A Review of Corporate Governance in China

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1. Introduction

Denis and McConnell (2003) define corporate governance as a set of mechanisms, both institutional and market based, that induce the self-interested controllers of a company (those that make decisions regarding how the company will be operated, including both managers and controlling shareholders) to make decisions that maximize the value of the company to its owners (the suppliers of capital). Good corporate governance can effectively mitigate agency problems, thus is of vital importance for shareholder protection and healthy stock markets (Shleifer and Vishny, 1997; Gillan, 2006). Broadly speaking, researchers generally place corporate governance into two categories: internal and external governance (Hopt et al., 1998; Keasey et al., 1999). Internal governance is primarily constituted of ownership and control, characteristics and composition of the board of directors, and executive compensation and succession; while external governance covers the market for corporate control (the takeover market), production market competition, and the legal systems (Huson et al. 2001; Denis and McConnell 2003; Gillan, 2006). Some previous studies suggest that significant creditors, like banks, can also provide effective monitoring to firms. (e.g. Ahn and Choi, 2009; Diamond, 1984; Hoshi et al., 1991; James, 1987; Lummer and

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McConnell, 1989).

As the largest transition economy, China has become a focus of corporate governance research in recent years. Chinese companies experience special agency problems due to concentrated state ownership and unique split share structure, which generate agency conflict between controlling and minority shareholders. When controlling shareholder has sufficient equity stakes to control a company, they will pursue private benefits of control that are not shared by minority shareholder, which results in decreased firm value (Shleifer and Vishny, 1997).

In China, government bodies hold a majority or controlling ownership in many publicly listed companies. As agents of the government, Chinese state-owned enterprises (SOEs) have multiple and often conflicting objectives pursued by the state shareholder during their operations (Chang and Wong, 2009; Bai et al., 2000; Bai et al., 2006; Liao, Chen, Jing, and Sun, 2009). On the one hand, they need to achieve good performance to ensure the appreciation of state-owned assets. On the other hand, SOEs are subject to the influence and control of the government, which tends to use a firm's resources to promote social and political objectives (e.g. maintain social stability and improve employment). However, minority shareholders who held small shares of listed firms had little ability to monitor listed SOEs and had limited influence over managerial decisions.

Additionally, the shares of listed firms were split into non-publicly tradable shares (NPTS), typically held by controlling shareholders, and publicly tradable shares (PTS) that are usually held by minority shareholders, about two-thirds of shares were non-tradable (e.g., Fan et al., 2007; Huang al., 2011; Li et al. 2011; Wei and Xiao, 2009; Yeh et al., 2009).[1] This structure came about because when the idea of setting up a stock market was first proposed in the early 1990s, political leaders worried that the government would lose control of its important state-owned enterprises (SOEs). Thus, this special and intentional split ownership structure implemented helped relieve this concern by maintaining the state as the controlling shareholder in listed firms. Indeed, the holder of non-tradable shares is typically the state. This split ownership structure prevents controlling shareholders from trading their shares and achieving capital gains, as a result, controlling shareholders have an incentive to obtain benefits through other channels, such as unfair related-party transactions, supply of corporate loans to controlling shareholder, payments made on behalf of controlling shareholders, loan guarantees on behalf of controlling shareholders, or tunneling dividend (Berkman et al., 2009; Jiang et a., 2010; Lee and Xiao, 2004; Li, 2010; Zhou and Lv, 2008). Those behaviors of controlling shareholder lead to significant private benefits for themselves at the expense of the minority shareholders. Zou et al. (2008) point out that the conflict of interest between controlling and minority shareholders was exacerbated in China due to the special split-share ownership structure.

1) Both types of shares have the same cash flow and voting rights.

In order to improve the level of listed firm's corporate governance and offer minority shareholder better protection, the China Securities Regulatory Commission (CSRC) launched the Split-share structure reform program in 2005, with the aiming of converting NPTS into PTS (CSRC, 2005). In this program, CSRC required firms to initiate the reform by the end of 2006. In order to obtain the right to sell their untradeable shares in the future, NPTS holders pay compensations to PTS holders, which is determined through negotiation between tradable and non-tradable shareholders. After a company's compensation proposal is accepted, NPTS held by controlling shareholders, were converted to PTS gradually in the subsequent few years in order to mitigate stock price volatility (CSRC, 2005).[2)] The conversion of NPTS into PTS is likely to increase controlling shareholders' incentives of shareholder value-maximization, which ultimately decreases agency conflicts between controlling and minority shareholders.

