The influence of western banks on corporate governance in China

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Abstract

This study draws on in-depth qualitative interviews to investigate the variety of institutional forces which influence the adoption of western corporate governance mechanisms in Chinese banks. Following path dependency models of institutional change it was shown that cognitive and normative institutions, including a ‘who you know’ or guanxi credit culture, mean that the practical influence of western banks on corporate governance reforms was perceived to be ineffectual in most cases. Given the failure of western credit-rating systems in the sub-prime crisis, it is likely that this perception will increase in the future. The majority of western actors believed that the main reason Chinese banks seek to co-operate with western institutions was to enhance the legitimacy of the Chinese bank in the global financial environment, rather than to actively change existing governance mechanisms.

Keywords

Banking, China, Corporate governance, Guanxi, Institutional change, Legitimacy seeking

Introduction

The development of China's economy has, to date, been driven by its considerable supply of cheap labour and its many and varied production opportunities. Whether or not capital was allocated efficiently has been of little consequence and, until fairly recently, the financial sector has been characterized by state-owned banks lending to state-owned enterprises (SOEs) on the basis of social policy principles rather than profitability and managerial competence (Branstetter, 2007; Cousin, 2007). Yet as China's economy advances the development of the financial sector is set to become ever more important. Banks cannot indefinitely continue to make huge loans to inefficient enterprises which will never be repaid and many financial institutions remain compromised by the corporate governance problems associated with having the state as both official regulator and principal shareholder (IFC, 2005; Li *et al.*, 2008)

That said, the reform of China's banks is now well underway and the basic methods employed for restructuring have been large capital injections, the setting up of 'bad-banks' and asset management companies, initial public offerings, partnerships with foreign banks (with the aim of improving management and IT development) and the inclusion of overseas board members to help improve corporate governance (Hu, 2005; Zhang *et al.*, 2006). Some see these moves as part of a broader interest by Chinese officials in developing an economic institutional environment which is more reflective of the international business community (Guthrie, 1998; Wang, 2007). And, at a theoretical level, these adjustments raise some important questions about the nature of institutional change in China's economic transition, such as whether China

will develop its own unique form of corporate governance, or whether it will converge towards the more market-based models commonly found in the west.

While the opening of the market to western banks has been seen as a key plank of the reform programme (Huan, 2005; Liu, *et al.* 2005), at the time of writing, many economies in the western world are struggling to cope with the fall-out from the sub-prime mortgage debacle, and the credibility of western banks is under severe strain (Bloomberg, 2009). Some have argued that recent events could see economic power shift from west to east and much attention is now focused on the nature of China's position in the global economic order (Brown, 2008; Time, 2009). China's banks are now very large, with three in the world's top 10 by market capitalization¹. However, such large assets should not detract from the problems which remain in the Chinese banking system including a shallow talent pool, a shortage of managerial and technical expertise, a local currency that is not convertible and weak corporate governance mechanisms (Brown and Skully, 2005; Calomiris, 2007; Cousin, 2007).

This study aims to investigate the institutional forces which affect the adoption of western corporate governance mechanisms in Chinese banks. The data comes from a series of in-depth qualitative interviews with senior managers who were either employed in western banks with stockholdings in Chinese institutions, held non-executive directorships of Chinese banks, or had participated in other financial advisory roles. The following sections will enlarge on the corporate governance literature in relation to both western and Chinese banks and discuss the theoretical frameworks which can help explain how goals, beliefs and organizations are structured by institutions. Next, the research methodology will be outlined and the

findings will be introduced structured around the institutional forces which influence both internal and external governance mechanisms as well as related technical assistance projects. The study concludes with a discussion of the importance of legitimacy-seeking in motivating Chinese banks to seek collaboration with western institutions and will underscore the importance of local informal institutions in ensuring path dependent change. Finally, some of the key assumptions of western models of governance will be challenged, particularly the belief that market forces alone can ensure the efficient allocation of credit.

Literature Review

The Chinese banking sector is extremely large and highly complex. According to the most recently available data at the end of 2007, the total assets of the banking sector amounted to RMB 52.6 trillion (over 7.5 trillion dollars) while liabilities reached RMB 49.6 trillion (around 7.1 trillion dollars) (CBRC, 2008). As of June 2007 the banking system consisted of over 8,877 institutions, with 189,921 outlets and 2,696,760 employees. The top three types of institution, assessed by asset scale were:

- the 5 state-owned commercial banks with 53% of total banking assets (including such recognizable names as the Bank of China and the Industrial and Commercial Bank of China).
- the 12 joint-stock commercial banks with 14% of total banking assets (for example the Bank of Communications, China Minsheng Banking Corporation and China Everbright Bank).
- the 8,348 rural co-operative financial institutions with 11% of total assets.

Other important banking institutions are the 3 remaining policy banks, the 124 city commercial banks and the 29 locally incorporated foreign bank subsidiaries (such as HSBC and Citibank).

Couple this enormous size and diversity of form with an organizational history driven by the goals of socialist planning, where the key purpose of the bank was to act as a conduit for the implementation of the state's objectives, and it comes as no surprise to find that transforming the financial system has been, and continues to be, a difficult and complicated process. As well as reducing staggeringly large non-performing loans, the bank reforms involved moving from lending practices based on government policy aims to those based on commercial and market principles. This required fundamental shifts in regulation and accounting standards, which, in turn, required building new skills in risk management and creating new forms of management incentives, both of which required a radical and extremely challenging shift in organizational culture (Cousin, 2007; Hamid and Tenev, 2008; Stiglitz, 1999).

