

# CORPORATE GOVERNANCE IN CHINA

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# Agency Problems

- The type I agency problem
  - Firms with diffused ownership structure
  - Conflict of interests between managers and shareholders
- The type II agency problem
  - Firms with concentrated ownership structure
  - Conflict of interests between controlling shareholders and minority shareholders

# The Type II Agency Problem: The conflict of interests between controlling and minority shareholders

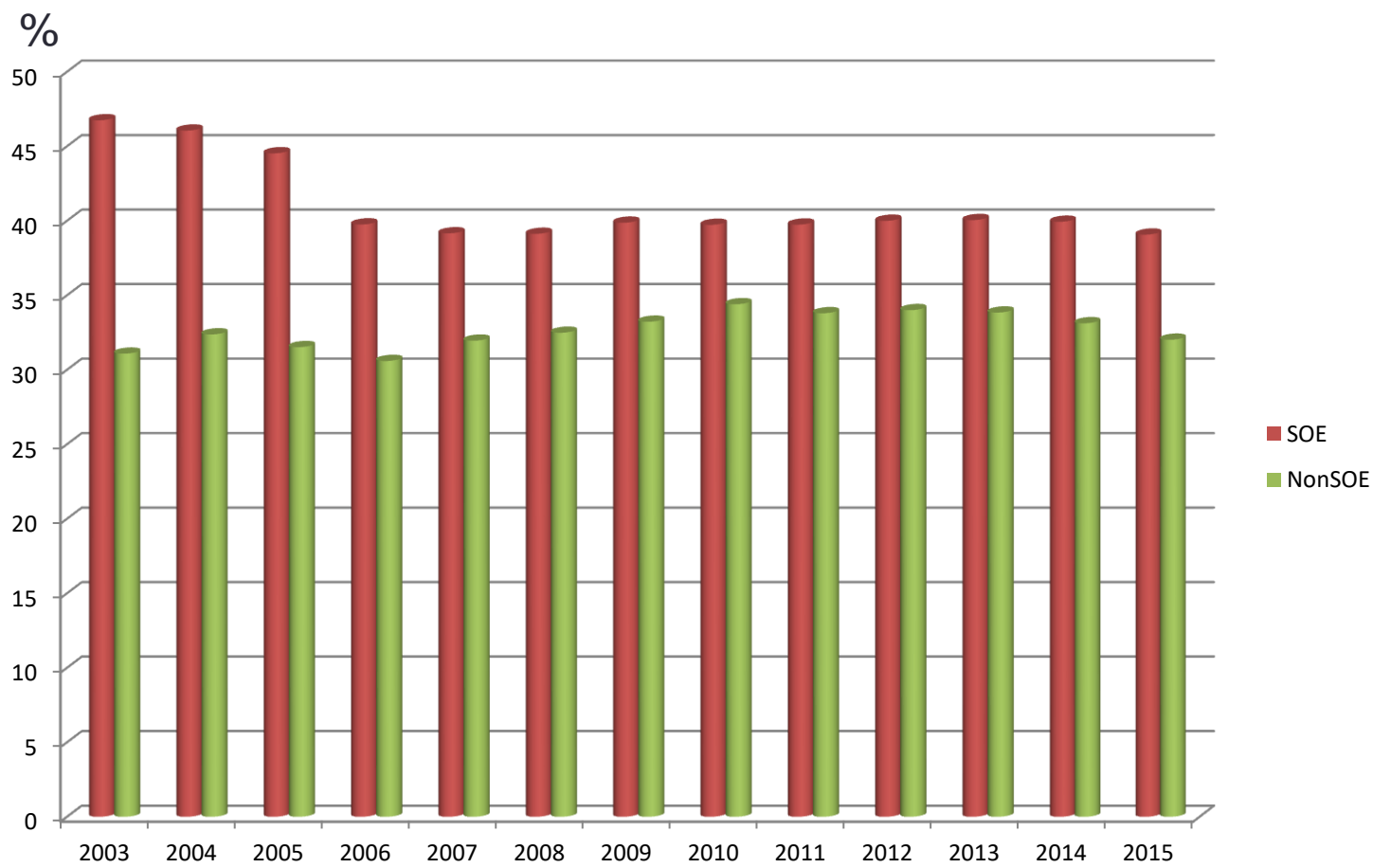
- Ownership held by controlling owners (in percentage points)

SOE								
<u>Year</u>	<u>N</u>	<u>Mean</u>	<u>Std</u>	<u>P10</u>	<u>P25</u>	<u>Median</u>	<u>P75</u>	<u>P90</u>
2003	677	46.74	16.48	25.00	33.36	47.31	59.68	67.57
2004	904	46.05	16.57	24.31	31.48	46.62	59.63	67.57
2005	881	44.53	16.18	23.62	30.18	44.65	57.95	65.81
2006	877	39.75	15.71	19.82	27.45	39.04	51.51	60.08
2007	899	39.16	15.73	19.43	26.61	38.74	50.50	60.01
2008	914	39.12	15.62	18.86	26.58	38.92	50.74	59.81
2009	919	39.87	16.02	19.19	27.46	39.28	51.45	61.04
2010	962	39.73	15.87	19.68	26.91	39.37	51.51	61.06
2011	965	39.74	16.06	19.36	26.78	39.27	51.33	61.36
2012	969	40.00	15.99	19.86	27.00	39.37	51.64	61.49
2013	961	40.05	15.96	20.00	27.26	39.34	51.73	61.51
2014	959	39.93	15.82	20.07	27.19	39.46	51.33	61.42
2015	992	39.07	15.54	20.08	26.59	37.82	50.25	60.19

NonSOE								
<u>Year</u>	<u>N</u>	<u>Mean</u>	<u>Std</u>	<u>P10</u>	<u>P25</u>	<u>Median</u>	<u>P75</u>	<u>P90</u>
2003	108	31.08	12.61	16.53	23.75	28.97	36.13	52.34
2004	317	32.38	12.85	18.62	24.58	29.01	39.94	52.50
2005	343	31.52	12.31	18.12	23.86	28.88	37.41	51.92
2006	417	30.59	12.92	17.80	21.74	27.40	36.91	49.66
2007	504	31.95	14.09	16.90	21.84	29.19	41.01	51.62
2008	546	32.49	14.42	16.54	21.95	29.49	41.86	52.28
2009	674	33.23	15.28	16.39	22.10	29.90	42.49	53.66
2010	971	34.40	15.69	16.97	22.56	31.39	44.46	55.06
2011	1206	33.79	14.66	16.48	22.77	31.29	43.16	53.82
2012	1300	34.00	14.62	17.04	22.67	31.56	43.23	54.55
2013	1332	33.84	14.80	16.65	22.57	31.46	42.93	54.08
2014	1437	33.12	14.33	16.38	22.17	31.14	42.01	52.36
2015	1611	32.02	13.64	15.72	21.45	30.29	40.91	50.36