China has adopted corporate structures that resemble Western corporations. However, Chinese corporate governance has specific features inherited from a socialist background (Fan et al., 2007; Nolan, 1996; Huang and Song, 2005). Since Chinese firms are operating in a context that is different from a western market economy, the effectiveness of governance mechanisms may be different with that in western countries (Hoskisson et al., 2000; Tian and Lau, 2001).

This paper reviews the literature relating to corporate governance in China to provide an integrated picture of the factors affecting the effectiveness of corporate governance mechanisms. The remainder of the paper is organized as follows: section 2 discusses internal governance mechanisms in China, while the section 3 presents an analysis of external governance devices. Conclusions and Suggestions section presents my conclusions and suggested policies for enhancing corporate governance.

2. Internal governance

2.1 Ownership structure

In China, ownership structure is highly concentrated (e.g., Chen et al., 2009; Cheng et al., 2009; Firth et al., 2006a; Gul et al., 2010; Wang, 2005). Scholars have widely tested the effect of concentrated and split ownership structures on listed firms' performance and other corporate factors. For instance, Li et al. (2004) collected evidence on tunneling of big shareholders focusing on the embezzlement of funds and asset transfers related to mergers and acquisition; they found that concentrated ownership enhances asset appropriation by block-holding shareholders. Liu

2) After a company's reform proposal is approved, the owners of the formerly non-tradable shares must wait 12 months before selling any shares. Moreover, immediately following the lockup, nontradable shareholders who possessed more than 5 per centof the company's shares were prohibited from trading on the open market for more than 5 per cent (10 per cent) of the company's shares within 12 months (24 months)(CSRC, 2005).

and Lu (2007) report a non-linear relationship between the largest shareholder's holdings and firms' earning management activities among Chinese listed firms. Lin, Ma, and Su (2009) report a similar result of a U-shaped relationship between the shareholding of the largest shareholder and firm efficiency. Jiang et al. (2010) provide evidence of wealth tunneling in China by demonstrating the widespread use by controlling shareholders of corporate loans to extract funds from the firms. Berkman et al. (2009) show that publicly traded Chinese firms issued loan guarantees to their related parties (usually the controlling block holders) thereby expropriating wealth from minority shareholders.

It has been widely documented that the non-tradability of shares was a main determinant of Chinese controlling shareholders' preferences for cash dividends, which conflict with the interest of minority shareholder (e.g., Cheng et al., 2009; Huang et al., 2011; Wei and Xiao, 2009). For instance, Wei and Xiao (2009) find that stock dividends are preferred by tradable shareholders and the non-tradable shareholders prefer cash dividends. Yi et al. (2007) study dividend policy of Chinese listed companies during 2003 and 2004. They document that non-tradable shareholders prefer cash dividends rather than stock dividends, since the shares paid as dividends cannot be traded. On the other hand, stock dividends are preferred by tradable shareholders, as abnormal returns from stock dividends are significantly larger than those from cash dividends in short-run.

Scholars have reported state ownership as an ineffective corporate governance mechanism in China. For instance, Sun and Tong (2003) find that share issue privatization – a reduction in state ownership – is associated with improved corporate performance. Bai et al. (2004) find that when the largest shareholder is the state, the firms tend to have lower market valuation. Li et al. (2004) found that companies controlled by the government or business groups experienced the most severe form of tunneling. Gunasekarage et al. (2007) find that, on average, the firms' stock performance is negatively influenced by the state ownership. However, such a negative relationship is significant only at high levels of government ownership. Conyon and He (2011) shows that executive pay and CEO incentives are lower in State controlled firms, and Non-State (private) controlled firms are more likely to replace the CEO for poor performance.

Thirdly, managerial and employee shareholdings are extremely small in China's listed firms. At the end of 2004, management, foreign, and employee shares represented less than 2 per cent of the listed firms' outstanding shares, so these investors do not constitute major voting blocks (Chen et al., 2009). Managerial share ownership is typically less than 1 per cent of the total shares on issue (Wei et al., 2005). There are some studies that have tested the significance of managerial shareholdings in China. Most of them report positive results. Gao and Kling (2008) report that managers' shareholdings are an effective governance mechanism for mitigating tunneling activities, although the economic significance is small. Li et al. (2007) examine the relationship between managerial ownership and firm performance for a sample of SOEs privatized over the period 1992-2000. Their results indicate that managerial ownership has a positive effect on firm performance. Based on Chinese non-listed firms, Hu and Zhou (2008) find that firms with significant managerial ownership levels outperform those whose managers do not own equity shares. In addition, Ning and Zhou (2005) find that employee stock ownership does not improve firm performance significantly in China, suggesting that a negligible fractional ownership does not provide a meaningful employee incentive.