However, in an extensive report for the OECD, Thompson (2005) notes that a number of steps have been taken by the Chinese authorities in recent years with the aim of improving the corporate governance of Chinese banks. These include capacity building and specialization amongst the regulators, such as the creation of the China Banking Regulatory Commission (CBRC), improvements in the legal regulatory environment and methods for enforcement, increased information disclosure and market discipline mechanisms, ownership structure reform (such as the diversification of shareholders and the inclusion of foreign strategic investors), and increased competition through direct foreign market entry at the end of WTO transition period.

On the other hand, Ewing (2005) argues that despite these reforms, the fact remains that in most cases the state is still the controlling shareholder and continues to allocate to enterprises social and welfare goals such as generating employment and encouraging economic growth in certain industries. Working with traditional agency and transaction cost models, Ewing argues that as the state is both outsider and insider at the same time, the principal does not become the control entity and conflicts of interest inevitably arise between the state and the bank, or in theoretical terms, between the principal and the agent. In the Chinese context, much analysis of the principal-agent relationship has pointed out that state ownership means that there is never an effective ultimate principal because, technically speaking, state ownership equates to ownership by the citizenry of china, a group which is generally considered too powerless and dispersed to play an effective monitoring role at the level of the firm (Clarke, 2003). The lack of a visible and present human principal who can both pressurize managers and monitor their actions so as to increase asset value, leads to significant agency costs, including losses associated with corruption (Li *et al.*, 2008; Peng, 2001). Moreover, principal-agent relationships are complex in China because profit maximization for the principal is not the only incentive for managers. As Ling and Guo (2006) note, the chairman of the Board of Directors is usually also the firms' secretary of the Party Committee. Consequently managers' incentives are also partly driven by party loyalty which can be in conflict with other, more market-orientated, governance mechanisms. Moreover, there are often a number of different types of government agencies, (central, local or regional) which control the equity stake of companies and they may have different (and possibly conflicting) objectives and management incentives which further complicate the nature of the principal-agent relationship (Li, *et al.* 2008).

Against this background, the introduction of western corporate governance structures are viewed as particularly important (OECD, 2005) because it is believed that they can reduce the inefficiencies associated with confused principal-agent relationships and can also improve internal controls and risk management. To expand on this it is helpful to distinguish between corporate governance mechanisms which are internal and those which are external (Denis and McConnell, 2002, Wei, 2005). The Board of Directors (in conjunction with a supervisory board in China) and the nature of the ownership structure of a company are the two most important internal control mechanisms. In theory, the board's responsibility is to hire, monitor and fire senior management, in practice, however, the separation between the roles and responsibilities of the board and management is not always clear cut (Cousin, 2007; Clarke, 2003; Xu *et al.*, 2002). Interestingly, a number of studies have shown that foreign ownership can help to align management and shareholders interests and has a positive effect on market valuation, largely through the generation of investor confidence (Bai *et al.*, 2003). The threat of take-over or bankruptcy and the legal and enforceable protection of investor rights are the key external mechanisms which encourage managers to perform in the interests of shareholders (Ewing, 2005). However, it should be noted that in the Chinese case the threat of bankruptcy is a rather weak mechanism as banks are likely to be restructured, merged or 'saved' in some way by the state (Cousin, 2007; Liu, *et al.* 2007).

Although many of these governance mechanisms are being introduced and developed in China they remain somewhat fragile. While corporate governance is considered to be a high priority by Chinese banking regulators and authorities (CBRC, 2008), it is

still problematic to assess how much power the authorities, who are also acting as shareholders, are willing to defer in the process of improving governance standards. On the face of it, Chinese banks use a Board of Directors consisting of, among others, independent directors supervising senior management and a Supervisory Board which supervises the Board of Directors. However, in a review of international investors' perspectives on this structure, the Institute of International Finance notes that in China the power of the Board of Directors is often very restricted and in practice it has little more than a 'rubber stamp' function (IIF, 2006).

From the perspective of Chinese banks, it is thought that part foreign ownership is particularly helpful in improving internal governance structures such as risk management and performance incentives, and helping with the development of new technology and products (Cousin, 2007; CBRC, 2008). Moreover, the inclusion of a well-known foreign brand name can be attractive to some customers and can also help increase opportunities for international funding (Liu *et al.*, 2005). There is certainly some evidence that so-called 'technical assistance' projects between Chinese and western banks have worked reasonably well (Hamid and Tenev, 2008). One of the most quotable examples are the investments made by the International Finance Corporation's (IFC) in several city commercial banks, the China Minsheng Banking Corporation, and a number of rural credit cooperatives. In addition to their equity investments, the IFC engaged in technical assistance to facilitate the transfer of internal corporate governance practices, credit analysis, risk management practices and the development of internal lending controls, see Table 1.

TABLE 1 HERE

Noting that Chinese banks continue to offer a very restricted range of products and poor quality service, IFC emphasizes that foreign banks have had, and will continue to have, a positive influence on product development and corporate governance in the mainland and they remain optimistic about the future of co-operation between Chinese and western banks (Hamid and Tenev, 2008). The data and its analyses is provided by the IFC itself and although they are generally positive about progress to date they continue to note that corporate governance remains weak and credit risk management skills low.

Theory

In the west it is possible to distinguish at least two forms of corporate governance: i) the Anglo-Saxon model based on prioritising shareholder interests and a belief that self-interest and decentralized markets are capable of functioning efficiently and fairly; and ii) the continental European model based on a stakeholder theory of the firm, where the interests of not just shareholders, but of other groups, such as trade unions and work councils, are also considered (Gernont, 2004; Luo, 2007). In East Asia there are also a number of distinctive models including the Keiretsu model in Japan (sets of companies with interlocking relationships and shareholdings) (Witt, 2006) and the Chaebol model in South Korea (Government-supported global conglomerates such as Samsung) (Sung, 2003). Liu (2006) has argued that the corporate governance system in China is one which is 'control-based', rather than market orientated because China's unique institutional setting means that the

regulators and authorities still make extensive use of administrative measures to control developments in the economy.

