The post-financial crisis challenges for corporate governance and banking reform in China

The Post-Financial Crisis Challenges for Corporate Governance and Banking Reform in China

by

Dr. Jessica Hong Yang and Prof. Nada Kakabadse

Contact address and email:

University of East London, Dockland Campus, University Way, London, E16 2RD
Email: j.h.yang@uel.ac.uk

University of Northampton, Park Campus, Boughton Green Road, Northampton NN2 7AL
Email: nada.kakabadse@northampton.ac.uk

Track: Corporate Governance

Word Count: 1988

The Post-Financial Crisis Challenges for Corporate Governance and Banking Reform in China

Summary

The purpose of this paper is to review the impact of the global financial crisis on banking reform in China. The significant doubt concerning the efficiencies of Anglo-American model of corporate governance has raised a critical political question amongst scholars and practitioners as to whether China should continue to follow the U.K.-U.S. path in relation to financial reform. This conceptual paper provides an insightful review of the corporate governance literature and regulatory reports. After examining the fundamental limitations of the laissez-faire philosophy that underpins the neo-liberal model of capitalism, which promotes greater liberalization and less control, the paper considers the risks in opening China's financial markets and relaxing monetary and fiscal policies. A critique of shareholder-capitalism is outlined in relation to the German's "social market economy" styled capitalism. Through such analysis the paper explores a number of implications for China to consider in terms of developing a new and sustainable corporate governance model applicable to the Chinese context.

Introduction

The past few years have witnessed a series of major reforms of China's state-owned commercial banks, insurance companies and securities companies in light of modern enterprise systems. The development of China's financial service sector means financial product innovation with the further opening of financial markets and the development of the insurance and bond market, has increased liquidity as well as reduced financial risks. The US subprime crisis indicated that financial innovations can be beneficial for the economy, but without proper control, they may lead to unexpected consequences. Kirkpatrick (2009) argues that the financial crisis can be attributed to failures and weaknesses in corporate governance arrangements and insufficient accounting standards and regulatory requirements, which have failed to serve their purpose to safeguard against excessive risk taking in a number of financial services companies. Similar to the financial crises of the last decade, the global financial crisis (GFC) which sparked in 2008, surfaced a variety of significant corporate governance failures – the dysfunction of market mechanisms, the lack of transparency and accountability, misaligned compensation arrangements and the late response of government all which encouraged management short-termism, poor risk management, as well as some fraudulent schemes. The unique characteristics of the Chinese banking system have proved to be an interesting point for studying post-crisis corporate governance reform. Considering that China's governance system was modelled on the Anglo-American system which prevailed in U.S.-U.K., this paper examines the impact of the financial crisis on corporate governance reform in developed economies particularly examining China's reform of its banking sector. In particular, the paper examines Chinese government's role in bank supervision and risk management. In this regard, the paper contributes to the corporate governance body of literature within the Chinese context by providing insights into the contributing factors to the corporate governance failure that led to the global financial crisis.

China's Banking Sector and the Global Financial Crisis

China's banking sector has been relatively less affected by the GFC due to China's "closed" capital account and insulated banking sector primarily relying on deposits and not being exposed to risky Western financial instruments (Schmidt 2009). Ma (2008) summarises that large foreign exchange reserves, unconvertible RMB and an under-developed banking sector have helped to explain why China has not been too much affected by the GFC. Given the government's huge fiscal stimulus package (RMB 4 trillion or approximately $585 billion), the impressive resultant growth has been maintained, evidenced by the 8.7 percent increase in GDP in 2009, by far the best among the G20 economies (Lo 2010). This strong growth, however, is not sustainable. China's financial system has faced the problems that have arisen as a result of the surge in bank lending as part of the fiscal stimulus program, the further financial liberalization, the internationalization of Chinese banks and the eventual convertibility of the RMB (Bell and Chao 2010).

The Debate on Financialised Capitalism

Adam Smith (1776) states that a free and competitive market economy enables corporations to efficiently and effectively use society's resources to create value and use market mechanisms to prevent corporations from abusing their power and defrauding their stakeholders. The existence of free markets may facilitate reallocations of scare resources in their most productive way (Moerland 1995). It is argued that the competitive market economy is in the best interest of shareholders but also of the economy as a whole. Based on the concept of market capitalism, the Anglo-American governance system is founded on the belief that self-interest and de-centralised markets can function in a self-regulating manner (Cernat 2004). The Anglo-American model is characterised by well-developed financial

