Critical Issues Confronting China: Corporate Governance with Chinese Characteristics

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It is a conventional wisdom in the investment community that “[c]apital goes where it is welcome and stays where it is well treated.” After 40 years of opening and reform in China, is capital still welcome? And how is capital treated in China? Jeffrey R. Williams, Senior Fellow at the Ash Center for Democratic Governance and Innovation at the Harvard Kennedy School, addressed these questions based on a 2018 China Corporate Governance Report by the Asian Corporate Governance Association (ACGA) and on his considerable business experiences in China over the past four decades. These included opening Citibank’s first China branch in Shenzhen in 1988, and serving as the Taiwan country manager for American Express and for Standard Chartered in the 1990s. Fluent in Mandarin Chinese, in 2004–06, he was the first foreign president of a Chinese commercial bank, Shenzhen Development Bank.

Williams first gave a synoptic account of the development of the Chinese capital market since the establishment of the Shenzhen and Shanghai stock markets in the early 1990s. Although very volatile, punctuated by occasional “stock calamities (股灾),” these stock markets have grown rapidly, now comprising of more than 3,000 companies. With a market capitalization equivalent to 60 percent of China’s GDP, China is the largest stock market in Asia and the second largest in the world, only after New York. In 2002, the Chinese financial authorities instigated the category of Qualified Foreign Institutional Investors (QFII) to allow certain foreign investments into the Chinese capital market. In addition, in 2005–06, the financial authorities resolved the overhang of a legal person’s shares (法人股) by allowing them to convert into exchangeable shares and join market circulation; and in 2014–16, they established the Shenzhen-Hong Kong Connect and the Shanghai-Hong Kong Connect in an attempt to integrate these markets with some degree of control, such as a daily upper limit. As a result of this control, foreign ownership of Chinese stocks is only about two percent of the entire market.

However, the most significant development, in 2017, was the inclusion of about 200 large Chinese companies’ stocks in the A-share market into the Morgan Stanley Composite Index for Emerging Market (MSCI EM). The Chinese take great pride in this inclusion. It should lead many passive institutional investors, such as pension funds, endowments, insurance companies and some mutual funds, to invest in Chinese stocks because these investors, by their mandates,
can only invest by tracking indices of broader markets. More importantly, it signifies recognition by the international capital market of the maturity of the Chinese stock market.

Williams pointed out a major change in the composition of investors in the Chinese stock market over the past two decades: a significant decline of retail investors to 25 percent of all the investors, and a correspondingly large increase of institutional investors to 55 percent. This change entails an extensive emphasis on corporate governance, as retail investors generally don’t have sufficient resources or capability to scrutinize; they “vote with their feet” by simply selling securities they don’t like. Corporate governance was a consideration in the Zhu Rongji era in the 1990s, when some Chinese companies were allowed to go public on the Hong Kong stock exchange as a way to import best practices.

Now institutional investors play a much more active role with their voting power to influence companies’ decisions. Long-term institutional investors are concerned about how companies are managed, and try to use their clout to steer companies’ behavior toward environmental and social goals, or to demand changes in corporate practices such as auditing quality and management compensation. They advocate transparency in corporate disclosure and protection of minority shareholders’ interests.

An experienced corporate and non-profit director, Williams was recently elected to the governing council of the ACGA, an independent, non-profit membership organization founded in 1999 in Hong Kong. Believing that sound corporate governance is fundamental to the long-term development of Asian economies and capital markets, the ACGA is dedicated to working with investors, companies and regulators to implement effective corporate governance practice throughout Asia. Its member companies have combined assets of about $30 trillion; about half of the members are headquartered throughout Asia.

The ACGA’s corporate governance report ranks twelve Asian countries’ corporate governance ecology based on a number of criteria: corporate rules and practices, enforcement effectiveness, quality of auditing and accounting, political environment and corporate regulations, and corporate governance culture. Based on this cross-country comparative analysis, China has been consistently ranked No. 10, with some worrisome signs pointing to a lower ranking. For example, in 2017, the Chinese authorities began to require all state-owned enterprises (SOEs), including those listed in Hong Kong, to amend their corporate by-laws to formally include the Communist Party Committee as a part of the corporate governance structure. The Party Committee had been a de facto part of the governance structure, but has now been codified into these companies’ by-laws.

The Party Committee is supposed to be consulted before any board meeting about “any
important matters, important personnel decisions, and important projects, plus any items involving large expenditures (三重一大).” Institutional investors, in fulfilling their fiduciary duty to asset owners, hope to engage with key decision-makers at invested companies, not only the company’s CEO and his management team, but also the board, especially its independent directors. But China’s corporate governance structure now includes, in addition to management and the Board of Directors, a Board of Supervisors (which comes from the German corporate model), and the Party Committee, which apparently has the authority to approve anything important. This raises the question of “who has the last word:” the Board, the management team, or the Party Committee? If the Party Committee has the last word, how are institutional investors to effectively engage? This ambiguity is intrinsic to China. The degree of state intrusion in the management of SOEs depends on the preference or personality of the Party Chairmen–some are more laid back than others–and varies significantly across Chinese companies and different situations. So far, this part of the governance structure seems opaque to international investors.

In conclusion, Williams posed some questions for the future. If China were to open up its capital market and the RMB becomes a completely convertible currency, would there be a net capital outflow from or a capital inflow into the country? Should China try to improve corporate governance according to established international practices in order to attract more foreign portfolio investment? Or will Chinese businesses be governed with “Chinese characteristics?” When the next serious economic downturn hits, China is unlikely to be able to take another giant step as large in scale as the fiscal stimulus package of 2009. Then where will capital for economic growth come from? If China opens up more markets to attract capital, will more capital come and, if so, from where?