Cousin (2007) argues that corporate governance in Chinese banks poses a distinctive set of problems which are somewhat different to those encountered by other Chinese firms. First, the principal-agent relations are even more complex because they must take account of a wider range of stakeholders including depositors, lenders, supervisors and regulators (Cao and Zhao, 2004). Second because of the importance of the financial system to economic growth and social stability bank failures will not be allowed and in the event of potential collapse they are likely to be saved (Wang and Huang, 2004). Of course, recent events in the global economy have shown that this behaviour is not unique to the Chinese system, however the implications of a government guarantee to maintain 'financial security' means that internal controls should, in theory, be much stronger than in industries where the threat of collapse is far more real (Cao and Zhao, 2004; Wang and Huang, 2004). Finally, information asymmetry is deeper in banks than in other companies because quality in financial intermediation cannot be assessed immediately. For example, non-performing loans tend to be discovered in the future not at the time of issuance (Wei, 2005). It is clear that, in the Chinese case, the state has allocated to itself the main role in the banking system and, historically speaking at least, this differentiates Chinese corporate governance models from those found in Anglo-Saxon countries. Officials argue for the merits of this system on the basis that, at China's current stage of development, markets would not fairly allocate resources and the government has a responsibility for managing the financial system so that development occurs rapidly, but with stability (Zhou, 2004).

That there are differences between the Anglo-Saxon and the Chinese models of corporate governance is hardly surprising. The ‘varieties of capitalism’ research tradition has produced numerous case studies demonstrating that there has been little convergence in terms of governance structures or economic policy making over the last 20 years despite extensive financial globalization (Clarke, 2003; Nee, 2005; Streek and Thelen, 2005). Comparative organizational scholars have also produced many studies which show that firms adopt various modes of economic action and organizational forms which are largely based on the institutional structures embedded in their nation-state base (Boisot and Child, 1998; Guillen, 2001, Redding and Witt, 2007). Moreover, Chinese thinking about international norms has been shown to vary across time, sector and issue (Wang, 2007). In a study of policy documents and media commentary, Wang suggests that Chinese officials remain open to international norms in the economic and technical realms but less so to those governing other issues, especially political and military matters. Wang argues that it seems likely that China will abide by prevailing international economic and technical norms and will become an increasingly congruent and co-operative economic partner in the global arena. It is probably fair to say that, at the official level, the reform of China’s banking system was partly influenced by the policy discourse ‘link up with the international track’ (yuguoji jiegui 与国际接轨) whereby China’s banks were encouraged to move towards international standards both in terms of product innovation, accounting procedures and corporate governance mechanisms (Cousin, 2007; Calomiris, 2007, Wang, 2007).

This publicly-stated objective, does, however, raise interesting questions as to the practicalities of transferring corporate governance practices across culture, and,

following Aguilera and Jackson (2003), this study will argue that multiple institutions will interact to influence the perceived legitimacy and utility of western corporate governance practices in the Chinese context. Although there is some discussion over just quite what an 'institution' is, it is probably fair to say that most would agree that an institution encompasses both the informal beliefs and behaviours of a given society and the formal organizations of the state that govern those beliefs and behaviours (Nee, 2005). Within this general framework, it is possible to differentiate further between functionalist or 'rational choice' theories and path dependency or 'varieties of capitalism' approaches to institutional change (with the latter sometimes referred to as 'neo-institutionalism'). Each approach rests on different behavioural assumptions (principally the degree to which rational action is limited and shaped by context), and foregrounds different explanatory mechanisms (social networks and ties, state regulations, collective action, transaction-cost economising, and so on) (Nee, 2005; Campbell, 2004).

The fundamental premise of the functional approach is that, in a global arena, institutions tend to converge, or become similar in form, because markets create incentives for actors to replace poor institutions with more efficient ones and actors learn from the behaviour of institutions who survive in the face of competition (North, 1990; Weingast, 2002). In other words, efficient institutions in some way or another promote *rational* behaviour and reduce transactions costs (Williamson, 1981).

There are, however, problems in accounting for the pace of institutional change within the functional framework, which, some argue, has been somewhat slower in certain countries than would be expected given efficiency and rational-choice assumptions

(Furubotn and Richter, 1997). For example, China's adoption of a gradualist approach to reform, focusing on selective economic development in specific regions, and avoiding radical political change altogether seem to raise doubts over the degree to which functionalist theories are relevant in the Chinese case (Nee and Yang, 1999). Indeed, what the Chinese example highlights is the way in which pre-existing social and institutional arrangements, which are embedded in interpersonal ties, networks, and cultural beliefs, have enduring influence and thus contribute to a process of 'path dependence' (Nee, 2005; Wilson, 2008; Witt and Redding, 2007). In this framework, institutional change is not viewed as a product of rationalization and market forces, but, rather, is theorized as a gradually emerging outcome based on local ideological preferences (Campbell, 2004; DiMaggio and Powell, 1983).

Building on both DiMaggio and Powell (1983, 1991) and North (1990), Scott's (2001) highly influential account of institutional theory categorizes formal and informal institutions into regulatory, normative and cognitive groupings. The regulatory level is the most formal and includes such things as legal rules and other forms of codified sanctions. Normative institutions are somewhat less formal and can be identified as the authority systems or principles that guide behavioural goals and legitimate ways to achieve them. Finally cultural-cognitive institutions are the most informal and represent the most taken for granted assumptions about reality and the way in which it is perceived, and are established and developed through social interactions. While it is probably fair to say that these dimensions must be intertwined and mutually reinforcing, it is reasonable to assume that there may be inconsistencies between the dimensions and the logics which guide them, particularly during a period of transition (Campbell, 2004). A key theoretical assumption within

institutional theory, however, is that social and organizational actors are, essentially, seeking legitimacy, as well as material advancement. Subsequently, they are constantly re-inventing legitimacy norms within an evolving institutional environment (Scott, 2001). It is this fundamental principle which will guide the research aims of this study.