2.2 Board of directors

It has been widely demonstrated through empirical studies that independent directors are an effective corporate governance mechanism in developed countries (e.g., Dahya et al., 2008; Rosenstein and Wyatt, 1990; Weisbach, 1988). In China, the distinguishing characteristic of board of directors is the mandatory high board independence. The CSRC issued 'Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies' in 2001. The guidelines are mandatory and required all listed firms to have at least two independent directors on their boards by 30 June 2002, and at least one-third of the board members had to be independent directors by 30 June 2003.

Literature on the effects of independent directors in China is mixed. Kato and Long (2006a) reported that independent directors strengthen the association between poor firm performance and CEO turnover. Fan et al. (2007) found that independent directors have a positive effect on CEO monitoring (CEO turnover). Gao and Kling (2008) analyze asset appropriation by principal shareholders in China and uncover that outsiders in the board of directors prevent operational tunneling. Conyon and He (2011) find that firms with more independent directors on the board have a higher pay-for-performance link, and firms with more independent directors on the board are more likely to replace the CEO for poor performance. To the contrary, Chen et al. (2004) find that politicians and state controlling owners occupy most board seats, there are few professionals (lawyers, accountants, finance experts) on Chinese boards and almost no representation by minority shareholders, and argues that although the proportion of outsider directors on the board is high, the level of board independence and professionalism is not necessarily good. Further, based on 494 Chinese listed companies that began to recruit independent directors in 2002, Liao, Sun, and Young (2009) report that Chinese firms implement board independence by adding extra members instead of removing inside directors, except in the case where board size (before the recruitment of independent directors) was already too large. Using data on 1117 Chinese listed firms that completed the share reform by the end of 2006, Qiu and Yao (2009) suggest that outside directors are not really independent and give evidence that independent directors did not positively affect firm performance before or after the Split-share reform. Consequently, it is crucial to ensure the independence of independent directors.

A second factor perceived to affect the board's ability to function effectively is the size of the board. Lipton and Lorsch (1992) and Jensen (1993) suggest that larger boards could be less effective than smaller boards because of coordination problems and director free-riding. However, Coles et al. (2008) argued that complex firms stand to benefit from having more directors on their boards, because CEOs of complex firms have a greater need for advice and expertise. Researches on board size rarely find that board size has significant effect in China's listed firms. As an exception, Liao, Sun, and Young (2009) report that there is a negative relationship between board size and firm performance, however, Tobin's Q increases in relation to board size for complex (large and diversified) firms.

2.3 CEO duality, CEO compensation, and CEO turnover

(1) CEO duality

The literature reports contradictory opinions about Chief Executive Officer (CEO) duality in developed countries. Some suggest that splitting the board chair and CEO provides more effective monitoring and control of the CEO; and firms that separate the two positions outperform those that do not (e.g., Rechner and Dalton 1991). However, others argue that CEO duality establishes strong and unambiguous leadership and increases board efficiency. It is argued that firms with CEO duality can make better and faster decisions and hence outperform those without CEO duality (for example, Donaldson and Davis 1991).

There is little research on CEO duality in China. Chen et al. (2009) found that the proportion of CEO duality in listed firms has fallen from 27.3 per cent to 13.8 per cent over the period from 1999 to 2002; but they report that CEO duality has a statistically insignificant impact on firm efficiency. However, Bai et al. (2004) report a negative relationship between CEO duality and firm performance. Kato and Long (2006a) find that CEO duality reduces the probability of CEO turnover. Fan et al. (2007) find that CEO duality is marginally negatively related to CEO turnover.

(2) CEO compensation

A strong relation between compensation and firm performance would enable a better alignment of interests between shareholders and managers (Jensen and Murphy, 1990). Researchers have examined the relationship between compensation and firm performance, and find a positive relation between pay and performance (e.g., Barro and Barro, 1990; Jensen and Murphy, 1990; Kaplan, 1994).

Existing literatures in China investigate the linkage between CEO compensation and firm performance, and report mixed results. For instance, Firth et al. (2006a) reported that firms that have private blockholders or SOEs as their major shareholders relate the CEO's pay to increases in stockholders'wealth or increases in profitability. However the pay-performance sensitivities for CEOs are low and this raises questions about the effectiveness of firms' incentive systems. Firth et al. (2006a) argue that CEO compensation policy is used more as an instrument to achieve the dominant shareholders' objectives under the current concentrated ownership structure. Moreover, Firth et al. (2007) found no association between CEO's pay and firms' stock returns. In contrast, Kato and Long (2006b) investigated a sample of 937 publicly traded firms in China from 1998 to 2002. They find that executive cash compensation is positively related to firm performance. They also find some evidence that the pay-for-performance link is weaker in State owned firms. Conyon and He (2011) use data on publically traded Chinese firms listed on the domestic exchanges from 2001 to 2005, and find that executive compensation is positively correlated to firm performance.