markets, dispersed equity ownership, large institutional holdings, a strong emphasis on shareholder value maximisation, protection of minority interests through the law and regulation and strong requirements for disclosure (Shleifer and Vishny 1986; Walsh and Seward 1990; Shleifer and Vishny 1997; Reinecke 2004). In the Anglo-American tradition, the corporate concept is based on the fiduciary relationship between shareholders and managers (Jensen and Meckling 1976). The system stresses the importance of the enhancement of monitoring and accountability mechanisms (Walsh and Seward 1990). The existence of an active external market for shareholders allows for the threat of hostile takeover which is thought to discipline and replace inefficient managers and exert pressure on corporate bosses to act in the interest of shareholders (Goldstein 2000; Reinecke 2004). Kay and Silberston (1995) assert that the threat of hostile takeover has led to an increased focus on shareholder interests and that corporate control is seen as nothing more than a nexus of contacts between managers and shareholders.

The system is certainly imperfect. The main criticisms of the Anglo-American regime include the short-term perspective adopted by shareholders, the abuse of management power and the overriding of other stakeholder interests. The reinforcement of profit-oriented behavior and a struggle for material success have shaped the practice of short-term shareholder value maximisation behaviour in the Anglo-American model (Moerland 1995). The exclusive focus of corporate governance on shareholder wealth maximisation conflicts with the interests of other corporate constituencies and those other interests will remain ignored, unless managers are legally required to take those interests into account (Maassen 2002). Marx (1867) termed shareholder-value capital as 'fictitious capital' since the return to shareholders in the form of dividends and capital gains is not derived from the physical properties of the company but from anticipated future earning power (Ireland 2008). Consequently, companies operating within the Anglo-American regime have been exposed from their inception with fraudulent manipulation of expectations, speculative bubbles, periods of frenzied company promotions and spectacular financial collapses (Taylor 2006).

The GFC has raised questions concerning the effectiveness of "American style" corporate governance in serving its stated purpose to safeguard shareholder value (Berle and Means 1932; Cadbury 1992; Shleifer and Vishny 1997; Cadbury 2000). Ireland (2008) argued that American corporate ownership and governance structures were seriously defective through pursuing short-term shareholder returns over longer-term prosperity. Motivated by remuneration that was geared to short-term gain, bankers, fund managers and board directors have pocketed bonuses with no seeming thought for longer-term consequences (The Economist 2008). Smith (1776:50) was aware of some of the limitations of "*free*" markets as markets, by themselves, often destroy the possibility of a decent human existence. During the 1990s and 2000s, the trend towards neo-liberalism led to deregulation in many of the formerly regulated industries (e.g. banking, electricity, airlines and telecommunications) (Baker and Quéré 2010). Former Chairman of the Federal Reserve Bank, Alan Greenspan, during his leadership presumed that the self-interests of organizations were best capable of protecting their shareholders and the equity of the firm (Mertzanis 2009). He stated that increasingly complex financial instruments have contributed to the development of a far more efficient, flexible, and hence resilient financial market (The Economist 2008). The post GFC turmoil, however, indicates that the consequence of a laissez-faire philosophy encouraged financial services to innovate and use high leverage created a complex system prone to risk and fraud (Spitzer 2009). Bratton (2002) concludes that the incentive structures and their reliance on sophisticated institutional monitoring and

the development of "best practice" governance codes in fact, generate less powerful checks against abuse.

The old-fashioned German "social market economy" style capitalism has shown its strength during the financial crisis due to its lesser dependence on financial market (Gumbel 2009). The German trusteeship model positions coronations as institutions of the social market economy, which require the manager to 'balance the conflicting interests of current shareholders and additionally to weigh the interests of present and future shareholders' (Ireland 1996:298). Many commentators have believed that the more-stakeholder-friendly models developed in Germany and Japan are more socially cohesive than their shareholder-oriented counterparts in the US and the UK (Ireland 2008). Also they are economically more efficient. Freeman et al (2004) suggest that the idea of value creation and trade is intimately connected to the idea of creating value for shareholders because business is about putting together a deal so that all stakeholders win continuously over time. Stakeholder theory claims that whatever the ultimate aim of the corporation, managers must take into account the legitimate interests of those groups and individuals who are affected (or be affected) by their activities (Freeman 1984; Donaldson and Preston 1995). Donaldson and Preston (1995) suggest that stakeholder theory offers a framework for determining the structure and operation of the firm to seek multiple and diverging goals. Jensen (2001) argues that stakeholder theory should not be viewed as a legitimate contender to value maximisation because it fails to provide a complete specification of the corporate purpose and directs corporate managers to serve "many masters". Solomon (2007) sates that a sustainable organisation recognises the interdependencies and synergies between the company, its stakeholders, its value-based networks and society. The most recent series of corporate scandals all took place under the veil of shareholder value maximisation because focusing upon a single objective in a complex and uncertain business world leads to short termism and a misguided perspective concerning firm performance (Cullen, Kirwan et al. 2006). Knyght, Kakabadse et al. (2011) also argue that the requirement of "socialised capitalism" is for the public good rather than for the benefit of the selected few and urge for a paradigm shift from neo-liberal market economies to a more stakeholder oriented model of capitalism.