Data Source: CSMAR

# Ownership Held by Controlling Owners



Data Source: CSMAR

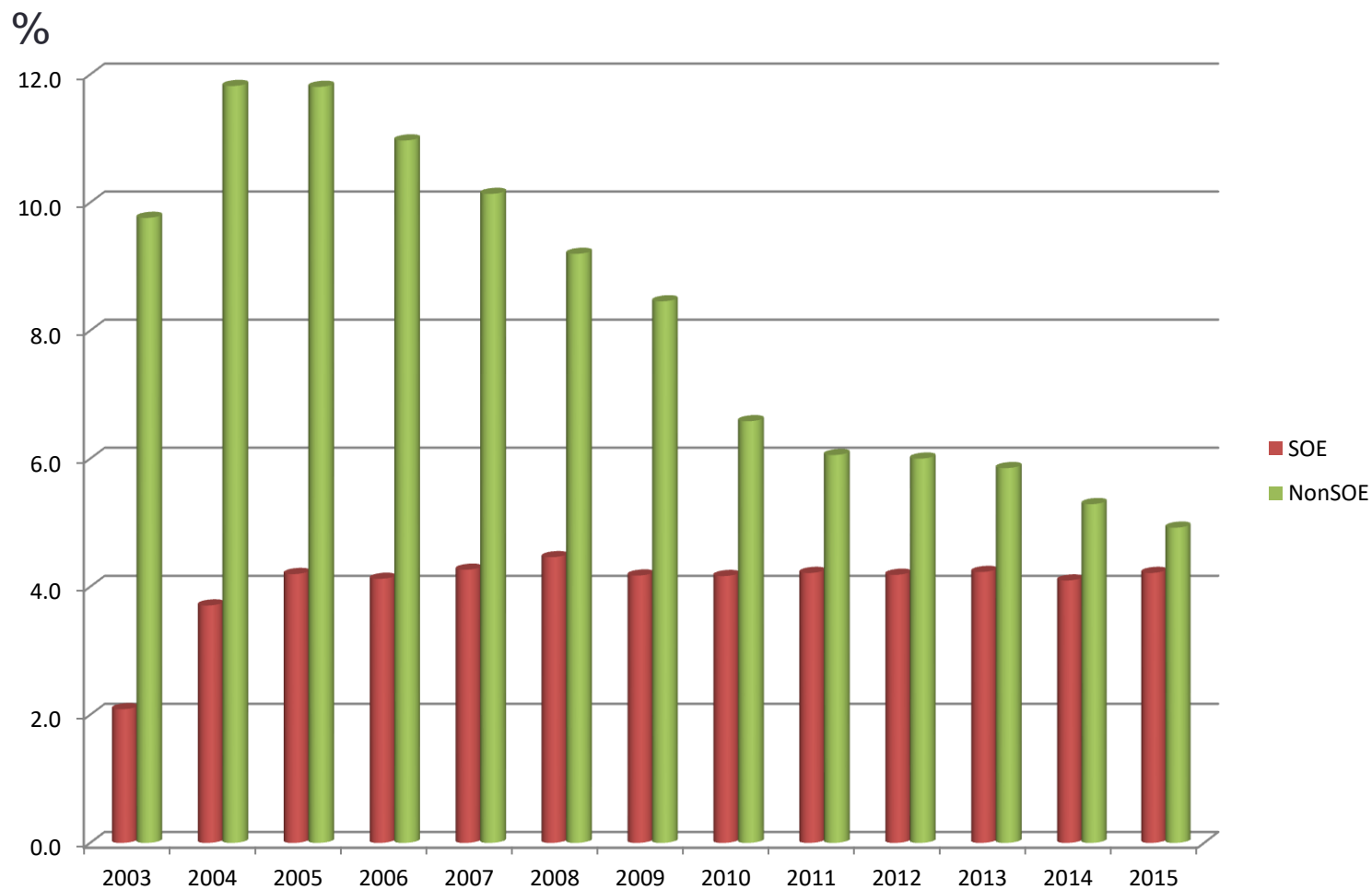
# The Type II Agency Problem

- Separation of ownership and control (excess control rights in percentage points)

year		SOE	NonSOE	p-values for mean/median difference test
2003	Mean	2.09	9.76	<0.001
	Median	0.00	9.17	<0.001
2004	Mean	3.71	11.82	<0.001
	Median	0.00	11.22	<0.001
2005	Mean	4.20	11.81	<0.001
	Median	0.00	11.12	<0.001
2006	Mean	4.12	10.97	<0.001
	Median	0.00	9.91	<0.001
2007	Mean	4.27	10.14	<0.001
	Median	0.00	8.66	<0.001
2008	Mean	4.46	9.20	<0.001
	Median	0.00	7.32	<0.001
2009	Mean	4.18	8.46	<0.001
	Median	0.00	5.92	<0.001
2010	Mean	4.17	6.58	<0.001
	Median	0.00	2.61	<0.001
2011	Mean	4.22	6.06	<0.001
	Median	0.00	1.58	<0.001
2012	Mean	4.19	6.00	<0.001
	Median	0.00	1.16	<0.001
2013	Mean	4.23	5.85	<0.001
	Median	0.00	0.73	<0.001
2014	Mean	4.10	5.29	<0.001
	Median	0.00	0.40	<0.001
2015	Mean	4.22	4.92	0.019
	Median	0.00	0.13	<0.001

Data Source:  
CSMAR

# Wedge between Control Rights and Cash-flow Rights



Data Source: CSMAR

# The Type II Agency Problem: An Example

- The Fraud and Delisting of Dandong Xintai Electric Stock Co. Ltd. (**丹东欣泰电气股份有限公司**)
- Founded in 1999, main line of business is manufacturing electronic capacitors;
- IPO in January 2014, but was charged of fraudulent listing and forced to be delisted in June 2017 (the first company delisted from the growth enterprise board);
- Convicted of providing fake financial data in its IPO application and releasing false information in regular reports.

# The Type II Agency Problem: An example

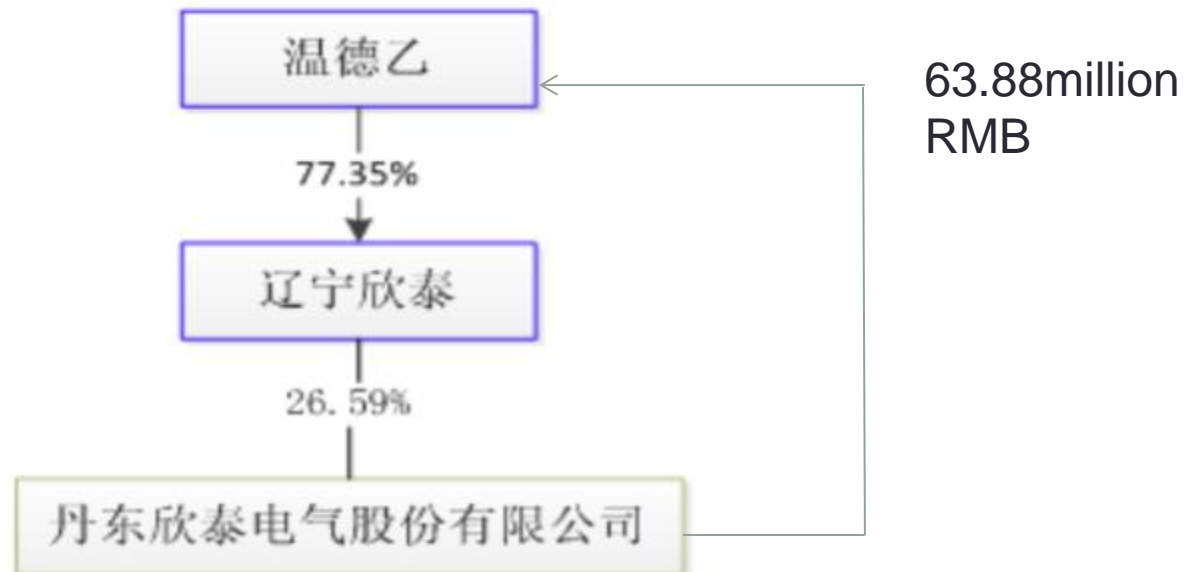
- Had kept a large balance of receivables, a risk that can increase of the chance of IPO failure.
- Reduce the balance of receivables at the end of accounting period via external loans or forged bank bills.
- Continued to do so after IPO.
- Investigation from CSRC showed that the company made up that it had taken back 72.62 million RMB of receivables and 74.78 million RMB of other receivables in year 2014.

报表项目	2014/12/31	2013/12/31	变动比率%	变动原因说明
应收账款	390,049,011.15	207,819,469.93	87.69	主要系期末部分货款尚未结清所致
预付款项	84,093,124.16	51,819,695.91	62.28	主要系期末部分采购款尚未结算所致
其他应收款	14,753,762.89	6,915,821.62	113.33	主要系期末员工及办事处备用金增加所致