(3) CEO turnover

The relationship between management turnover and poor firm performance is a good way of assessing the effectiveness of a firm's governance system and has been widely investigated in developed countries. Researchers have examined how well these corporate governance mechanism, such as board composition, ownership structure, industry competition, and legal protection of investors, influence the effectiveness of CEO turnover (e.g., DeFond and Hung, 2004; DeFond and Park, 1999; Denis and Denis, 1995; Huson et al., 2004; Kang and Shivdasani, 1995).

In addition to studying the sensitivity of CEO turnover to firm performance, another approach in assessing CEO turnover quality is to investigate the subsequent firm performance. It is also documented that forced managerial turnover is followed by improved firm performance in developed countries (e.g., Huson et al., 2004; Kang and Shivdasani, 1995).

The evidence from China mainly investigates the sensitivity of turnover and performance, and how corporate governance mechanisms influence the sensitivity (Chi and Wang, 2009; Chang and Wong, 2009; Conyon and He, 2011; Firth et al., 2006b; Kato and Long, 2006a; Kato and Long, 2006b; Wang, 2010). For instance, Kato and Long (2006a) find evidence that CEO turnover is significantly and inversely related to firm performance, although the magnitude of the relationship is modest. In addition, they find that this turnover-performance link is weaker for listed firms that are still controlled by the state, and the appointment of independent directors enhances the turnover-performance link. Shen and Lin (2009) find that profitability and state ownership has a negative impact on top management turnover when profitability is below target (measured by industry median), but no impact when profitability is above target. Chang and Wong (2009) examine the relationship between CEO turnover and the performance of listed Chinese firms, and find a negative relationship between the level of pre-turnover profitability and CEO turnover when firms are incurring financial losses, but no such relationship when they are making profits. Conyon and He (2011) find that CEO turnover is negatively correlated to firm performance, and privately controlled firms and firms with more independent directors on the board are more likely to replace the CEO for poor performance.

There are some studies that have investigated the performance following managerial turnover in China. Basically, they report improved firm performance. Kato and Long (2006b) examine CEO turnover of 634 listed firms from 1998 to 2002 and find that listed firms appear to subsequently experience greater performance improvement (measured either as shareholder returns or return on assets) after the replacement of their CEOs when the firms are privately controlled or have a majority controlling shareholder. Shen and Lin (2009) find that top management turnover has a positive impact on subsequent firm profitability when it occurs under performance below target. Chang and Wong (2009) examine the post-turnover performance of China's listed firms and find that there is an improvement in post-turnover accounting performance in loss-making firms.

3. External governance mechanisms

3.1 Takeover market

An active corporate control market is considered to be essential for the efficient allocation of resources (Bai et al., 2004). However, this kind of market is not well developed in China. Indeed, prior to the non-tradable shares reform it was almost impossible for investors to gain control of a Chinese listed firm through purchasing tradable shares, as on average only one-third of total shares of listed firms were tradable. Moreover, a company could not acquire another firm without the approval of the state. Chi et al. (2011) reported that tender offers are still very rare and target firms are often not listed. They found a strong political connection between acquiring and target firms in most mergers and acquisitions (M&As) and a significantly positive impact on the acquiring firm's market performance. Due to the special characteristics of Chinese M&As caused by the share segmentation system, there is little literature about the effect of the takeover market as an external corporate governance mechanism in China.

3.2 Production market competition

Competition in product markets has been regarded as an effective corporate governance mechanism in previous studies (Alison and Mayes, 1991; Cuñat and Guadalupe, 2005; Hart, 1983; Haskel, 1991; Hay and Liu, 1997). In China, SOE reforms have been implemented in the 1990s accompanied by the introduction of market competition, and market based competition becomes to put greater pressures for firms' R&D for efficient production process and competitive products (Liu and White, 2001). There are a few researches that pay attention to the effectiveness of product markets competition in China's firms, and they find a positive result. For instance, firm-level studies show that the increase in the intensification of competition has significantly improved the managerial incentives and total factor productivity of SOE's (Li, 1997). Using data on rural financial institutions in China, Park, et al. (2003) test empirically the effects of competition on deposit growth, loan portfolio composition, repayment rates, and other effort measures, finding positive effects of competition on effort and financial performance.