Research Questions

Based on the theoretical and empirical literature outlined above, the following questions will direct the empirical and theoretical focus of the paper:

- i) What are the different kinds of institutional influences which structure the role of foreign banks in developing external and internal corporate governance mechanisms in China?
- ii) Why do constraints and enablers on governance vary at different institutional levels (such as the regulatory, normative or cognitive)?
- iii) How pertinent is legitimacy-seeking in understanding the attitudes and behaviour of key actors in the banking sector?

Methodology

Method of data collection

Theorising on corporate governance in China's banks is still in its infancy due to the rapid changes which have occurred in the sector since the end of the WTO transition period in 2006. New topic areas such as this are often studied using qualitative

techniques because it is believed that these approaches allow for maximum exploration of the subject matter (Campbell, 2004; Eisenhardt, 1989; Meyer *et al.*, 1987; Strauss and Corbin, 2008). By interviewing influential actors face-to-face it is possible to elicit their views in an open-ended format which allows for the discovery of new concepts, relationships and perceptions. For these reasons, the method adopted in this study was the in-depth semi-structured interview.

Sample characteristics

The informants in this study were regional chief executive officers (CEOs), chief representative officers and general managers who were either employed in western banks with shareholdings in Chinese banks, or had been involved in an advisory role or non-executive directorship with a Chinese bank. All of the participants were men and were aged between 37 and 63. The total population of western banks in China is, in fact, relatively small. According to the China Financial Services Directory in September 2007 there were 69 banks in total, with 53 from Europe, 13 from North America and three from Australia (Guo, 2007). The banks selected for the sample were either locally incorporated (offering retail and commercial banking services to Chinese customers) or banks with representative offices in China (who principally provide support to home-based customers but may also be involved in technical assistance projects or other advisory roles with Chinese banks). Initially fifty of the bank managers were approached on the basis that their bank was either Tier 1 or Tier 2 capital-rated and that they had been established in China for more than 12 months². Of the 50 that were approached 26 agreed to be interviewed; one from Australia, six from North America (three of whom were Chinese-American) and 19 from Europe. Compared to the population the sample contains a good geographical spread, but has more banks from the Tier 1 range. Nevertheless, as the aim is not to

make a statistically generalizable statement about corporate governance at a macro level but to examine the specific attitudes and experiences of senior managers in a given context, the sample is certainly heterogeneous enough to serve this purpose.

Procedure

Access was obtained through personal introductions and through direct approach by email and letter. The interviews were conducted under conditions of anonymity and confidentiality. It is not possible to reveal the identity of the banks because, given the seniority of some of the individuals interviewed, this could lead to the identification of the participant. The interviews took place in Hong Kong, Shanghai and Beijing between October 2007 and May 2008. Managers in Hong Kong were interviewed about their experiences of banking in mainland China. The interview schedule contained questions relating to the work history of the participant and the performance of the company and also examined the following themes: i) perceptions of the regulatory environment in China; ii) perceptions and views of the importance of governance mechanisms; and iii) the practical steps and specific behaviours used in order to develop governance procedures. The interviews were recorded in 19 of the 26 interviews, however seven participants requested not to be recorded and notes were taken during these interviews which were typed up immediately following the meeting

Data analysis method

The data was analysed using a grounded theory approach (Strauss and Corbin, 2008) where the emphasis is placed on concept and thematic development and an examination of the conditions and consequences which influence perceptions. It was possible to divide the participants into groups based on emerging themes. However,

these should not be taken as an indicator of generalizability but, rather, of heterogeneity in the specific sample under investigation.

Data analysis

External governance mechanisms

Legal Environment

As Ewing (2005) notes, perhaps the most important external governance control mechanism is the existence of a robust legal environment. In the case of banking, this would mean that a detailed and comprehensive set of legislation, which is impartially enforced so as to protect investor rights, should be in place. Certainly, some scholars believe that China has made good progress towards establishing a sound rational-legal framework which has reduced the influence of personal connections (or *guanxi*) on business decision making (Guthrie, 1998). In the banking sector it is notable that the CBRC, working with high profile foreign advisors such as Howard Davis (former Chairman of the UK Financial Services Authority) Gerald Corrigan (Managing Director of Goldman Sachs) and Jamie Caruna (Director of the IMF Monetary and Capital Markets Department) has been heavily involved in developing national legislation in the financial sector. Some of the key areas of development have been the introduction of the Anti-Money Laundering Law, the Anti-Monopoly Law and the Banking Supervision Law (CBRC, 2008). At the regulatory level, therefore, it is certainly true that there have been some significant institutional changes in recent years.

A small number of participants (seven) noted with optimism their belief that sufficient regulations were now in place to protect shareholders. An American institutional investor noted:

I do believe that in spite of everything that's happening, the next 5 years will be extremely exciting, particularly given that the legal framework has changed. For example, the bankruptcy law, and enterprise law, partnership law. We can be much more confident that what we buy will give us a return. There is more certainty, so that part is better.