# The Type II Agency Problem: An example

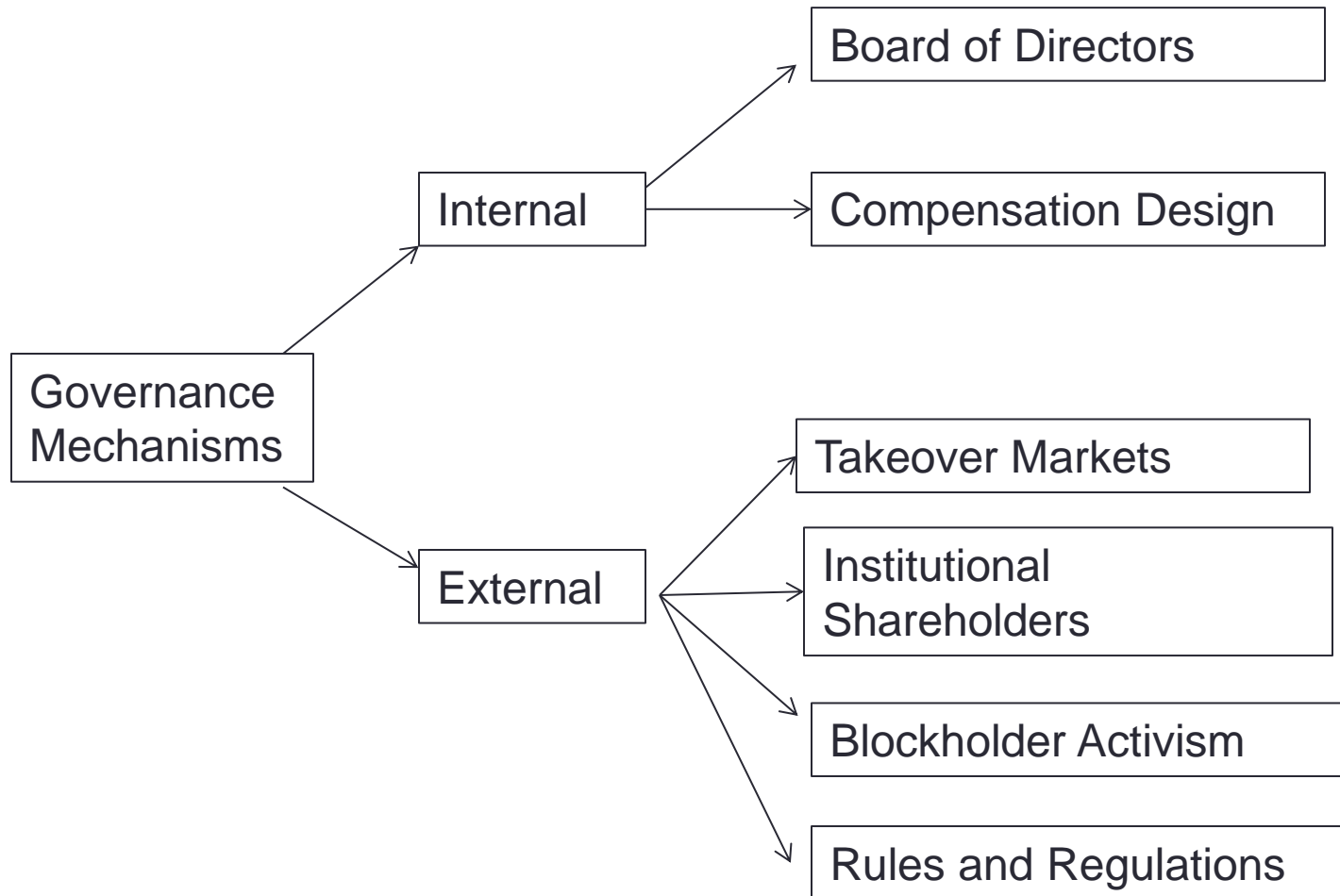
- 63.88 million RMB of receivables was due to fund occupation by the controlling owner.
- Fund occupation is a primary channel through which controlling owners tunnel resources out of listed companies.



# The Type II Agency Problem: Ways to Expropriate Minority Shareholders

- Fund occupation by the controlling shareholder (termed “intercorporate loans in Jiang, Lee, and Yue (2010)
  - Most of these loans do not accrue interest, and sometimes the principals were never paid back
- Buying assets at high premiums from the controlling shareholder
- Selling high quality assets at cheap price to the controlling shareholder
- Provide loan guarantee when the controlling shareholder borrows from banks

# Corporate Governance Mechanisms



# Board of Directors

- Two-tier board system: The board of directors and the supervisory board;
- The number of director sitting on the board must be at least 5 and no more than 19;
- The supervisory board must have at least 3 members, 1/3 of which have to be employee representatives;
- 1/3 of board members must be independent directors (after 2003);
- An independent director cannot be a significant shareholder who owns more than 1% of shares or be related to a shareholder who holds more than 5% of the shares.

# Board of Directors

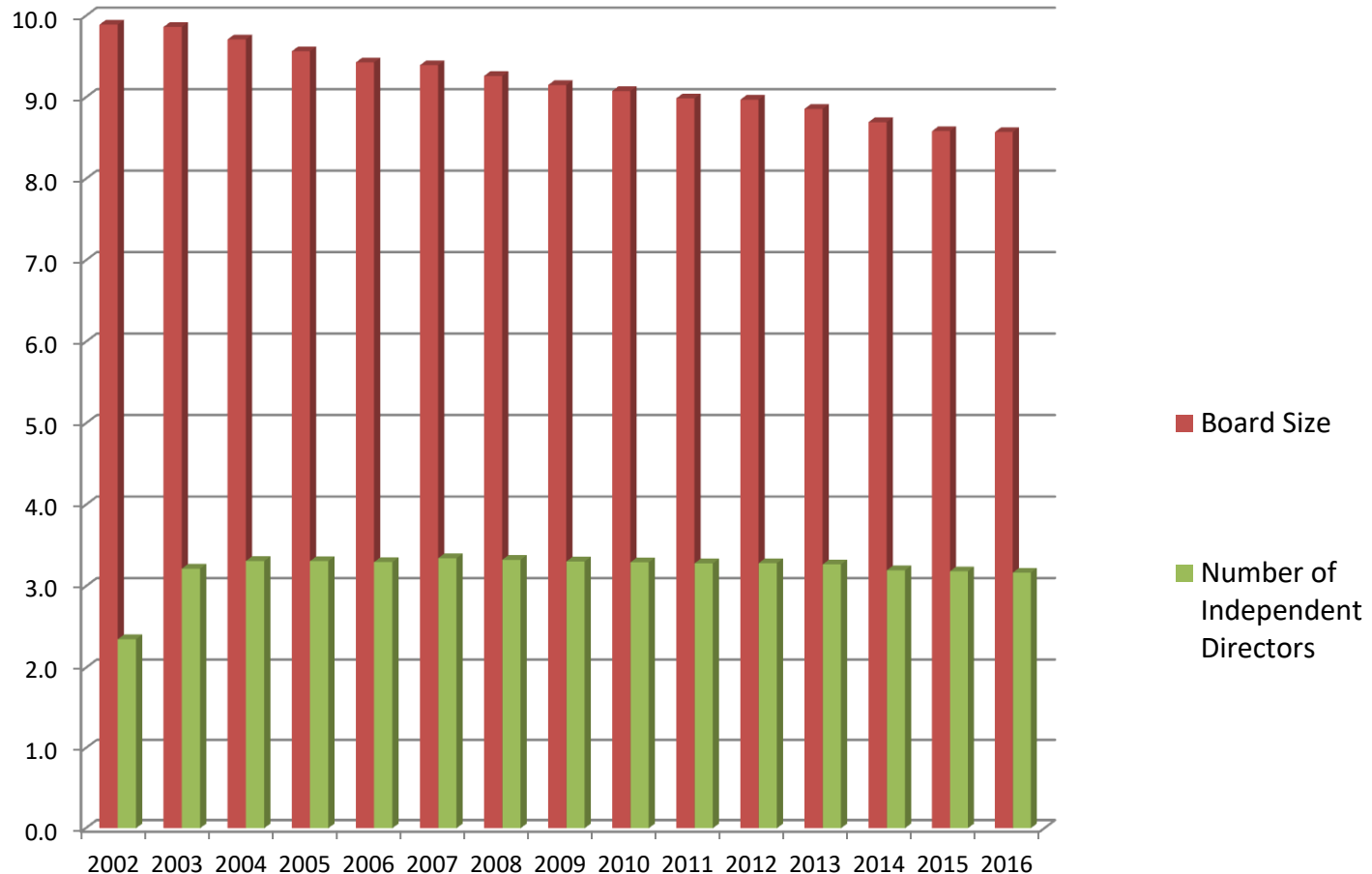
- Staggered boards are not allowed in China
  - But a director can serve up to two consecutive terms on the board and each term is three years
  - Only directors whose first terms are expiring stand up for reelection each year, rather than all at once
  - Similar to a staggered board
- Cumulative voting system for director election
- Board committees
  - Most companies have 4 committees: an audit committee, a nomination committee, a compensation committee, and a corporate strategy committee.
  - The first three committees must be chaired by independent directors and have the majority of committee members being independent.
  - At least one independent director on the audit committee needs to be an accounting expert

# Board of Directors

- Which types of directors can enhance board monitoring?—U.S. evidence
  - Independent directors with no social connections with managers (former colleagues at other firms, went to the same school, belong to the same golf club, etc.) (Hwang and Kim, 2009)
  - Directors who are less busy (Fich and Shivdasani, 2006)
  - Independent directors with expertise in the firm's industry (Wang, Xie, and Zhu, 2015)