3.3 Legal infrastructure

Recent studies stress that legal system is an important factor associated with developments of securities markets and the effectiveness of corporate governance (e.g., Allen et al., 2005; DeFond and Hung, 2004; Klapper and Love, 2004; La Porta et al., 1997; La Porta et al., 1998; La Porta et al., 2000). However, legal protection for investors is poor in China. Researchers argue that without a truly independent judicial system and under the condition of the state playing both the role of regulator and market participant, the interests of investors (especially minority investors) cannot be well protected. For example, Allen et al. (2005) point out that China does not have an independent and effective judicial system. They also examine measures of China's legal system and compare them to the average measures of the 49 countries studied in La Porta et al. (1998). They show evidence that almost half of countries in the French-origin subsample, who having the poorest protection, have equal or better measures of creditor and shareholder rights than China does. Regarding the law enforcement, only criminal legal actions (e.g., actions taken by the Securities Exchange Commission) can be taken against public companies in China, and civil litigation (e.g. shareholder class action lawsuits) against public companies is practically unavailable (Li, 2010). Jiang et al. (2010) point out that the legal system in China offers few options for minority shareholders to take private enforcement action against blockholder misconduct. Further, public enforcement, including fines and prison terms for tunneling, has been hampered by the limited authority of security market regulators. Additionally, as the number of local listed firms is one of the major metrics of performance on which the promotion of local government officials is evaluated, and listed firms can help local governments achieve both political and social objectives, law enforcement cannot be guaranteed (Chen 2003). Listed firms can usually gain protection from the local government. Consequently, it is still extremely difficult for minority investors who suffer from the inappropriate behaviours of directors, supervisors, and managers to acquire civil remedy through the courts (Chen 2003).

3.4 Bank monitoring

Some previous studies show that bank borrowing can enhance firm value by providing effective monitoring to borrowers. For instance, Ahn and Choi (2009) provide evidence that bank reputation, the size of loans, and the length of loan maturity reduce firms' earnings management activities in America. Byers et al. (2008) report an inverse relationship between loan announcement abnormal returns and internal governance variables and provide evidence that banks can be substitute monitors for internal governance mechanisms such as independent directors, CEO incentive-based pay, and director shareholdings.

In China, the big four state-owned banks still dominate the market (Berger et al., 2009). The government serves as both a lender and a borrower. There exist some studies that explore the role of bank as a corporate governance mechanism in China. For instance, Tian and Estrin (2007) have studied the impact of bank loans on firm performance. They argue that government banks would not provide effective governance to borrowers as the state usually sacrifices financial interests to social and political interests. The soft budget constraint is the key obstacle preventing banks from providing significant monitoring to firms since the state is still the ultimate owner of the major banks and most listed firms. Lin, Zhang, and Zhu (2009) investigate the effect of bank ownership on firm value in China, they find that banks appoint board members through equity holdings, and companies with banks as leading shareholders witness relatively poor operating performance. Further analysis indicates that inefficient investments resulting from bank ownership are responsible for the disappointing performance.

4. Conclusions and suggestions

This paper has reviewed studies on corporate governance in China, and suggests that (1) controlling shareholders expropriate minority shareholders' wealth through varied ways; (2) state ownership is an ineffective corporate governance mechanism; (3) evidences on effects of independent directors, and the linkage between CEO compensation and firm performance are mixed; (4) top managers are likely to be replaced when firms' performance is poor; (5) Firm performance of underperformed firm improved following top management turnover; (6) Effective external governance devices are almost absent in China.

The conflict of interest between controlling and minority shareholders induced by split shares structure is likely to be mitigated gradually with the completion of Split-share structure reform. However, few studies pay attention to the effect of Split-share structure reform on corporate governance. Based on the existing studies, the potential direction of future research could aim at whether stock performance following top management turnover is improved—after the completion of Split-share structure reform and/or how the cash dividend payment changes in response to the reduction of non-publicly tradable shares.

Currently, the leading reasons that influence the effectiveness of internal and external governance mechanisms are: (1) the large existence of the state control in listed firms; (2) strong political connections between listed firms andthe government; and (3) the absence of truly independent judicial system. Hence, both the central and local governments should keep reducing their shareholdings and personnel connections in listed firms. The government should perform the role of regulator, rather than be both regulator and the major market participant. Further, the government should offer individual investors with the right to bring law suits against large block holders and directors in order to constrain the opportunistic behaviours of these insiders. We believe that if these suggestions are taken up, corporate governance mechanisms would become more effective in China.

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