It is interesting that this participant felt reassured by the development of the legal framework despite the widely reported difficulties in enforcing certain laws, such as the bankruptcy law (Cousin, 2007). Bankruptcy is a two-sided issue for banks in relation both to the failure of an enterprise which the bank has lent to, and to the failure of the bank itself. In the first case, the failure of enterprises, Chinese bank behaviour is most likely to be that of a 'passive creditor' (Goodhart and Zeng, 2005) who avoids pushing for bankruptcy, which is expensive and time consuming in China (World Bank, 2000; Wormuth, 2004). As for the case of the bankruptcy of the bank itself, it is widely acknowledged that, as an external sanctioning tool, it is somewhat ineffective as the large state owned banks frequently fall into the 'too big to fail' category (Cousin, 2007). Moreover, in the case of smaller failing banks, the usual process is an order by the regulator to merge, a take-over or some other form of restructuring (Zhang and Cheng, 2003). As such, despite the introduction of new laws, developed with the assistance of foreign experts, banks often have few external governance incentives to improve their practices.

Enduring influence of guanxi

Indeed, the majority of informants were not optimistic about the effectiveness of new regulations and were concerned with the practical implications of working within a constantly changing legal framework. This, in fact, contributed to a sense of uncertainty which the managers sought to alleviate through their local Chinese networks, what they defined as ‘*guanxi*’. One of the main reasons why *guanxi* networks were seen as essential was because the quality of information available through the local financial press was viewed as in some way biased and overly-influenced by the state. Indeed, as Roe (2002) argues, if corporate governance is to be effective, it is not enough just to introduce formal regulations, other, robust, intermediate institutions must also be in place, not least of which is a dynamic, well-informed and accurate financial press. It is no secret that the financial services industry in China faces significant drawbacks because of the state’s enduring control over information (Clarke, 2003; Cousin, 2007). As one general manager noted:

We don’t have the Wall Street Journal or the Dow Jones to tell us what’s going on. The way this economy works it’s been developed by the government in a way to obfuscate. The way I stay on top of what’s happening with regulation is through my network, through my guanxi.

However, in contrast to the theoretical assumption that information asymmetry occurs in these situations because one party has greater knowledge than the other (Guthrie, 2002), managers here felt that one of the key difficulties was that the regulatory system wasn’t clearly understood by those on the Chinese side either. In other words, the information deficit related to a perception that officials themselves are uncertain

of the rules and of where internal power bases lie. The chief representative officer of a European bank noted:

I think one problem is that you don't really know who sits on the power. There are different layers, different ministries, different persons, and they themselves have not decided who has got the power. So we don't have a clear picture of who is in charge, and, I think, neither do they.

In brief, for the majority of managers, the cultural-cognitive institution of informal relationships was of much more importance to them than the establishment of external governance mechanisms such as formal laws and enforcement procedures.

Internal governance mechanisms

Board of Directors

Internal control mechanisms such as the structure of the Board of Directors are thought to be essential for the establishment of sound corporate governance because they ensure clarification of lines of responsibility and help prevent conflicts of interest between agents and principals. Three of the participants were positive about the role foreign board members play in contributing to the development of this aspect of governance in Chinese banks. As one consultant who was closely involved with some of the IFC reforms noted:

... it is very clear that the foreign appointed non-executive director in a Chinese bank make a contribution of genuine value ... and this includes such things as the establishment and monitoring of credit committees and supervisory committees and

they absolutely do help to maintain standards of corporate governance that simply would not be otherwise maintained.

While acknowledging that the changes in board composition were an evolving ‘process’ rather than a completed transition, these informants remained optimistic in their assessment of the influence of foreign non-executive directors in improving governance structures, pointing out the now almost ubiquitous adoption of separate credit and supervisory committees in Chinese banks. Those who were confident about the role of non-executive foreign directors on boards were, however, in the distinct minority. The overwhelming majority of participants were deeply sceptical about their role. A senior executive at a locally-incorporated foreign bank noted:

They have no influence, the board doesn't feel any real obligation to take on their advice, the overall direction of the Bank is determined by the majority shareholder, i.e. the Communist party, the appointment of any influential board member is made by them and that person may be technically and managerially quite competent, but ultimately they're motivated by factors which are not commercial and they think about their career in terms of political progression as much as anything.

Clearly those informants who were at the cynical end of the spectrum (the majority) were unconvinced that the inclusion of foreign non-executive directors was resolving the principal-agent problem. When the state is the principal shareholder then the power of the minority shareholder is extremely weak and blurred boundaries in roles and responsibilities remain embedded in the management structure.

Ownership structure

In a similar way to adopting a Board of Directors management structure, diversified ownership was thought to be important for improving governance because it can help align management and shareholder interests. In the Chinese context, foreign ownership has been shown to improve the market valuation of a company through an increase in investor confidence by the association with a well-known international brand name. However, in a similar vein to the discussion of the role of the Board of Directors, participants were somewhat sceptical about the ability of foreign investment to actually improve governance. As one director involved in a co-operation agreement with a Chinese bank notes:

I'm cautious about over-stating the influence of foreign investment in reforming the banks. Our experience hasn't been good. Obviously we remain minority shareholders and have no rights ...the way they see it, is that they are in control and they're going to do what they like. They want us to help them develop their consumer credit cards and that's it, they really have no interest in us as far as corporate governance issues are concerned.

This is an interesting example of the difficulties in assuming that the inclusion of foreign investment will align managers' and shareholders' interests. Given that the limits on outside share-ownership remains capped at 20%, banks, like other large SOEs, are not, in fact, exposed to the market rigours and ownership pressures which are presumed in the Anglo-Saxon model to create sound governance systems. Indeed, a number of other participants noted that the belief that a foreign investor had any significant influence over governance issues was naive. Most emphasized that it was

the *belief* by those outside the region that foreign investment could offer good governance which was important. A management consultant who had been involved in the IPO listing of a major Chinese bank noted:

When you're looking at a 'big name' deal with one of the State-Owned Commercial Banks, it's done mainly because of the branding. Really the Chinese bank isn't that interested in advice about governance, what they want is to get listed on the Hong Kong market, and for that a foreign brand name really helps. These guys aren't comfortable with strict rules. So everyone just pretends that everyone needs governance advice but actually they [Chinese banks] don't really pay any attention to this.