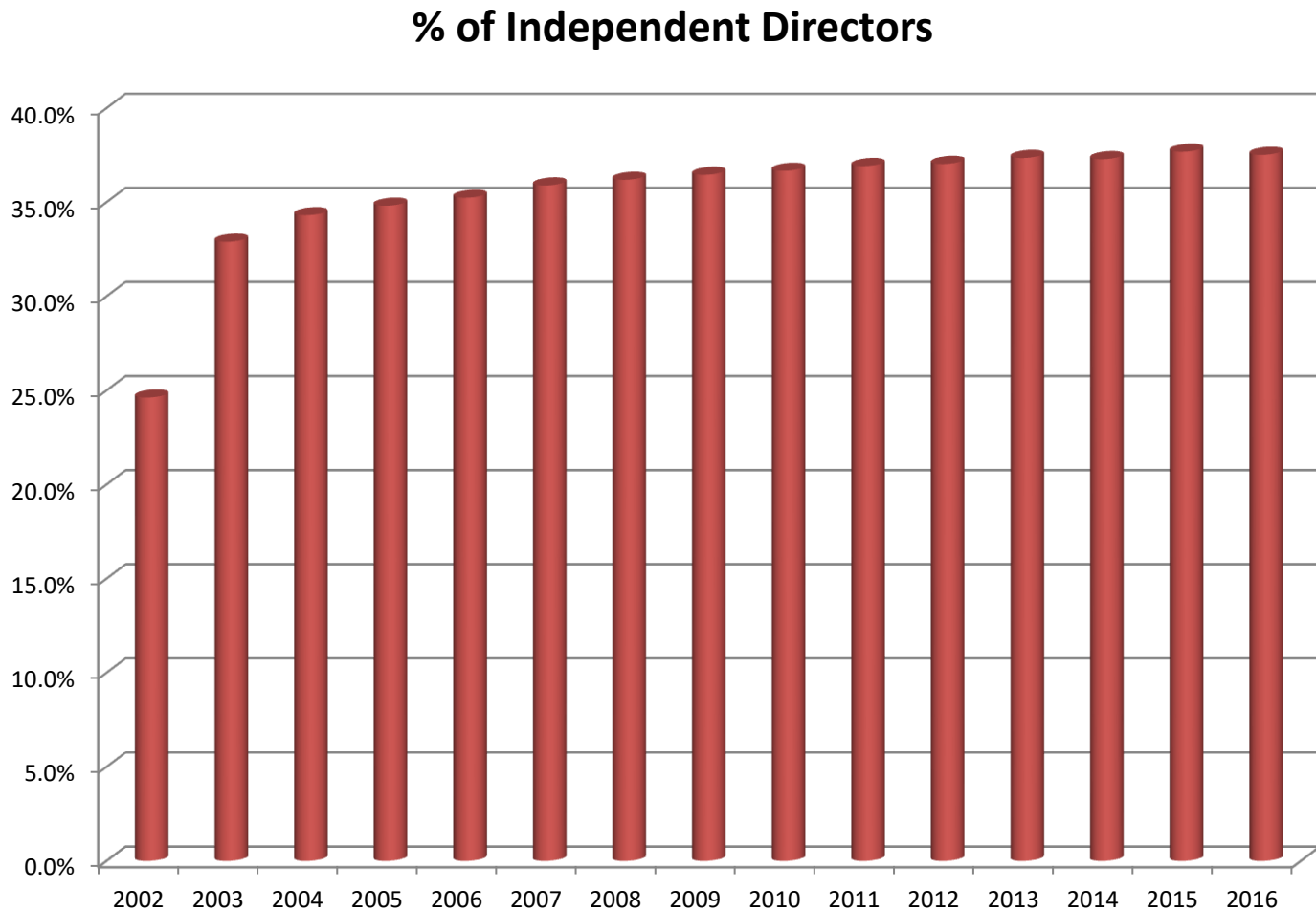
# Board of Directors: Board Size and the Number of Independent Directors

Number of directors



Data Source: CSMAR

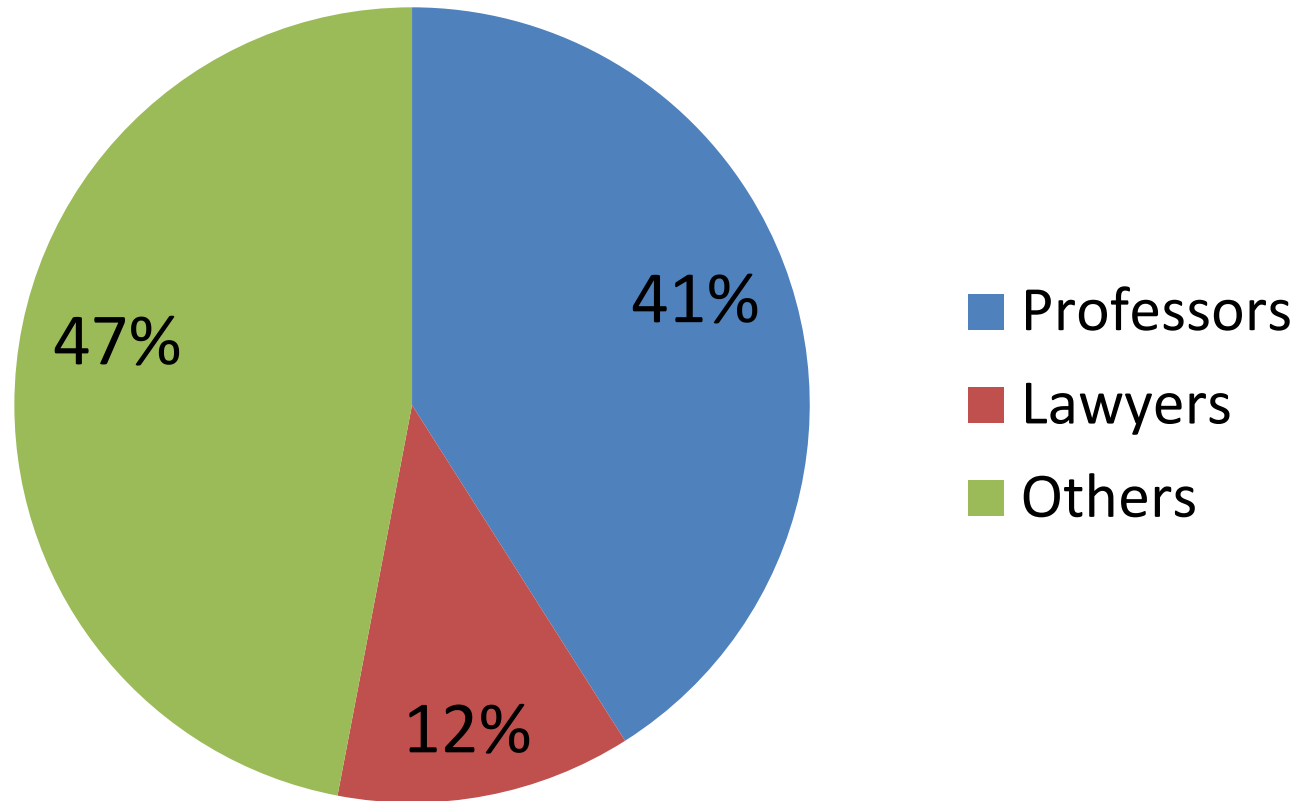
# Board of Directors: Percentage of Independent Directors



