Bank Investment Company institutional passivity does not exit. As a matter of fact the Special Bank Investment Company is truly monitoring activism. As the sole shareholder of a wholly state-owned commercial bank, only the Special Bank Investment Company and the government as the former beneficiary, would benefit from its successful monitoring. No other institutions would share the gains arising from its successful intervention. Therefore there is no "free riding" prevalence. What distinguishes a Special Bank Investment Company from institutional investors is that the former is a pure equity investor and its sole interest is in investment returns. The company does not have any business relationships with the portfolio banks. Thus, Special Bank Investment Companies would not give rise to conflicts of interest that would accompany active investments by commercial banks, pension funds, mutual funds, or insurance companies.

IV. Concluding Remarks

The OECD Principles of Corporate Governance and the BIS Banking Corporate Governance focus on publicly traded companies and banks. However, their general principles are also useful tools to improve corporate governance in non-traded banks. They imply that there is no single form of corporate governance model that has emerged as dominant.[99] Privatization may not be the sole way to solve the problem of corporate governance in China's state-owned banks. In other words, even in the absence of privatization, it is still possible to run the public sector efficiently if there is clarity of corporate objectives, clear lines of responsibility, independent agencies for monitoring, strong financial incentives, and competitive pressures. As we discussed above, the important consideration is that banks are in some way accountable to and monitored by their owners. The current reality is that China has decided that neither the government nor the people, the theoretical owner of the state-assets in state-owned banks, is qualified for this monitoring role.

The absolute dominance of the state in wholly state-owned commercial banks indicates that China could start from a stage of corporate development in terms of ownership composition that has taken the West many decades to develop.[100] Concentrated ownership in the four biggest banks does not require a solution to weak corporate governance in these

97. Many institutional investors face conflicts of interest. For example, money mangers that vote against a company's proposals are likely to lose any business that they conduct with the company. Money mangers that develop an anti-manager reputation may lose corporate business, or find it harder to gain new business. These conflicts lead some institutions to vote pro-manager even when doing so is likely to decrease company value. *See* Black, *supra* note 79, at 826. *See also* Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. Pa. L. Rev. 1469, 1503–04 (1991).

98. Although an institutional investor that undertakes successful shareholder interventions may attract new clients, other fund managers also benefit from the successful intervention. *See* Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 Mich. L. Rev. 1997, 2057 (1994). *See also* Monika Queisser, *The Role of Pension Funds in the Stabilization of the Domestic Financial Sector*, *in* International Financial Sector Reform: Standard Setting and Infrastructure Development, *supra* note 5 (stating that any gains a pension fund might reap from a more active participation in company management must be shared with the other investors in the company, including institutional investors competing with the pension or mutual fund mangers).

99. Norton, *supra* note 1, at 225.

100. *See* Tam, *supra* note 57, at 49.

banks through privatization. However, due to the existence of ambiguous property rights, the government may lack incentives to monitor banks on fully commercial principles. Moreover, such monitoring often turns into governmental intervention. For these reasons, improving corporate governance in China's state-owned commercial banks is not to dilute ownership in these banks, but to find an agency that has strong financial incentives to monitor banks on behalf of the state. This is one of the main reasons that we introduce the concept of the Special Bank Investment Company, which is a purely commercial entity.

A more significant problem with corporate governance, in our opinion, is that banks have established wrong performance accountability.[101] In other words, they do not know for what they should be held accountable. The long-practiced methods of applying administrative means to economic activities have formulated such a value that the relation between banks and governments is that of inferiority and superiority. As a result, banks are accountable to governments for obeying their orders and regard satisfactorily fulfilling the governments' tasks as a duty (sometimes the governments' tasks would be called as political tasks). The performance in this regard has much to do with the promotion of bank officials, in particular when the governments at various levels maintain authority over bank personnel within their localities. So it is understandable that banks may focus on how to satisfy the governments rather than on how to increase the value of state-owned assets at banks.

Therefore, what corporate governance reforms in China's state-owned banks are facing is not only to identify to whom those banks are accountable, but also to clarify for what they are accountable. The establishment of Special Bank Investment Company cuts off the connection between the government and the banks, and holds banks accountable to the Special Bank Investment Companies. As these Special Bank Investment Companies are purely commercial entities, they have proper incentives to require the banks to act in their interests. It appears that the Special Bank Investment Company may be an effective approach to improving corporate governance of China's state-owned commercial banks. However, the barrier to the establishment of Special Bank Investment Company is whether the government can delegate state-owned assets to these companies.

101. "Performance accountability" is borrowed from Dr. Lastra when she discusses the issue of central bank accountability. Performance is generally measured with relation to the statutory goal(s) to be achieved. The governing bodies of the central bank, particularly the governor should be held accountable for failing to achieve such objectives. *See* ROSA M. LASTRA, CENTRAL BANKING AND BANKING REGULATION 51 (1996).