This observation highlights the importance of legitimacy-seeking in the motivation of Chinese banks to seek foreign investment. The sociological approach to the analysis of institutions makes much of the importance of perceived legitimacy in shaping institutions (Suchman, 1995). To the extent that China wishes to develop an international profile for its major companies, including banks, then it must seek legitimacy with its international business peers. As such, the perception that it is trying to develop corporate governance practices is clearly important. Life within the organizational context itself, however, appears to be lagging behind publicly stated aims. This becomes more apparent in the following sections when we begin to examine some of the technical assistance projects linked to corporate governance issues, such as credit risk management and related product development.

Technical Assistance

Credit rating and risk management

Perhaps one of the major hurdles which China faces in relation to the development of the banking sector is its lack of reliable credit rating systems which would allow for consumer credit checks. This matter looks set to remain a problem in the near future because, as Caijing (2008) reports, China still has no clear regulations in this area and the central bank is plagued by difficulties in establishing a rating system. Difficulties include gaining the cooperation of other government departments in the sharing of credit-related information, and difficulties in finding a way of consolidating diverse and complex data systems.

As was shown in the discussion of the IFC technical assistance projects, the co-operation between foreign and Chinese banks is viewed as an important means of improving credit checking systems and risk management, systems which are particularly important for the establishment of good governance. The participants interviewed in this study noted, however, that there are major organizational difficulties in actualising knowledge transfer. One executive directly involved in a technical assistance project noted:

The practicality of it is that we don't have any way to do the technology transfer. We don't have anybody really of consequence to go in and train the people. And the Chinese can't get access to the people that they need to access to because they are not in Asia, they're in America. And so what do we do, we say, put your hand up everybody who speaks Chinese. We find some relatively low-level people in America, we find some people here and there. ... And then you hear great things in the

newspaper [about technical assistance]. But then you go and talk to the rank and file and its like: "Get me out of here, this is awful, it doesn't work". They feel they are going into a situation that's completely contrived.

Such accounts alert us to the difficulties of initiating organizational change when skills deficits run high on both sides. On top of this, however, was a widely-held perception that in the majority of cases 'technical assistance' was no longer really required. The main object of collaboration was to boost investor confidence. A regional CEO noted:

But your typical guy who is working at a relatively senior level at a bank in China has more exposure to state of the art credit scoring, credit analysis than anybody in a US bank, and then these American guys are sitting there trying to sell it to them. The Chinese know what they're doing now; it has nothing to do with that anymore, they know how to do all that. This is nothing to do with learning from [US Bank]³ – that's all nonsense. It's a show for everybody outside the region. That's what it's for.

The majority of participants in this study believed that it was not lack of 'know how' that was impeding the development of effective credit rating, but, rather, enduring organizational and cultural factors. Given the history of Chinese banks as policy lenders facing few commercial pressures, there has traditionally been little culture of credit checking and risk management. Moreover, the reform process in this area is generally hindered by the lack of cooperation by bank managers (Caijing, 2008). In particular, the problem of so-called *guanxi* loans is still a major difficulty, where loans are based on subjective considerations such as connections of influence rather than on

objective credit criteria such as assets and repayment history. As one Regional Chief Executive Officer noted:

Typically the problem with the Chinese banks I've worked with is that, well, the provincial governor, his brother is running the bank and the customers are working on building up those links. Then those people in the top positions approve the credits then those people start falling behind and don't pay back. That's the biggest problem in the Chinese banking system today – those guanxi credits.

Further illustration for this problem is abundant. Liu Jiayi, auditor general of the National Audit Office, reported that financial investigations in 2008 uncovered that six billion Yuan (878 million dollars) was misused in 20 major cases. About half of the cases involved three of China's biggest state-owned banks: Industrial and Commercial Bank of China, Bank of China and Construction Bank of China (AFP, February 18 2009). That the loans were examples of 'serious illegality and economic crime' was largely attributed to the fact that the loans were granted, not on the basis of risk management principles, but on the 'who you know' basis, or as *guanxi* loans (Reuters, Feb 19, 2009). All of this indicates that there is much work to be done on implementing a valid and reliable credit rating system in China which has little to do with influence of foreign investment and technical assistance. A much more fundamental shift in the local cognitive institutions of *guanxi* would be required to achieve that goal.

Securitization

A final related point is the link between credit rating, risk management and the development of new financial products. Prior to the sub-prime crisis a widely held assumption was that western credit rating systems were sound enough to act as a safety net for the development of more sophisticated forms of finance. While it is too early to assess the implications of the significant failings of western credit-rating agencies in this regard, it is interesting to note here that the vast majority of participants felt that the technical expertise, credibility and legitimacy of western banks in China had been severely damaged by the problem relating to securitization. One senior Chinese-American banker noted:

...look at Northern Rock, look at the entire sub-prime issue in the US, these global banks have been out here preaching about how to do banking and they are now all in dire straits and coming here to ask for capital ... So of course we're wondering, should we really listen to these guys? The western rating agencies that say they know everything, they have totally messed up.

It should come as no surprise that the general view was that western financial systems now face credibility issues. One investment banker working for an American bank with shares in a State-Owned Commercial Bank noted:

...before 2007, securitization was a big buzz word in China – everyone was excited about it. “You can diversify etc”. Now all this has come to a halt because we don't understand securitization. And I think we've also come to the shock realization that the western experts actually didn't understand securitization either.

As the global financial environment is currently in a state of rapid flux, the influence of recent events on the relationships between western and Chinese banks remains to be seen. However, Howard Davis (former Chairman of the UK Financial Services Authority) noted that in a meeting with the vice-Premier Wang Qisheng he had been pointedly asked “Whether we should continue to take our Wall Street teachers’ lessons seriously” (Davis, 2008). It is certainly questionable as to what extent either ‘legitimacy-seeking’ or ‘technical expertise’ will continue to be important influences in the future.