Data Source: CSMAR



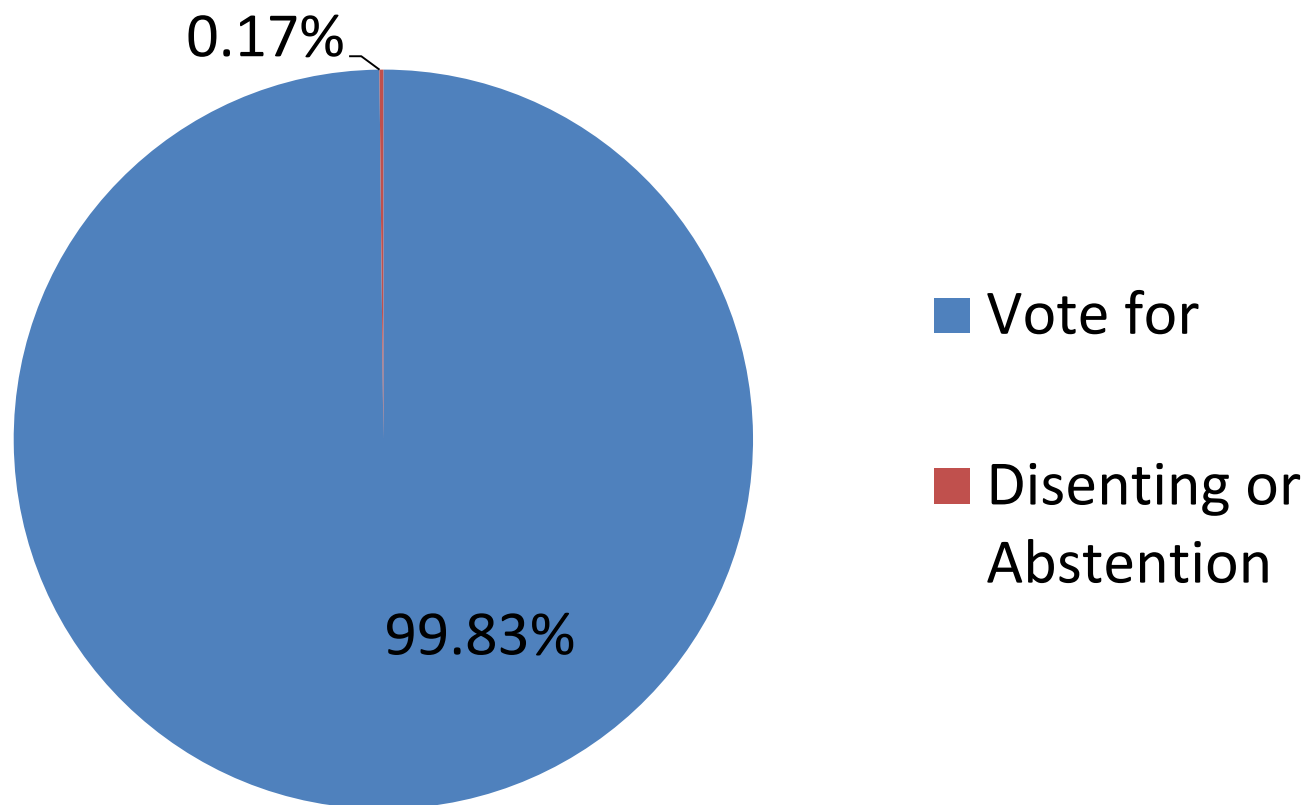
# Board of Directors: Who Are the Independent Directors?



Data Source: CSMAR

## Board of Directors: How Do Directors Vote?

In 2004, CSRC mandated that public-traded firms in China disclose how directors vote on proposals sponsored by management or controlling shareholders.



Data Source: CSMAR

# Executive Compensation

- Li, Lou, Wang, Yuan (2013), “A survey of executive compensation contracts in China’s listed companies” (China Journal of Accounting Research)
  - Hand-collected 228 executive compensation contracts disclosed by public firms
  - Firms are required to disclose the total compensation for top managers, directors, and members of the supervisory board
  - Firms are also required to disclose equity-based incentive plans when adopting such plans
  - Disclosure of the details of compensation contracts is voluntary

# Executive Compensation

- Findings of Li, Lou, Wang, Yuan (2013)
  - Chinese companies do use performance-based compensation

Descriptive statistics on compensation structure.

	Number of disclosures	Average (RMB)	Minimum (RMB)	Median (RMB)	Maximum (RMB)
<i>Panel A: Descriptive statistics on basic salaries and performance compensation</i>					
Basic salary	41	261,716	24,000	180,000	1,080,800
Performance	41	265,101	1,600	200,000	1,079,600
Performance/basic salary	41	1.38	0.01	1.03	5.02
<i>Panel B: Performance to basic salary ratio by ownership</i>					
Non-government controlled	16	1.00	0.04	0.67	4.00
Local government controlled	20	1.63	0.01	1.36	5.02
Central government controlled	5	1.62	0.03	1.56	3.06
<i>Panel C: Relative weight of basic salary and performance compensation</i>					
	Total	Privately owned	Local state-owned enterprise	Central state-owned enterprise	
Performance compensation is lower than basic salary	18 44%	11 69%	5 25%	2 40%	
Performance compensation is the same as or higher than basic salary	23 56%	5 31%	15 75%	3 60%	
Total	41	16	20	5	

# Executive Compensation

- Findings of Li, Lou, Wang, Yuan (2013)
  - Chinese companies do use performance-based compensation
  - Performance measures in compensation contracts are mostly accounting measures, rarely based on stock returns
  - Performance measures are in absolute terms, rarely benchmarked to industry peers
  - Executive compensation primarily consists of basic salary and performance compensation (bonus), but relatively little equity-based compensation
  - SOEs offer more performance-based pay than Non-SOEs

# Institutional Shareholders

- Ownership held by institutional shareholders(in percentage points)

<u>Year</u>	<u>Number of firms</u>	<u>Mean</u>	<u>Std.</u>	<u>P10</u>	<u>P25</u>	<u>Median</u>	<u>P75</u>	<u>P90</u>
2003	930	7.30	14.28	0.16	0.72	2.45	6.25	16.60
2004	969	8.80	15.00	0.33	1.08	3.12	9.05	23.64
2005	975	9.24	14.56	0.40	1.19	4.00	10.25	22.80
2006	1078	9.41	13.13	0.60	1.59	4.62	11.60	22.18
2007	1166	9.69	12.75	0.53	1.52	5.47	12.76	21.84
2008	1134	9.57	12.67	0.68	1.76	5.35	12.10	21.56
2009	1375	8.37	11.41	0.48	1.48	4.95	10.35	18.60
2010	1753	8.00	10.49	0.60	1.86	5.04	9.83	16.80
2011	2051	7.08	9.75	0.54	1.48	4.29	8.87	14.75
2012	2174	6.36	9.59	0.44	1.08	3.28	7.66	13.99
2013	2045	6.94	9.90	0.46	1.30	3.91	8.56	15.14
2014	2360	6.54	9.18	0.58	1.54	3.74	8.04	13.99
2015	2615	6.40	8.57	0.67	1.82	4.25	7.72	12.36
2016	2781	6.63	8.60	0.67	1.93	4.38	8.01	13.54
2017	2847	6.08	8.35	0.53	1.56	3.66	7.44	12.88

Data  
Source:  
CSMAR

# Institutional Shareholders

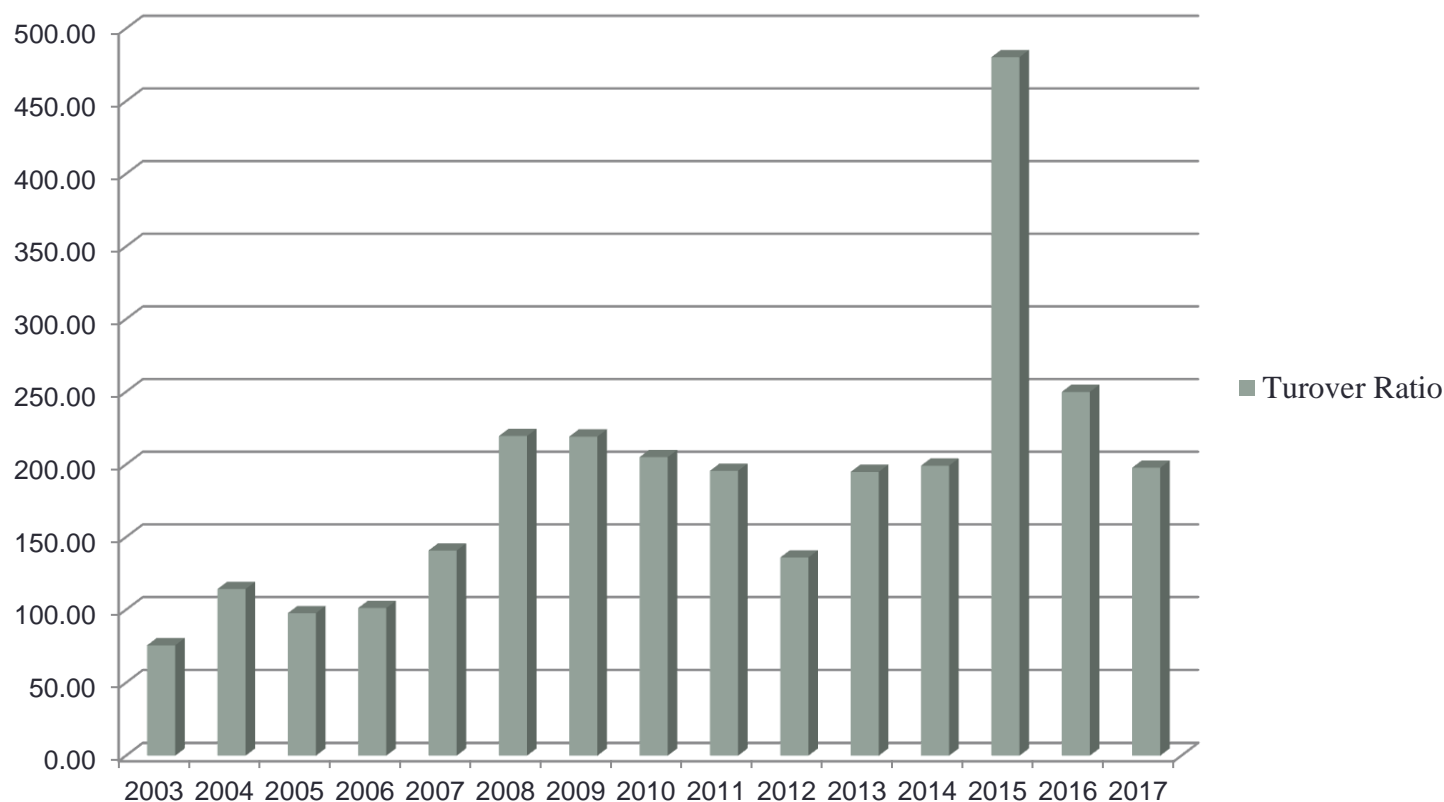
- Ownership held by different types of institutional shareholders(in percentage points, at the end of 2017)