Towards a New Model of Corporate Governance for China?

Although democracy is an aspirational and desirable model of governance, the democratic model promoted by Anglo-American governance principally defined in terms of capitalist markets and WTO trade rules is 'clearly conceived within the fundaments of market ideology' (Sussman and Krader 2008:93). For example, Sussman and Krader (2008) show that the democratic motives of the principal U.S. based institutions are to identify 'targets of opportunity' interventions in Eastern European, and in turn have created a number of the "coloured revolutions" in order to advance US economic, military, and strategic political objectives under the banner of promoting democracy. Moreover, liberalization of trade though GATT/WTO, with Neo-liberal recipes pushed by the World Bank and the IMF, have empowered and engaged trans-national corporations ("corpocracy") and weakened governments to the point where national economic policies can no longer be decided by elected officials alone but must take into account, if not favor, the interests of huge corporations (Kakabadse, Kakabadse et al. 2006; Klein 2007). We, therefore, suggest that the Anglo-American model of corporate governance needs to be examined in order to understand the underlying motives that underpin it. After the GFC, precipitated by the sub-mortgage market failure, reveals the shareholder primacy of the Anglo-American model of corporate governance as being no longer the only intellectually respectable efficiency theory. The

Anglo-American contractarian corporation defines its own terms without undue legislative interference.

In the context of China, the banking industry still lags behind in corporate governance, financial innovation and risk management. The non-market strategies offer additional governmental support, favourable laws and effective ways for firms working with governmental agencies which alter market conditions. The government agency is the unique customer and, at the same time, a provider of scarce resources, legitimacy and recognition, local firms need to grow and develop (Li and Zhou 2005). China's corporate governance system needs to mitigate between the two conflicting goals of the allocation of scarce resources and local needs. A trade-off has been made between immediate economic growth and long-term sustainability. The primary concern is the extent to which the State should exercise control in the financial sector. Good corporate governance practices go beyond regulation and legislation and consider ethics within a social context. Hence, China needs to follow its own path in the reform of the banking sector. The GFC might help China to rethink the nature of corporate governance, identify its weakness and assess the current reform agenda.

Development Plan

The paper will be further developed based on the review of current literature, regulation and empirical papers on corporate governance systems. Particular attention will be paid to the assessment of the role of the State in risk management and supervision of the further deregulated banking sector in China. A conceptual framework will be proposed to help China's policy makers analyse its governance issues, reflect on its strengths and weaknesses and implement a corporate governance system to address areas which need attention.

Reference

Anonymous (2008). "What went wrong - Wall Street's crisis; The financial system." The Economist **386**(8572): 92.

Baker, C. R. and B. P. Quéré (2010). Accountability, Corporate Governance and the Role of the State. SIXTH ASIA PACIFIC INTERDISCIPLINARY RESEARCH IN ACCOUNTING CONFERENCE, The University of Sydney.

Bell, S. K. and H. Chao (2010). "The Financial Service in China: Risks and Opportunities Following the Global Financial Crisis."

Berle, A. A. and G. C. Means (1932). The Modern Corporation and Private Property. New York, Harcourt, Brace & World.

Bratton, W. W. (2002). "Enron and the Dark Side of Shareholder Value." Tulane Law Review.

Cadbury, A. (1992). Report of the Committee on the Financial Aspects of Corporate Governance: The Code of Best Practice (Cadbury Code).

Cadbury, A. (2000). "The Corporate Governance Agenda." Corporate Governance **8**(1): 7-15.

Cernat, L. (2004). "The Emerging European Corporate Governance Model: Anglo-Saxon, Continental, or Still the Century of Diversity?" Journal of European Public Policy **11** (1): 147-166.

Cullen, M., C. Kirwan, et al. (2006). Comparative Analysis Corporate Governance Theory: The Agency-Stewardship Continuum. 20th Annual Conference of the Irish Accounting & Finance Association Institute of Technology Tralee, Institute of Technology Tralee.

Donaldson, T. and L. E. Preston (1995). "The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications." Academy of Management **20**(1): 65-90.