Discussion

This study has investigated the variety of institutional forces which influence the adoption of western corporate governance mechanisms in Chinese banks. A summary of the findings is shown in Table 2. External governance mechanisms, such as the development of a robust legal environment are certainly developing apace. However, most participants felt that lack of transparency and significant information asymmetry would ensure that informal cognitive institutions such as *guanxi* would continue to be of influence for some time to come. Internal governance mechanisms, such as the Board of Directors and diversified ownership structures have been widely adopted. The perception of the informants, however, was that as the majority shareholder in most banks is still the state, then the inclusion of foreign shareholders and non-executive directors is not a solution to the principal-agent problem. In fact, the main advantage of having foreign co-operation was, to use the words of one participant “a show for those outside the region”. It was the view of participants that the main

reason for including foreign directors on the board or of pursuing foreign ownership was to enhance the perceived legitimacy of Chinese banks in the international financial community. Similar themes were found in the examination of technical assistance projects related to credit rating and risk management. Here, however, the managers were also coping with the implications of the sub-prime crisis which was seen as a severe blow to the credibility of western rating systems. The study shows, then, that although regulatory, normative and cognitive institutional forces impact government mechanisms to varying degrees, western managers perceive that the overriding concern of Chinese banks is with establishing legitimacy rather than practically changing existing forms of governance.

TABLE 2 HERE

However, it is important to re-iterate that the publicly-stated aim of allowing foreign banks entry into the Chinese market was that they could assist local banks with the introduction of new technologies and products, and enhance corporate governance of local banks, both directly (through joint ventures and shareholdings in Chinese banks) and indirectly (through creating competitive pressures) (Cousins, 2007). Some theorists have argued that these moves are indicators that Chinese officials wish to develop an economic institutional environment which broadly converges with the international business community (Guthrie, 1998; Wang, 2007). As would be predicted by the path dependency approach to institutional change, however, this study has shown that cognitive and normative institutions remain powerful influences on the inclination and capacity of Chinese banks to engage in changing corporate governance mechanisms. While regulators may still aim for international

standardization, the experience of the participants in this study is that, at the level of the organization, there is little will, and few incentives, to change current practices.

Of course it is important to remember that change occurs at different rates in different dimensions of an institution and so there is a need to be sensitive to the time-frames used in interpreting the data. While it was possible to observe relatively rapid change in the formal legislative environment in which the banks operated, the informal normative and cultural-cognitive realms were clearly lagging behind. As a cross-sectional study, this paper can only offer a snapshot of the range of perceptions at a given point in time. What cannot be discussed is how these will change in the mid to long term, particularly as the impact of the sub-prime crises becomes more apparent. Furthermore, it is important to emphasize that the perceptions analysed here are mainly those of foreign managers and senior employees. It is highly likely that a somewhat different set of narratives would have been presented if the views of senior Chinese managers who have worked with foreign board members had been analysed. . Indeed, one would expect that other cognitive institutions, besides *guanxi*, may be more pertinent to this group, such as, for example, low-trust relationships, face (*mianzi*) and fatalism. Ongoing research by the author is addressing this issue and it is hoped that future publications will offer an even more detailed analysis of the similarities and differences between western and Chinese perceptions of the influence of foreign banks on corporate governance in China. Moreover, there is a need to recognize that this study, because it is focusing on individuals responding to their social and institutional situations, is following a weak version of methodological individualism and does not consider in great detail the structural frameworks, particularly the role of the state as the sovereign actor, which can form ideas

(including norms like ‘legitimacy’) in the first place (North, 1981; Yee, 1996). The paper is not, however, an attempt to argue that micro-level analysis will account for all the complexity of institutional change (Arrow, 1994). The point here has been to track the perceptions of key western actors involved in transforming governance mechanisms in Chinese banks. By doing so, it has been possible to offer a more nuanced account of the variety of institutional influences which have been in play in this particular sector.

Theory and Policy Implications

A key plank of neo-institutional theory is that social and organizational actors are seeking legitimacy in a constantly changing environment. In other words legitimacy-seeking is not static and, as Scott (2001) argues, actors are constantly re-inventing legitimacy norms within an evolving institutional context. It is certainly true that the institutional environment in the Chinese financial sector is rapidly changing both internally and externally. Internally, actors encounter an uncertain and uncoordinated financial system in China where there is a low level of compliance with evolving rules, a scenario which encourages continuing reliance on informal cognitive institutions such as *guanxi*. However, we have also seen that, externally, the international environment is also in a state of flux and uncertainty and western credit-rating systems and related forms of governance have taken a severe blow to their credibility. Indeed, there are early indicators that they may well be unable to maintain their legitimacy as the ‘standard’ form. Wang (2007) has argued that, in relation to economic norms, China will become increasingly congruent with international standards. However, while this argument may yet prove to be valid, environmental

pressures both in the global and the Chinese environment mean that a more specifically Chinese form of corporate governance in relation to banking may develop.