<b><u>Types of Institutional Investors</u></b>	<b><u>Mean</u></b>	<b><u>Median</u></b>
Security Fund	1.49	0.54
Insurance Company	0.50	0.00
QFII	0.22	0.00
Trust	1.97	0.41
Banks	0.04	0.00
Finance Company	0.02	0.00
Non Finance Company	1.20	0.00

# High Turnover Ratio in China

- Turnover ratio= Value of domestic shares traded divided by their market capitalization (in percentage points)

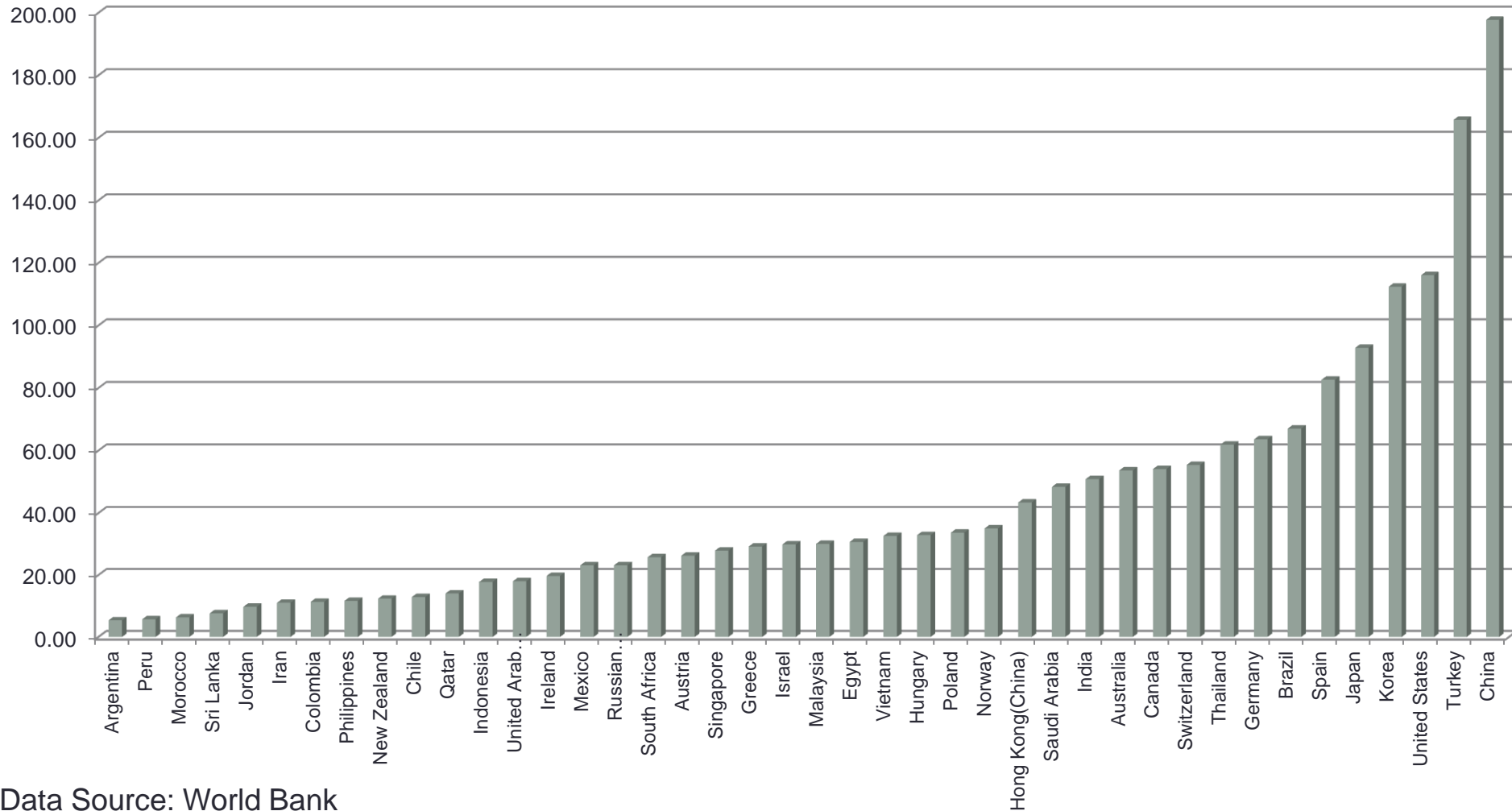
**Turover Ratio (China A Shares)**





# Turnover Ratios: Cross-country comparison (2017)

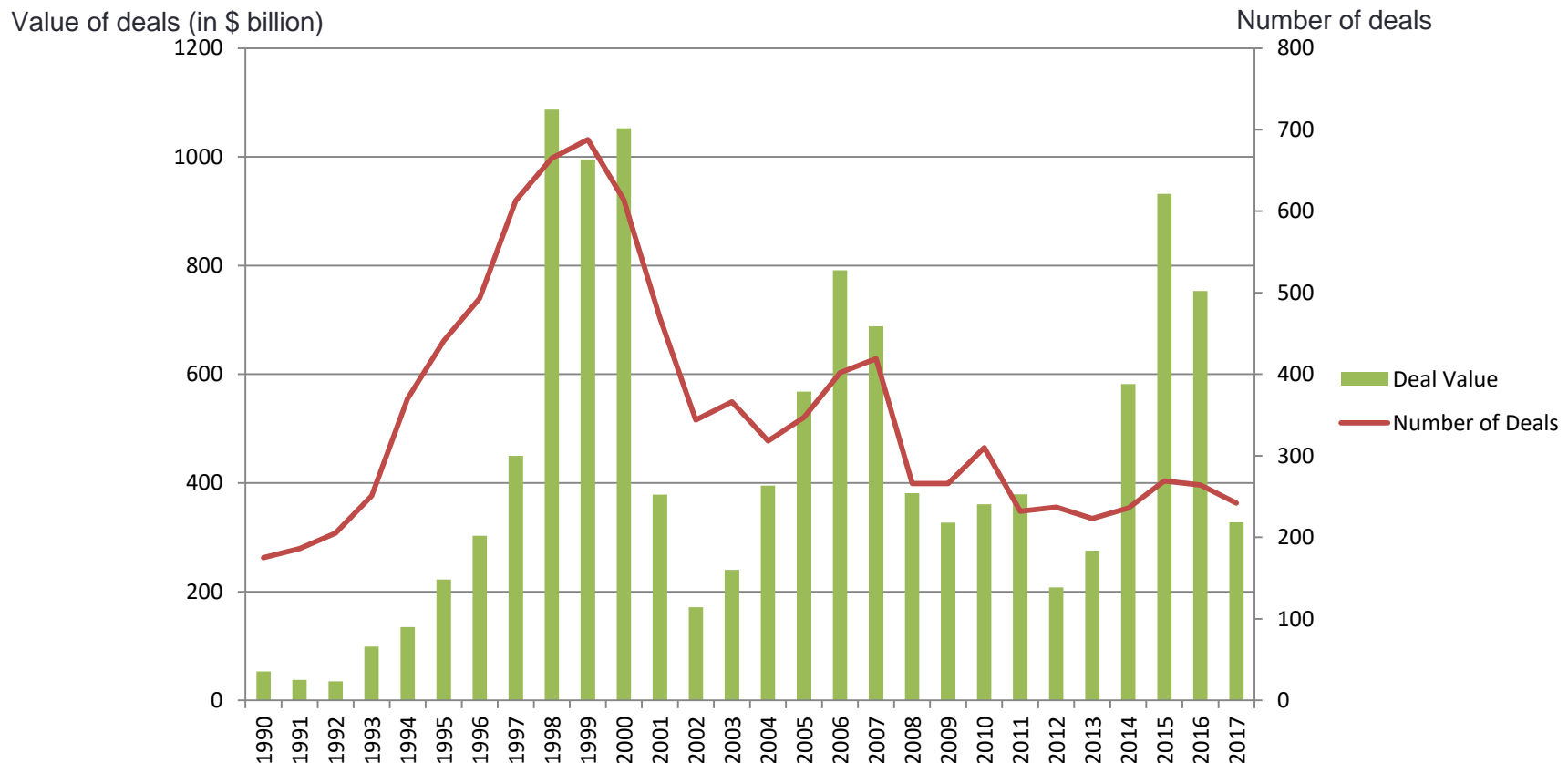
## 2017 Turnover Ratio



Data Source: World Bank

# The Market for Corporate Control

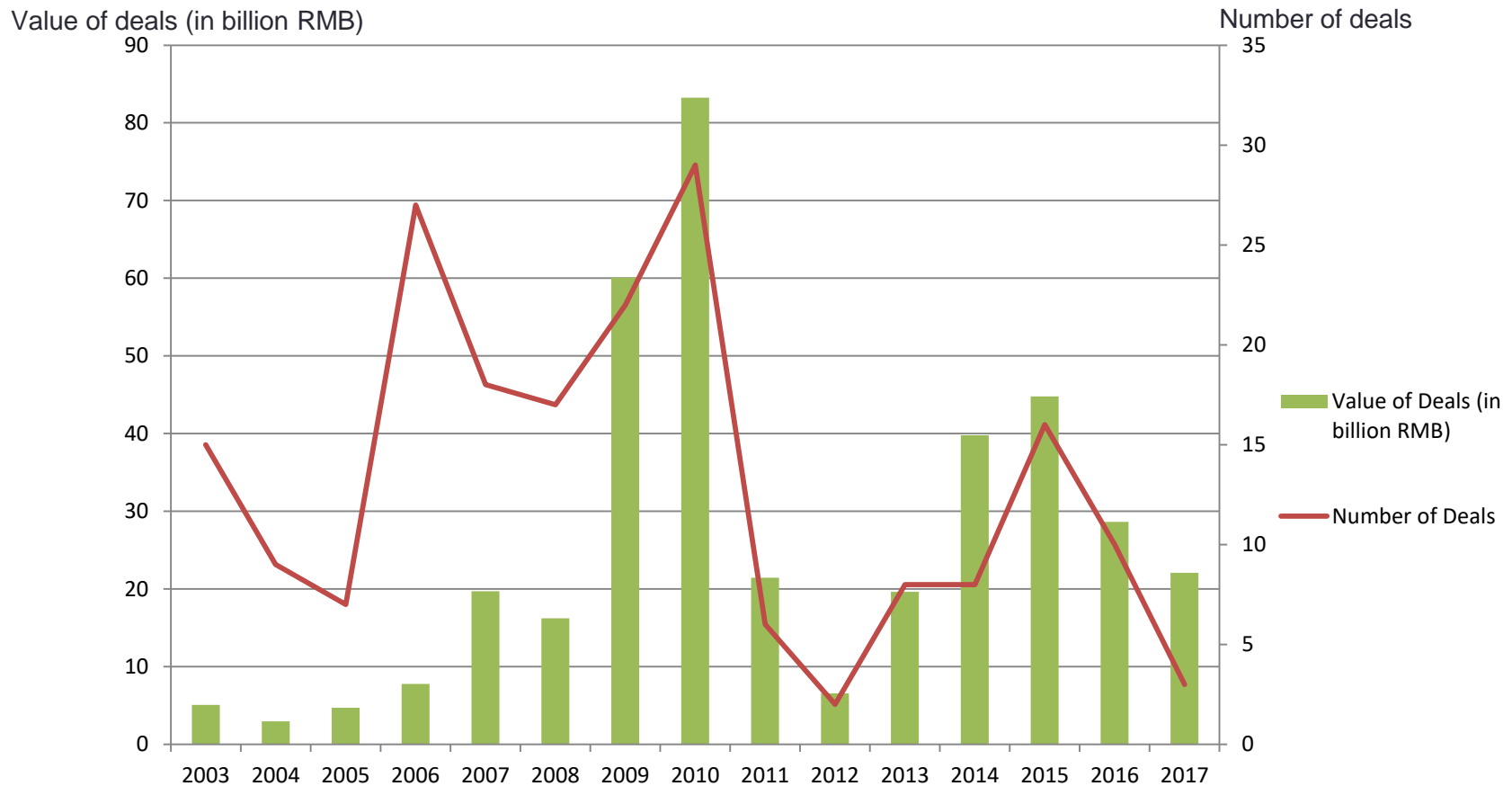
- Takeover Market in the **U.S.**: (1) Targets are public firms (2) Transactions result in change-in-control (acquired over 51% of shares).



Data Source: Thomson Reuters SDC

# The Market for Corporate Control

- Takeover Market in China: (1) Targets are public firms (2) Transactions result in change-in-control (acquired over 30% of shares).



Data Source: WIND

# The Takeover Battle between Vanke and Baoneng

- Vanke is one of the largest real estate developers in China.
  - Relatively diffused ownership structure
  - Performance lagged behind industry peers
- Baoneng is a low-profile conglomerate based in Shenzhen
  - Bought over 25% of Vanke's shares in June 2016 in an attempt to oust its the management.
- The hostile takeover eventually failed.
  - Vanke rescued by a “white knight”, Shenzhen Metro Group