Freeman, R. E. (1984). Strategic Management: A stakeholder approach. Boston, Pitman.

Freeman, R. E., A. C. WicKs, et al. (2004). "Stakeholder Theory and "The Corporate Objective Revisited"." Organisation Science **15**(3): 364-369.

Goldstein, A. E. (2000). "Corporate Governance and Regulation in Privatized Utilities: Telecommunications in Four European Countries." Business and Politics **2**(2): 189-223.

Gumbel, P. (2009). "Rethinking Marx." Time **January**(4).

Ireland, P. (1996). "Corporate Governance, Stakeholding, and the company: Towards a Less Degenerate Capitalism?" Journal of Law and Society **23**(3): 287-320.

Ireland, P. (2008). Financialization and Corporate Governance. Corporate Governance and Gobalisation Colloquium. Belfast.

Jensen, M. C. (2001). Value Maximization, Stakeholder Theory, and the Corporate Objective Function, SSRN.

Jensen, M. C. and W. H. Meckling (1976). "Theory of the firm: Managerial behavior, agency costs, and ownership structure." Journal of financial economics **3**: 305 - 360.

Kakabadse, A., N. Kakabadse, et al. (2006). Pathways to Dictatorship: Parallel Democratic Convergence to Oligarchy. Governance, Strategy and Policy: Seven Critical Essays. N. Kakabadse and A. Kakabadse. London, Palgrave**:** 166-212.

Kay, J. and A. Silberston (1995). "Corporate Governance." National Institute Economic Review **153**(1): 84-107.

Kirkpatrick, G. (2009). "The Corporate Governance Lessons from the Financial Crisis." Financial Market Trends **2009/1**.

Klein, N. (2007). The Shock Doctrine: The Rise of Disaster Capitalism. New York, Allen Lane/Penguin Books.

Knyght, P. R., N. K. Kakabadse, et al. (2011). "Chronic limitations of neo-liberal capitalism and oligopolistic markets: An urgent case for socialized capital." Society and Business Review **6**(1): 7-26.

Li, M. and H. Zhou (2005). Knowing the Business Environment: The Use of Non-Market-Based Strategies in Chinese Local Firms. Ivey Business Journal Online. **November/December**.

Lo, B. (2010). China and the global financial crisis, The Centre for European Reform.

Ma, Q. P. (2008). "Current Financial Crisis, Impact of Rescue Measures and Policy Choices for China." GFC Working Paper 200806.

Maassen, G. F. (2002). An International Comparison of Corporate Governance Models. Amsterdam, Spencer Stuart.

Marx, K. (1867). Capital: Critique of Political Economy, Penguin Classics.

Mertzanis, H. (2009). The Implications of the Financial Crisis for Financial and Corporate Governance Reform. Hellenic Capital Market Commission. Central Bank of Kosovo.

Moerland, P. W. (1995). "Alternative disciplinary mechanisms in different corporate systems." Journal of Economic Behavior & Organization **26**(1): 17-34.

Reinecke, J. (2004). The Convergence of the German Corporate Governance System with the Anglo-American Model: Does focusing on Shareholder Value Philosophy put an end to the German Social Model?, UCSD.

Schmidt, D. (2009). "The Financial Crisis and Its Impact on China." China Analysis **67**.

Shleifer, A. and R. Vishny (1986). "Large shareholders and corporate control." Journal of Political Economy **94**(31): 461-488.

Shleifer, A. and R. W. Vishny (1997). "A Survey of Corporate Governance." Journal of Finance **52**(2): 737-783.

Smith, A. (1776). An Inquiry into the Nature and Causes of the Wealth of Nations. Chicago University of Chicago Press.

Smith, A. (1776). The Wealth of Nations. London, Random House, Inc. .

Solomon, J. (2007). Corporate Governance and Accountability. Chichester, John Wiley & Sons, Ltd.

Spitzer, E. (2009). Restoring Trust in the Markets. 10th International Conference on Corporate Governance. London, World Council for Corporate Governance, Royal Oversees League.

Sussman, G. and S. Krader (2008). "Template Revolutions: Marketing U.S. Regime Change in Eastern Europe." Westminster Papers in Communication and Culture **5**(3): 91-112.

Taylor, J. (2006). Creating Capitalism: Joint -Stock Enterprise in British Politics and Culture, 1800 - 1870, Woodbridge, U.K.: Royal Historical Society/Boydell.

Walsh, J. P. and J. K. Seward (1990). "On the Efficiency of Internal and External Corporate Control Mechanisms." Academy of Management Review **15**: 421-458.