The assumption that convergence on western, particularly Anglo-Saxon, models of corporate governance was likely to occur was, to a large extent, informed by neo-classical economic assumptions that market forces have the power to efficiently allocate credit unaided by state ‘interference’ (Cernat, 2004; Luo, 2007). However, as participants’ discussion of securitization has illustrated, this model is under question. There is now a growing realization that the rapid expansion of securitization was linked to the expansion of government guarantees, both explicit and implicit, of large western financial institutions (White, 2009). Certainly, in light of recent events in the global financial arena, strong state intervention in some western countries is also proving necessary in order to encourage the primary goal of banking: that the people and institutions who should borrow money get to borrow money in a safe and secure way. The rather rigid view that when the principal is the state, then inefficiencies must inevitably follow, overlooks not only examples of non-profit organizations which operate effectively, but also the numerous instances of profit-based organizations with distant human ‘owners’ (such as pension funds) who have been shown to be able to increase value in efficient ways (Clarke, 2003). There is no doubt that the assumption that market forces and managerial incentives alone can ensure the most efficient allocation of money throughout society has been severely tested in the last two years. In this regard, it is interesting to note that the ‘control-based’ model of governance which is common in China, where the state takes a guiding role in ensuring that financial intermediation does not upset social stability, has now been adopted as a

policy (at least in the short-term) by the UK and US. Of course, the fact that the Chinese state has access to abundant funds to recapitalize any inefficient banks or to replenish the numerous large scale thefts which still regularly occur, should not detract from the fact that such moves are rather pointless if, in the long term, more fundamental changes in governance structures do not occur. But as the sub-prime crisis has shown, this can no longer be said to be a particularly Chinese ‘problem’.

Conclusion

This study has shown that while there has been relatively rapid change in the formal legislative environment in which banks operated, the informal normative and cultural-cognitive realms are changing at a much slower pace. Components of western models of corporate governance such as the Board of Directors, diversified ownership structures, and technical assistance in areas such as credit rating and risk management have certainly been widely adopted. However, the over-riding perception was that the motivation for this was legitimacy-seeking by Chinese banks in the global financial environment. Enduring cognitive and normative institutions including a ‘who you know’ credit culture and the importance of informal institutions such as *guanxi* mean that the influence of foreign banks on corporate governance reforms in China is perceived by informants as usually ineffective. Given the serious failures of western credit rating systems in the sub-prime crisis, it is likely that this perception will increase in the future. At the time of writing, the Chinese ‘control-based’ model of corporate governance, where the state intervenes in the banking sector to ensure financial stability and the achievement of social objectives such as employment and

enterprise support, is showing itself to be a workable policy model for some western economies too.

Notes

- ¹ Though this is partly due to the fall in market value of some western banks as opposed to the rise in Chinese banks per se.
- ² Tier rating indicates the size of capital adequacy in the bank as assessed by regulators. Tier 1 represents a bank with more resources than a Tier 2 institution.
- ³ Names of banks are anonymized to protect confidentiality.

Table 1 International Finance Corporation's (IFC) Technical Assistance to Chinese Banks

Bank	Pre-investment	At investment	Post-investment
Bank of Shanghai	Since 1995 IFC supported, with funding from Japan and EU, human resources management review, credit analysis, credit policies and procedures	Arranged for the adoption of IAS* audits	Review of credit procedures, stress test to monitor portfolio risks, SME business diagnostics and SME banking strategy.
Bank of Beijing	Credit risk management, business strategy development	Arranged for the adoption of IAS audits	Training for board members, portfolio stress test
China Minsheng Banking Corporation	\$700,000 in technical assistance at time of establishment; advice on strategic issues and business development, training of staff on credit analysis	Arranged for the adoption of IAS audits	At the request of Minsheng identified independent director, supported diagnostic review of SME lending and SME strategy development; supported energy efficiency loan program; introduced methodology for portfolio stress test.
Nanjing City Commercial Bank	Supported risk management training through Price Waterhouse and Coopers	Arranged for the adoption of IAS audits	With funding from Italy offered series of training programs on risk control; supported board members training; introduced portfolio stress test methodology.
United Rural Cooperative Bank		Arranged for the adoption of IAS audits	Upgraded credit policy and loan recovery manuals, introduced new credit scoring system; set up a Risk and Compliance Department, and a Credit Review Centre; conducted training on credit management; started branch management and benchmark models.
Xian City Bank	Training for bank staff on credit analysis	Arranged for the adoption of IAS audits	Supported credit training program in 2005; advised on acquisition of credit cooperative
China Industrial Bank		Arranged for the adoption of IAS audits	Provided corporate governance technical assistance in 2004; portfolio stress test in 2005; technical assistance on IT framework; SME lending diagnostics and strategy; supported energy efficiency lending.

Note * IAS – International Accounting Standards

Source: IFC cited in Hamid and Tenev (2008)

Table 2 Summary of institutional forces influencing corporate governance mechanisms between Chinese and western banks

Governance Mechanism	Institutional Influences	Explanation and examples
<i>External</i>		
Legal environment	Regulatory and normative institutions	High level international advisory board at CBRC. Introduction of a range of new legislation aimed at improving governance in the banking system including bankruptcy law, enterprise law and partnership law. Few participants optimistic about the reform of legal environment.
Informal relationship	Cognitive institutions	Enduring influence of <i>guanxi</i> in an environment where information is limited. Information asymmetry amongst Chinese regulators and managers as well as between western and Chinese managers.
<i>Internal</i>		
Board of Directors	Normative institutions	Widespread adoption of governance structures such as separate credit and supervisory committees and the appointment of non-executive directors. Majority of participants pessimistic about the ability of foreign directors to reduce conflict of interest associated with principal-agent problem in the Chinese context.
Ownership structure	Regulatory and normative	Foreign ownership largely perceived as a means of improving investor confidence. Satisfies legitimacy-seeking goals of Chinese institution. Majority shareholder, the state, continues to guide strategy.
<i>Technical Assistance</i>		
Credit rating and risk management	Normative and cognitive	Organizational constraints impede knowledge transfer: language skills of foreign bankers, enduring influence of <i>guanxi</i> loan practices. Partnerships perceived to be driven by legitimacy-seeking associated with having a foreign partner.
Securitization	Normative	Failure in western credit rating systems in the sub-prime crises indicates a shift in the perception of the importance foreign expertise of in certain corporate governance mechanisms.

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