  - Regulators investigated the Baoneng's funding of the takeover
  - Baoneng issued high-yield investment products to get the funding of the takeover
  - Baoneng's Chairman, Yao Zhenhua, was barred from insurance industry for 10 years.

## Shareholder Activism: An example

- Hualian Holdings (000036.SZ) is a real estate developer
- Stock price has been declining over years
- The company has a bunch of high quality assets and large amount of cash
- In July 2018, an individual shareholder who owns 2% of Hualian held a news press to dismiss the Chairman.
- One month later, the company announced a plan to buy back shares as a way to return cash to shareholders.

### 华联控股(000036) 融通

午间休市 08-16 11:30:10

# 5.10

-0.06 -1.16%

今开

5.13

昨收

5.16

成交量

2.95万手

换手率

0.26%

最高	5.17	最低	5.03	成交额	1505万
量比	1.24	市盈 <sup>动</sup>	13.82	总市值	58.2亿
市盈 <sup>静</sup>	4.33	市盈 <sup>TTM</sup>	8.44	流通市值	58.0亿
涨停价	5.68	跌停价	4.64	均价	5.10
内盘	1.64万	振幅	2.71%	委比	12.95%
外盘	1.31万	市净率	1.29	委差	288

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评论



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# Governance Reform and Monitoring from Regulators

- Split-share reform
  - Prior to 2005, most listed firms had both tradable shares (usually held by outside shareholders) and non-tradable shares (held by controlling shareholders)
  - The split-share structure creates misincentives for controlling shareholders
  - The reform converts non-tradable shares into tradable shares.

# Governance Reform and Monitoring from Regulators

- Split-share reform improves governance and leads to more shareholder-value increasing activities.
  - Mitigates the “free cash flow” problem (Chen, Chen, Schipper, Xu, and Xue, 2012)
  - Improves performance of SOEs (Liao, Liu, and Wang, 2014)
  - Increases value-enhancing tax avoidance activities (Li, Liu, and Ni, 2017)

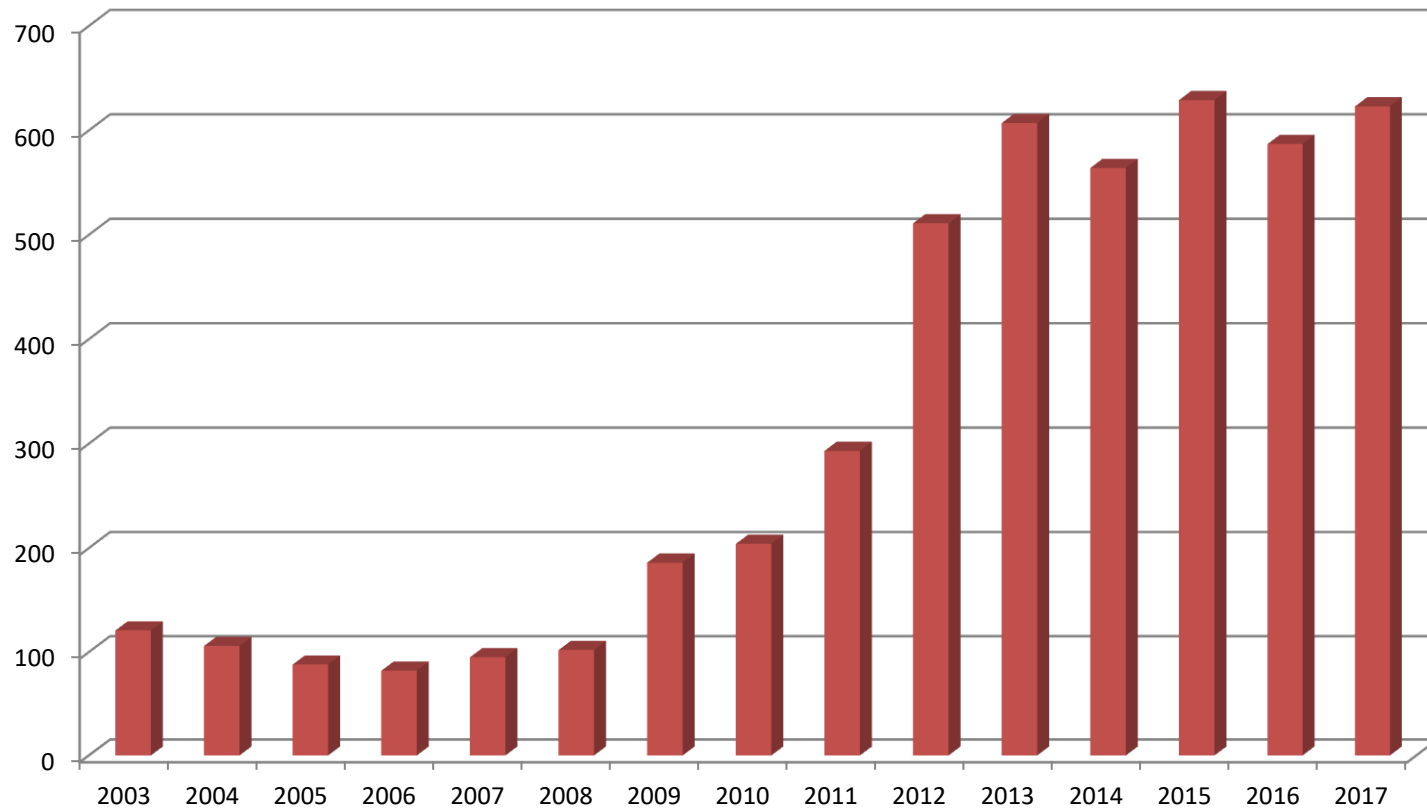


# Governance Reform and Monitoring from Regulators

- Major regulators of governance-related matters: CSRC and the two Stock Exchanges
- Regulatory agencies investigate violations of the securities laws and regulations and bring actions against alleged violators.
- Actions taken usually include: Monetary fines; Disgorgement of illegal profits; Condemn; Criticize; Warning; Banned from the market etc.

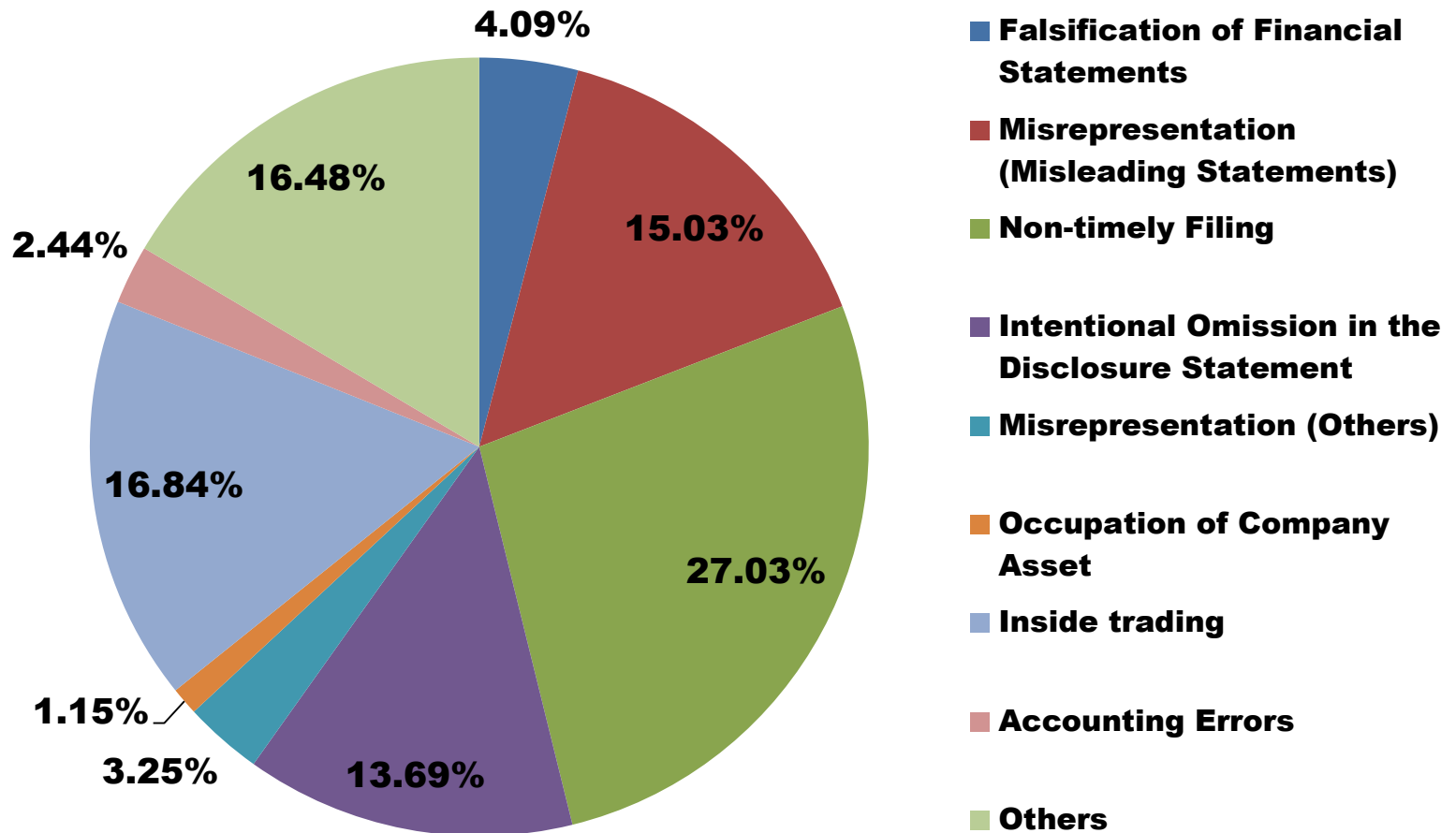
# Governance Reform and Monitoring from Regulators

**Number of Enforcement Actions**



Data Source: CSMAR

# Types of Enforcement Actions



Data Source: CSMAR

## Conclusion

- The aim of corporate governance in China is to mitigate the conflicts between controlling shareholders and minority shareholders
- Internal governance, especially boards of directors, are structured to fulfill regulatory requirements
- External governance still have a long way to become truly effective
- Governance reforms, rules, and regulatory enforcement actions play a dominant role.